

Banking Sector Reform in India

by

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It is widely believed² that the reforms of 1991 both in the industrial sector and the financial sector unleashed a variety of forces that have propelled India to a new growth trajectory³. In this paper we are going to try and offer a perspective that is somewhat different from the one stated above and to argue that while indeed the new growth trajectory may be very real, the role that the financial sector, particularly the banking sector has played in this growth has not been entirely clear.

We start first with a broader discussion on the role of financial intermediaries and banks in particular, moving on to the historical justification of regulation and its evolution over time. We then analyse the Indian regulatory framework at some length and identify the potential areas of improvement. We then move on to the more controversial debate over the outcome of the financial sector reforms initiated as a part of a larger set of reforms in 1991. We suggest that the period from 1991 to 1995 created certain problems for the banking system, the sources of which remain largely unresolved and that unless the unique set of circumstances⁴ that obtained during the last decade manifest themselves even in this decade, there is a strong possibility that the year 2010 could see the Indian banking system in a very different light. We conclude by suggesting some reform strategies that could equip the financial sector to better address the challenges that lie ahead.

The paper however, does not attempt to present a rigorous analysis of the issues at hand either theoretically or empirically but rather presents ideas and hypotheses based principally on the insights gained by the authors through observing these developments as participants in the system and on a broad review of the relevant literature on the subject.

Role and Regulation of Banks in India

The financial sector in any country acts as an intermediary between suppliers of funds and those who borrow funds. Due to several historical, regulatory, economic and legal reasons, a variety of intermediaries, such as banks, mutual funds, stock markets and insurance companies perform this role. Banks have traditionally taken centre stage among intermediaries for several reasons:

- Regulatory: Post the Great Depression and the passing of the Glass-Steagall Act of 1933⁵ there was a forced separation of banks, investment banking, insurance etc. Many countries followed suit in separating these activities and having independent

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² See DeLong (2003) and Clark and Wolcott (2003) for an alternate point of view.

³ See for example Mohan (2005)

⁴ Specifically, a decline in interest rates (see Exhibit 3) and the rapid growth in retail credit.

⁵ The Glass-Steagall Act was repealed only on November 12, 1999, when the Financial Modernization Act (the Gramm-Leach-Bliley Act) was passed.

regulators for each. The wave of bank failures during the Great Depression meant that many regulatory initiatives, including deposit insurance, were put in place. These cemented the 'safe haven' status of banks and ensured that they continued to be important destinations for public savings.

- Economic: Monetary policy, ignored in the decades following the great depression, has once more become an important tool. Banks typically have active treasury operations and are important conduits for open market operations. Further, they constitute the channel through which the money multiplier works.
- Financial: Most models of banks and banking⁶ focus on the credit and liquidity intermediation functions performed by banks. Prior to the development of active (liquid) markets in shares, bonds and foreign currencies, and the subsequent growth of the mutual fund industry, banks were the sole intermediary providing liquidity and credit intermediation functions. This role has continued even after alternative mechanisms have developed.

The regulatory framework that was put into place following the great depression had two broad goals. The wave of bank failures and the subsequent move by surviving banks into 'safe haven' investments (typically government bonds) meant that credit availability shrank dramatically, exacerbating the economic downturn. One goal of the Fed was to prevent this scenario from recurring. The resulting regulations were formulated with the goal of reducing the risks inherent in banking. The infamous Regulation Q⁷ controlled the cost of deposits and restrictions were placed on how banks operated⁸. Many central banks, including India's Reserve Bank of India (RBI) have followed these regulations. The second broad regulatory goal was to protect depositors from bank failures. By providing assurances of safety to depositors, the regulator could ensure that the supply of savings was not affected. In the US, this took the form of a formal deposit insurance scheme run by the FDIC since 1934. Diamond and Dybvig (1983) and Holmstrom and Tirole (1997) suggest that aggregate liquidity shortages provided the rationale for deposit insurance. The two regulatory goals were complementary: both helped ensure the flow of credit and the deposit insurance scheme was in a sense guaranteed by the regulated borrowing and lending rates. In India the Deposit Insurance & Credit Guarantee Corporation Act came into force only in 1962 and a formal deposit insurance scheme was introduced in 1969. The nationalization of the bulk of the banking sector in 1969 meant that an implicit guarantee from the Government applied to deposits in certain categories of banks⁹. It is also important to note that the system of industrial licensing which was in force in India until 1991 served to provide significant "credit insurance" to banks, by protecting borrowers from meaningful economic competition¹⁰.

Implicit in this model of regulation was the notion that the failure of a bank could cause a run¹¹, which could spread to other banks. This in turn created externalities: credit

⁶ See Diamond and Dybvig (1983), Diamond (1996) and Diamond and Rajan (2001). Diamond (1984) looks at banks as a mechanism for delegated monitoring.

⁷ The ceiling stipulated in Regulation Q became binding in the 1960s and was extended to all depository institutions after 1966

⁸ See, for example, Fabozzi, Modigliani, Jones and Ferri (2002) for a description of regulations governing financial intermediaries and the changes that have taken place.

⁹ This has been reinforced by the repeated injections of capital by the government into poorly performing government owned banks and financial institutions.

¹⁰ As the paper later argues, the removal of this form of "credit insurance" in 1991 led to a significant build up of non-performing assets in the banking system as banks lacked the capability to properly assess the enhanced level of credit risk.

¹¹ Diamond and Rajan (2001)

shortages with economic consequences and the failure of monetary policy as a tool as a result of the breakdown of an important transmission mechanism. In India, given the practice of monetizing the budget deficit¹² (until the Fiscal Responsibility and Budget Management Bill 2000 was enacted in Parliament) and the prevalence of directed credit essentially banks being told which sectors, or even which specific borrowers, to lend to), neither externality was of consequence. Banking regulation, nonetheless, followed the 'classical' pattern.

In practice, banking regulation in India meant:

- Senior management appointments decided by the regulatory authority.
- Ensuring that procedures were followed. Essentially, the banking process became the focus of regulation and supervision. The end result: the delivery of credit, and the risks assumed by the banking sector received very little attention from the regulator. Detailed guidelines covering various aspects of the borrowing and lending process were issued; inspections of banks focused on the extent to which these guidelines were followed.
- Fixing borrowing and lending rates.
- Directed lending toward certain 'priority' sectors (such as agriculture and small scale industries).

The rest of the financial sector in India (stock markets, insurance companies, non-banking financial intermediaries, mutual funds) were either owned by the government (rendering regulation unnecessary) or were regulated directly by the Ministry of Finance. Apart from the banking regulator, specialized regulatory agencies did not exist. This often meant that activities involving regulatory arbitrage flourished¹³, almost always to the detriment of the health of the financial system.

Following the breakdown of the Bretton Woods system in the late 1960s, administered prices in various markets gave way to market determined prices. The foreign exchange markets were the first to see this trend (resulting, among other things, in the first exchange traded financial futures contracts) followed by bond markets in different countries. The same general time period witnessed the rapid growth of mutual funds as alternative investment vehicles and this, in turn, meant added liquidity and volumes in various financial markets.

These changes, which have spread to most emerging financial markets, have important implications for regulators and for future developments in these markets.

From an investor's perspective these changes mean that banks are no longer the sole source of liquidity. Money market mutual funds, for example, are substitutes for bank savings accounts¹⁴. Markets in corporate debt and securitized cash flows now share Banks'

¹² Reddy (2002)

¹³ In the United States, for example the regulation of financial futures has been an issue between the Commodity Futures Trading Commission and the Securities and Exchange Commission. Several instances from India are provided in Mor and Nitsure (2002).

¹⁴ In the United States, the Garn-St. Germain Act of 1982 permitted banks to offer money market accounts. Claessens (2005) also makes the point that there is no specific reason to prefer banking as a vehicle for the provision of these services. However, in India Reserve Bank of India (RBI) and Securities Board of India (SEBI) regulations very carefully ensure that the two do not act as

credit intermediation functions. As a result, the systemic risks arising from failures in the banking sector now extend to other financial intermediaries. An example of the linkages arising from non-bank failures was the collapse of Long Term Capital Markets (LTCM)¹⁵. As part of its trading strategy, LTCM built up large positions in markets where it supplied liquidity to other market participants. The collapse of LTCM threatened to have a cascading impact on other markets and to seriously impair the health of the overall financial markets, leading to intervention from the Federal Reserve.

From a regulator's perspective, the broad question, which arises, is whether the risks, which arise from failures in financial intermediaries other than banks, create the sort of externalities, which call for regulation. A related question is the type of regulation needed in the event of such failures.

In many countries, regulation of markets and entities other than banks has progressed in piecemeal fashion, leading to multiple regulators, often with overlapping jurisdictions¹⁶. In India, the multiplicity of regulators (Table 1) has come about because of the sequential nature of the move from administered to market determined prices in different markets. Several issues arise: first, regulatory arbitrage; second, the lack of coordination between regulators¹⁷ in the event of a failure that affects multiple sectors; third, regulatory failures¹⁸; and fourth, turf wars between regulators (SEC vs CFTC).

substitutes (refer: www.rbi.org.in: DBOD.FSC.No. 56/24.01.001/2003-04). Footnote 13 in Ananth and Mor (2005) and Footnote 29 in Mor (2005) discuss this issue in more detail.

¹⁵ http://www.erisk.com/Learning/CaseStudies/ref_case_Itcm.asp and Jorion (2000)

¹⁶ Mor and Nitsure (2002)

¹⁷ Banks in India are regulated by the RBI, SEBI, Company Law Board, the Ministry of Labour and the Central Board of Direct Taxes.

¹⁸ In India, a form of financial intermediary called Non Bank Financial Companies (NBFC), normally regulated by the Reserve Bank of India, were allowed to accept public deposits which were not insured. A number of these entities evaded regulation. The RBI did not have the power to prohibit the non regulated NBFCs from accepting deposits; a large number since defaulted. Changes introduced in 1997 (to Section 45S of the RBI Act) and 1998 (NBFC Acceptance of Public Deposits (Reserve Bank) Directions) changed this.

Table 1
Select Regulators in India

Regulator	Area	Set Up
Reserve Bank of India	Banks & NBFCs	1935
Securities Exchange Board of India	Capital Market & Mutual Fund	1992*
Insurance Regulatory Development Authority	Insurance Industry	2000
National Housing Bank	Housing Finance Companies	1988
Ministry of Company Affairs	Corporate Sector	2004**

*SEBI was established as a statutory body on February 21, 1992

**Earlier known as Department of Company Affairs under Ministry of Finance

Source: RBI, SEBI, IRDA, NHB, and MCA

Regulators in such cases often lose sight of the rationale for regulation. Turf wars between regulators often lead to situations where regulators accede to lobbying efforts by the regulated entities with a view to securing their turf. This in turn leads to regulatory arbitrage, where regulated entities 'choose' the regulator with the lightest regulatory hand. In other cases entities could fall out of the regulatory net entirely. Mor and Nitsure (2002) cover these issues in some detail and make a strong case for a single regulator¹⁹. There have been moves towards single regulators²⁰ and, given the functional convergence of different intermediaries, similar changes in India and other emerging financial markets would seem appropriate²¹.

A basic question, which the 'super regulator' would need to ask, concerns the nature of the economic externalities that constitute the rationale for regulation. As mentioned earlier, there are two broad consequences of the failure of the contract between the lender and the financial intermediary: a 'run' on the intermediary which eventually leads to a system-wide contraction of credit, and the breakdown of the monetary policy transmission mechanism. In both cases, the non-performance of a private contract has an impact on other economic entities; this externality provides the rationale for regulation²².

The question then is why the contract failure cannot be addressed by private contracting mechanisms. One possibility is the legal system's inability to efficiently enforce contracts. In India, for example, a number of laws have been enacted²³ with a view to speeding up a lenders access to the pledged assets of a defaulting borrower. The necessity of such repeated laws shows up the inability of the legal system to enforce legally valid contracts. In India's case, the problem is not one of inadequate or non-existent laws but one where the mechanics of the legal system work poorly.

¹⁹ ICICiresearchcentre.org organised a conference during March, 2002 on the issue of the Single Regulator. The proceedings of this conference are now available in book titled "Regulation of Financial Intermediaries in Emerging Markets". The papers in the book discuss in great detail the various approaches to regulation.

²⁰ In the United Kingdom, the Financial Services and Markets Bill was implemented on December 1 2001 and consolidated regulatory authority in one body. Its ambit currently includes supervision of banking, stock markets, securities and futures, mortgages and insurance.

²¹ Knight (2004) discusses some of the common issues facing bank and insurance regulators.

²² In India, other ways of mitigating this risk such as the Real Time Gross Settlement (RTGS) mechanism have only recently been introduced. The Financial Services infrastructure to support this on a nation-wide basis is still not in place.

²³ The Recovery of Debts due to Banks and Financial Institutions Act (1993) (known as DRT), The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act (2002) (known as SARFAESI) are examples. Also refer to Visaria (2005).

Reforms to the financial sector would have to include resolution of these issues. It should be noted here that these issues affect all financial intermediaries, old and new, state-controlled and private. Suggestions to resolve these problems have typically meant allowing exemptions from certain legal provisions for some entities²⁴. This approach is faulty, and could lead to the wrong incentives being created for both borrowers and lenders. A better approach would be to tackle the mechanics of the legal process directly, by limiting the possibilities of delays, by enforcing a quick discovery process, by encouraging or insisting on binding arbitration procedures, and by setting strict time limits for the legal process (limits which are not left to the discretion of the legal system)²⁵.

In a similar vein, reforms in the financial sector need to take into account the development of new instruments and the legal and tax ambiguities that surround them. An example is the Stamp Tax in India. This is a tax levied by states (as opposed to the Central Government) on transactions such as real estate purchases and other commercial transactions. The development of active secondary markets in securities and, in particular, in securitized instruments has led to situations where state governments have sought to tax transactions in these markets at the high rates applicable to other transactions. The growth of new markets (intermediaries) will be stunted unless an overall view is taken with a view to encouraging new intermediaries and competition between them²⁶.

A second issue concerns the moral hazard problems raised by deposit insurance²⁷. The problem is a simple one: if most depositors are protected by a deposit insurance scheme which does not discriminate between banks (or equivalent financial intermediaries), individual banks have an incentive to take on added risks. Any downside (failed loans) is taken care of by the insurance scheme; banks get all of the upside. Most current deposit insurance schemes suffer from this problem. In effect, the insurance premium paid does not reflect the risks involved. The market provides part of the answer to this problem. Most intermediaries raise funds from multiple sources. One subset - public deposits - is typically covered by formal deposit insurance schemes. The rest, including capital market borrowings, would reflect the risk of the borrower, thereby reducing or eliminating the moral hazard problem (the problem would be eliminated if contracts could be costlessly enforced). The moral hazard problem with public deposits would be less if the cost of the deposit insurance reflected the risks of the bank and were borne entirely by the bank. A way of allowing the market to assess the risk of the bank (and, hence, the insurance premium) would be to use Calomiris' suggestion²⁸ or some variant. By providing appropriate incentives to borrowers, the likelihood of a catastrophic collapse and the consequent cost to the public exchequer is reduced.

We had earlier mentioned the possibility of regulatory arbitrage, where intermediaries 'choose' regulators. While some intermediaries might be able to adapt structures and business practices which allow this choice, the more traditional intermediaries tend to

²⁴ Both DRT and SARFAESI follow this approach. This is also the approach followed for example in the case of agricultural assets where a class of higher risk assets are permitted more leeway in asset classification and provisioning to encourage lending by banks to these sectors.

²⁵ The Corporate Debt Restructuring (CDR) mechanism takes the approach of getting lenders to agree on a certain restructuring package - once 75% of the lenders (by value) have agreed the agreement is binding on the rest of the lenders. This provides government owned banks with a process which provides them with some protection from subsequent charges of corruption.

²⁶ For instance for guidelines on securitisation & reconstruction companies refer to RBI Notification No.DNBS.4 /CGM (OPA)/-2004 dated March 29, 2004. Also in many states the rate of stamp duty levied has been reduced for precisely this reason.

²⁷ Gopp and Vesala (2004) consider this in detail, providing evidence from European markets.

²⁸ Calomiris (1999)

have well defined structures and be part of historical regulatory frameworks. Banks, for example, will not have the luxury of choice. One possible outcome is one of adverse selection. Loosely regulated intermediaries, with their lower regulatory burdens, can offer better terms to both borrowers and lenders. They attract the better risks, leaving poorer risks (and, therefore, higher probabilities of systemic failures) to more heavily regulated entities. Once again, this calls for uniform regulation or, alternatively, a single 'super regulator'²⁹.

A final factor, which governs the nature of financial sector development and regulation, is the form of the contract between the intermediary and the investing public. Diamond and Rajan (2000) have shown that deposits are efficient contracts between lenders of funds and banks. This form of contract lends itself to the possibility of runs because of a collective action problem arising from the nature of the claims of depositors. Diamond (1984, 1996) demonstrates that diversification on the asset side reduces the monitoring costs of banks and reduces the risks of a highly leveraged capital structure. He suggests that laws that limit asset diversification by banks remove the advantage of the contracting structure that banks typically follow and increase the demand for deposit insurance. Berger, Herring and Szego (1995) quoted in Diamond and Rajan (2000) show that historically, book capital/assets have declined even in the absence of regulations giving implicit government capital. Diamond and Rajan (2000) suggest that this is due to increased liquidity of assets, better information availability, and the development of secondary markets. The thrust of development in the financial sector should therefore be on increasing the liquidity of the asset side of financial intermediaries' balance sheets.

Regulation should focus less on protecting depositors and more on improving the overall health of the financial sector. As we pointed out earlier, merely protecting depositors could create various adverse incentives. Regulation should have the following aims:

- Improving information availability across the sector
- Assessing the risks of the financial sector and developing early warning signalling mechanisms
- Preserving the incentive structure that allows intermediaries to balance risks and profits
- Ensuring the efficient allocation of capital³⁰
- Ensuring that risk sharing and/or mitigating mechanisms are readily accessible to intermediaries
- Promoting competition between intermediaries

²⁹ Sundararajan (2002) presents a careful set of arguments for and against the creation of a single Super-Regulator.

³⁰ Refer Nakada and Kapitan (2004) for a discussion of the use of Economic Capital by small banks in the United States.

³¹ Refer Clark and Wolcott (2003)

The Reforms of 1991

While there is some debate on whether the reforms of 1991 were the single point of departure for the reforms process within India³¹, there is no doubt that the measures that were announced then (and shortly thereafter) had a profound impact. Since the details of the full reform process are easily available elsewhere³², the following lists only a few of these measures.

1. Industrial licensing was effectively removed and entrepreneurs were free to set up any capacity subject only to obtaining some minimal clearances³³. The only real constraint now was availability of finance.
2. Commercial Banks (CBs) and Development Finance Institutions (DFIs) were given complete freedom to lend money to these industries at rates of interest that could be freely determined by them³⁴. However, for certain types of loans such as loans below Rs.200,000 interest rates remain capped to this date.
3. The pricing of Initial Public Offerings (IPOs) was completely liberalised. Also, from 1992 onwards, when the Capital Issue (Control) Act 1947 was repealed, the promoter and the merchant banker could decide the price of the issue.
4. While CBs and DFIs were given some freedom to set interest rates on time deposits, CBs were denied access to capital markets for senior debt while DFIs were not permitted to offer checking accounts (savings accounts and current accounts). However, very importantly, the rates of interest on the savings and current accounts were kept regulated³⁵ across the banking system - since these accounts together accounted for approximately 40% of the liabilities of the banking system they became the strong anchors of the entire interest rate structure.
5. Commercial banks continued to be required to maintain a high level of investment in (high duration) Government of India securities³⁶ and a substantial cash reserve ratio.
6. The Statutory Liquidity Ratio (SLR) status of bonds issued by the DFIs was also taken away in 1991³⁷.

The problems with this set of reform measures were many and some of the more important ones are listed below:

³² Refer Mohan (2005)

³³ Rajaraman (1993)

³⁴ Reddy (2002)

³⁵ Current Accounts were only permitted to businesses and had to offer a zero rate of interest. Savings Accounts were only permitted to individuals and had to offer 3.5% rate of interest (a lower rate was effectively given to active account holders because of the methods used in computing the principal amount to which this rate could be applied).

³⁶ It is not clear if this was really a penal measure since almost all the government owned CBs maintained a significantly higher than required proportion in these securities. The high duration was also in part a direct consequence of the issuance of these securities by the Government of India with long maturities combined with high durations (very little floating rate debt has to date been issued by the Government of India).

³⁷ The SLR status effectively ensured that CBs treated these bonds almost on par with Government of India Securities. Refer Pethe and Nitsure (2002) for a discussion of some of the implications on DFIs of this specific step and the kinds of anomalies that it created in the banking system. They make the case that from this point on the DFIs lost relative competitive strength when compared with CBs as the effective systemic subsidy provided to the CBs through strong interest rate controls on savings and current accounts remained high. This led to (a) a strong resistance on the part of the CBs for interest rate deregulation and (b) for an equally strong desire on the part of the DFIs for conversion to a CB.

1. The interest rate deregulation was partial and led to:
 - a. a sharp shift in the subsidy from DFIs to CBs with a consequent strong lobby being built up against further reform of interest rates and therefore a strong desire on the part of the DFIs to convert themselves into CBs³⁸.
 - b. a strong implied tax being imposed on the depositor (refer Table 2 which compares the risk free rate in the system on a 3 year Government of India security and the average rate on demand deposits - savings and current³⁹). The entire benefit of this difference was allowed to be retained as profits by the CBs.

Table 2
Savings Rate Vis-à-vis Yield on 3 Year Government Security (%)

Savings Rate		Yield on 3 Year Govt. of India Security	
Period	Rate	Period	Rate
April 29, 1998 - April 2, 2000	4.5	April 1998	10.47
April 3, 2000 - Feb 28, 2003	4	April 2000	9.58
March 2003 - till date	3.5	April 2003	5.33

Source: Various Issues of RBI Annual Reports

2. Neither the industrialists nor the bankers had any real experience of dealing with risk (credit risk and market risk) implications of free-markets and therefore financed projects in a mechanical manner and at fixed rates of interest despite multi-year drawdowns. The number of business houses were very few and the reform had the effect of transferring the decision making process from a few members in the planning commission (who at least had the benefit and the incentive to look at economy wide demand-supply gaps) to a few business men who neither had the incentive nor the competency to fully understand market dynamics of demand and supply.

The Immediate Consequences of Reform

The period from 1991 to 1994 was characterised by a high degree of enthusiasm and euphoria:

1. Interest rates saw large volatility, for instance call/notice money rates that were hovering around 19.57% during 1992, dropped to 6.99% in 1994 and rose back to 17.73% in 1996.
2. The stock market experienced boom and bust cycles in 1992 and 1994 (Exhibit 1). The fixed income and equity market scandal in 1992 led to the crash of the stock markets in April 1992, just after the sensx (Bombay Stock Exchange, sensitive index) reached its all time high. The income tax authorities froze shares of various big companies that belonged to proxy holders of those involved in the scandal. Similarly, in 1994 after the sensx reached an all time high in September, due to a ban on "badla" (forward) transactions trading thinned.

Exhibit 1 Sensx Movement During the 1990's

³⁸ This was also the principal reason why, despite strong arguments being presented to the contrary, the RBI was unwilling to grant any exemptions on the provision of CRR and SLR on the historic bond liabilities to DFIs in their attempt to convert to CBs.

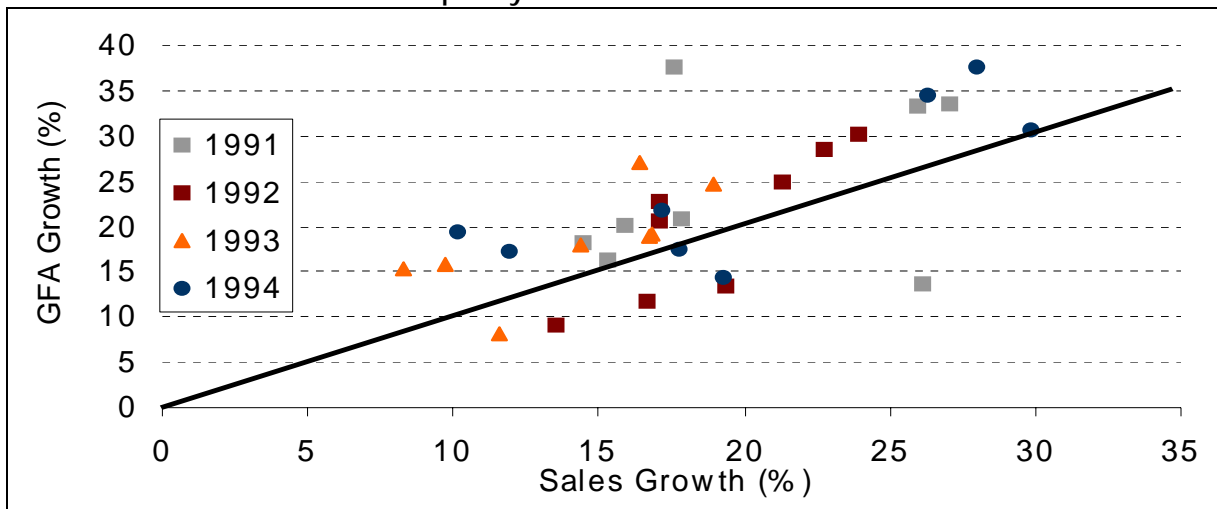
³⁹ The Current Account bears no interest.



Source: Bloomberg

3. In part led by the consortium financing system but largely because neither industrialists nor bankers had any experience in operating in liberalised environments, almost every project that was submitted for financing was accepted. The equity market supplied most of the equity and the developers effectively put in less than 5% of the risk-capital that was required.
4. The system created capacity (which is what showed up as growth numbers) in industry after industry - steel, man-made fibre, paper, cement, textiles, hotels, automobiles principally finance by very large loans given principally by the DFIs and partly by the Commercial Banks Exhibit 2 shows evidence of excess capacities created in the manufacturing sector, particularly textiles, chemicals, food and beverages and metals industry, which is reflected by the diversion between growth of fixed assets over sales of these industries.

Exhibit 2
Excess Capacity in Industries* Post-Reforms



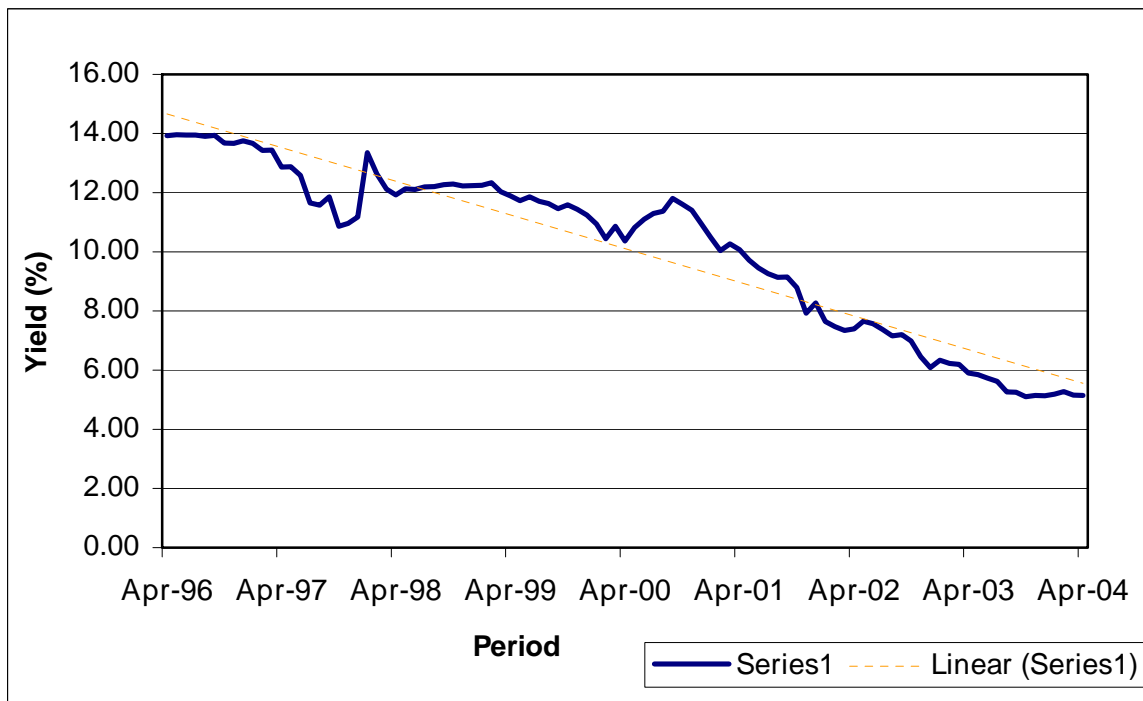
*Industries covered: Textiles, Food & Beverages, Chemicals, Machinery, Metal & Metal products, Non-Metallic Mineral products, Transport equipment & Miscellaneous Manufacturing.

Source: Prowess

The Aftermath of Reform

1. Interest rates fell in a secular manner from 1996 to 2004. Yield of 10-year government securities fell from 13.93% in April 1996 to a low of 5.15% in April 2004. (Exhibit 3).

Exhibit 3
Trend in Yield of 10 year Government of India Security



Source: RBI

2. Commercial Banks had largely stayed out of the project finance market but had built a large investment book of Government of India securities, working capital and priority sector advances.

3. Almost 4 in 5 projects experienced large delays in implementation and a few celebrated cases could not complete financial closure because of the collapse of equity markets
4. Reserve Bank of India (RBI), for the first time issued guidelines, in 1994, for the classification of assets and recognition and provisioning of non-performing assets using exclusively a days-overdue criterion and allowed a great deal of time before even unsecured defaulting loans had to be fully provided for. To-date this remains the sole benchmark of asset quality.
5. Three of the five major financial institutions, Unit Trust of India (UTI), Industrial Finance Corporation of India (IFCI) and Industrial Development Bank of India (IDBI) had to be given large infusions of capital by the Government of India. ICICI (formerly the Industrial Credit and Investment Corporation of India) entered the retail finance business and between itself and its subsidiary, ICICI Bank, raised about USD 1,948 million of capital from International and domestic sources between 1996-2002.
6. Despite staying largely out of the project finance business, the CBs also experienced a great deal of stress with net worth of three commercial banks turning negative. However, there were three significant factors that worked in their favour and allowed most of them to remain solvent or experience rapid “turn-around” in their profits:
 - The implied government guarantee ensured that the public never lost confidence in these banks. In fact, since the year 1996 when Indian Bank’s net worth turned negative it continues to maintain an average growth in deposits of more than 10%⁴¹.
 - The large and persistent difference between the cost of demand deposits (current and savings) and the rate of return on the government of India securities (risk-free rate), coupled with large investments in these long-duraton bonds by the public sector banks - a direct consequence of imprudent interest rate risk management, ensured that the profitability of these banks remained high despite little or no growth in other lending activities.
 - The secular fall in the interest rates on Government of India securities, the very long-duration issuance and purchase by the Public Sector banks and the very high level of duration mismatch between assets and liabilities of banks, allowed banks to book profits in their trading books at will by simply selling the older bonds and buying newly issued ones.
7. All industrial investment largely came to a halt with all players experiencing a knee-jerk reaction of these developments.

The Current Status

1. Thanks largely to Chinese demand and the domestic retail financing boom, prices in several key sectors are at all time highs consequent to which, barring a few cases, after some deep restructuring most of the non-performing assets have now started to generate an adequate level of cash to service their obligations.
2. Having used their trading gains to provision aggressively banks have very low levels of Non-Performing Assets.
3. All the large participants in the financial system, one way or another, are adequately capitalised⁴².

⁴¹ This is one of the key risks of privatisation. If the process of privatisation precedes the improvement in the manner in which these banks are run and managed, the recurrence of such an event could lead to a large run on these banks and / or a sharp increase in their cost of funds.

⁴² Mohan (2005)

4. Facilitative regulation and the development of asset reconstruction companies have made it somewhat easier to recover at least some money from bad loans.

Several reports have therefore assumed that since the data on Non Performing Assets and profitability look good there are no problems in the financial sector.

What is the Problem?

At first glance things look quite good and what then is the problem:

1. Commercial Banks (this now even includes even the former DFIs: ICICI and IDBI who have now converted themselves into Banks) continue to have on their books, very long-duration government of India securities with some holding as much as 45% of their assets in these securities⁴³.
2. Interest rates have started to rise with the 10 year Government of India security having gone from 5.11% in October 2003 to 6.99% in April 2005 (trading at 7.19% on May 16, 2005).
3. While there is clearly a strong desire to hold high quality of assets, given the virtual complete absence of transfer pricing methodologies in operation, there is no link between the cost of funds and the rates that are offered on loans⁴⁴.
4. Over 500 million people do not have bank accounts, against an estimated annual demand of Rs.45,000 crore (\$10 billion) the supply from the formal system is under Rs.2,000 crore (\$400 million) and Small and Medium Enterprises are not receiving adequate funds from Banks⁴⁵.
5. There is a strong demand for project finance emerging, given the complete absence of Risk Quantification and Capital Attribution methodologies⁴⁶ actually being used by banks, it is not clear if the Banks and DFIs will be able to correctly assess the risks inherent in these projects and meet the required demand.
6. Cost of intermediation is very high in India - possibly amongst the highest in the world. A McKinsey⁴⁷ study shows (something that is generally known to be true also for India) that it is the very heavy use of cash that is responsible for this very high cost of intermediation.
7. There has been a very strong upsurge of demand for retail loans. Unlike corporate loans where the focus is principally on the quality of analysis and (presumably) a multi-stage review process sometimes going all the way to the Chairman and Managing Director of the Bank, ensures that all of the talent of the Bank is brought to bear on the exposure, retail loans, given their inherently small value but very high numbers, need to be dealt with differently. Unless very tight process disciplines are maintained and a fair degree of centralised control is exercised through the use of technology and formalised protocols, underlying risk levels, in part linked to a rising incidence of fraud, can quickly start to produce very high levels of non-performing assets.
8. The formal rural financial sector is very deeply troubled with poor access combined with low levels of capitalisation and high default rates being experienced by both Regional Rural Banks (RRBs) and Co-operative Credit Institutions. The solutions

⁴³ Patnaik and Shah (2002).

⁴⁴ It is very difficult to find any direct relationship between rates of interest that are charged by the banks and the credit risk or market risk that these rates imply.

⁴⁵ Mor (2005)

⁴⁶ While many Banks will claim that they have these in place, even if they do have a formal Risk Department and Risk Policy in place, it would be important to see what the relationship between the pricing of specific loans is relative to the underlying rating, capital attribution and the Bank's target Return on Equity numbers.

⁴⁷ Bekier and Nickless (1998)

being attempted even at this stage are minor modifications of earlier solutions and do not appear to offer any real hope of solving either of the problems of access and asset quality. The 'semi-formal' institutions (eg: MFIs) that are rapidly building outreach to (previously unserved) poor households are often hampered by implicit price caps, in the case of credit. In the absence of a regulatory framework for correspondent banking arrangements, banks are currently unable to leverage this outreach built by MFIs for the purpose of extending saving facilities.

What Needs to be Done

The whole reform process has to be sequenced very carefully and it is not at all obvious to us that privatisation of the banking system is either a necessary or a sufficient condition for this reform:

1. Develop a detailed vision for the financial sector for say 2010 and articulate clearly what the desire would be (a) for interest rate regulation; (b) provisioning regulation; (c) sector specific caps and floors (unsecured loans, equity, priority sector); (d) markets activity (shorting, hedging, etc. for example). Clearly the underlying theme would have to be that all of the decisions would now be internal to the Bank and the RBI would focus much more on quality of disclosure.
2. Develop a specific set of questions which reflect the concerns of regulation but are answerable by looking merely at aggregate data at the bank level - this would include detailed segment level⁴⁸ Return on Equity (ROE) with capital being allocated using an internal risk-based algorithms (not just flat, regulatory capital), impact on the bank of pre-specified interest rate and credit shocks (all interest rates go up by 3%, all rating fall by one notch, etc.)⁴⁹.
3. Attempts should be made to link capital to overall balance sheet quality and not annual profit and loss considerations. Even under the proposed BASLE II norms to be implemented by RBI, large asset classes (such as fully committed but un-drawn-cash-credit lines) are excluded from assignment of capital, market risk capital is to be examined only on the traded book not on the entire balance sheet and under the standardised approach unrated paper has 100% risk weight creating a strong incentive for banks to choose this approach because lower grade ratings require higher risk weights. Such anomalies need to be addressed comprehensively.
4. The focus of inspection can then shift to qualitative issues around the actual manner in which a bank uses many of the processes and policies it has laid down. A fairly high degree of re-training of the regulatory staff (at all levels) would be required to shift from an adherence to procedure approach to a qualitative evaluation approach.
5. Assess the qualitative capability and preparedness of each bank to function in the 2010 environment - specifically focussing on three building blocks⁵⁰:
 - a. Risk Quantification Methodologies
 - b. Funds Transfer Pricing
 - c. Activity Based Costing
6. Once there is confidence that the banking system as a whole has this risk-absorption capacity, then gradually dismantle many of the risk absorption (but price distorting) mechanisms that have been put in place, such as, no-shorting, managed-float and interest rate controls, with the end date being 2010.

⁴⁸ http://www.bankofamerica.com/annualreport/2004/pdf/AnnualReport_2004.pdf for segment wise reporting of results by Bank of America as an example of how this may be done.

⁴⁹ Refer Mor (2005) for a listing of some of the un-asked questions.

⁵⁰ Refer Mor and Maheshwari (2004) and Mor and Sharma (2002) for a more detailed discussion of this and the basic requirements for a well-functioning bank.

7. The strategy of listing and then gradually selling the banks ensures that there is a wide shareholding base and government gets good value. However, the benefit of a directed shareholder proactively adding value to the management of the bank is not there. With improved regulation it will be come unnecessary for excessive concerns on ownership to become drivers. Even minority stakes by the public will become adequate as disciplining mechanisms on Public Sector Banks and institutions⁵¹. Without adequate disclosure and regulation even with wide shareholding it becomes impossible to discipline managements.
8. A lot more effort needs to be put in to put in place financial sector infrastructure, which is critical if scale up has to happen, and if systemic risk is to be avoided as the system scales up⁵². There are several specific issues that need to be addressed:
 - a. Increase penetration of electronic payments on a nationwide basis by taking a number of steps:
 - Extending the Electronic Credit System⁵³ to approximately 2000 locations immediately.
 - Moving towards national settlement in payment systems with two entities, one each in physical and electronic settlement respectively.
 - Allowing cash dispensation by debit to credit card.
 - b. If cash indeed has to be used then strengthen cash-handling capabilities nationwide. But provide strong incentives for switching to card based / electronic transactions; the national savings in costs as well as the consequent reduction in the size of the parallel economy could more than pay for the tax loss.
9. Improving access should also be a top priority of the players in the financial sector. Here again a number of measures could be taken:
 - a. Including explicitly in the mission statements of the regulators, improving access to financial services. If possible, specific and disclosed “universalisation by date” targets to be set by the finance ministry for each regulator. This is one of the most significant impediments faced even by those participants interested in this exercise.
 - b. Urgently build the infrastructure of: (a) biometric identity cards for every adult with a unique national number; (b) a rural credit bureau (c) universal internet connectivity (d) rural electronic weather stations.
 - c. Allow banks a great deal of freedom in terms of building outreach models (franchisee, branch, correspondent) with once again focussing on outcomes and not on approving uniform processes across banks.
 - d. Utilise grant funds available with NABARD to develop financing models in ‘untested areas’ such as watershed development, rural infrastructure, electricity etc where the subsidy insures the bank against policy shocks or addresses temporary viability gaps. Today, refinance is being provided for activities such as SHG-Bank Linkage whose potential has been clearly demonstrated with over 10 years of experience.

⁵¹ Since many Public Sector Banks are already listed and have significant minority shareholding, even under the current regulatory regime, in the interests of the minority shareholder, the Securities Exchange Board of India (SEBI) could require many of these disclosures to be made mandatory for all listed financial intermediaries. The requirement to disclose Net Asset Value on a daily basis has had a very deep impact on the governance of asset management companies - a similar requirement could easily be imposed on other listed intermediaries

⁵² Refer Mor (2005) for a discussion of some the basic Financial Market Infrastructure that would be needed.

⁵³ www.rbi.org.in/sec18/19632.doc

- e. Embed in the regulatory approach, explicit institution neutrality and focus only on desired outcomes. This is clearly not the case now:
 - While an RRB is able to operate as a full-service bank with only Rs. 10 million of capital a micro finance institution is not permitted even NBFC status with even Rs.20 million of capital. A co-operative bank can be set up with almost no capital.
 - Short-term refinance support from NABARD is provided only to co-operative institutions and not to any other rural financial institution no matter how much more effective and better performing it is in terms of indicators.
- f. Allow banks (with the assumption that their fitness of being banks has already been whetted) a great deal of freedom in terms of building hybrid outreach models (franchisee, branch, correspondent) for banking services with once again focussing on outcomes and not on approving uniform processes across banks.
- g. In order to gain a true picture of access to financial services and the dynamics thereof, NABARD could play a lead role in supporting panel surveys that provide robust access-related data for practitioners and policymakers.

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