

PLANNING COMMISSION

Vision 2020 for India

The Financial Sector

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Introduction

A financial system, which is inherently strong, functionally diverse and displays efficiency and flexibility, is critical to our national objectives of creating a market-driven, productive and competitive economy. A mature system supports higher levels of investment and promotes growth in the economy with its depth and coverage. The financial system in India comprises of financial institutions, financial markets, financial instruments and services. The Indian financial system is characterised by its two major segments - an organised sector and a traditional sector that is also known as informal credit market. Financial intermediation in the organised sector is conducted by a large number of financial institutions which are business organisations providing financial services to the community. Financial institutions whose activities may be either specialised or may overlap are further classified as banking and non-banking entities. The Reserve Bank of India (RBI) as the main regulator of credit is the apex institution in the financial system. Other important financial institutions are the commercial banks (in the public and private sector), cooperative banks, regional rural banks and development banks. Non-bank financial institutions include finance and leasing companies and other institutions like LIC, GIC, UTI, Mutual funds, Provident Funds, Post Office Banks etc.

The banking system is, by far, the most dominant segment of the financial sector, accounting as it does, for over 80 per cent of the funds flowing through

the financial sector. The aggregate deposits of the scheduled commercial banks (SCBs) rose from Rs.5,05,599 crore in March 1997 to Rs.11,03,360 crore in March 2002 representing a rise of 17 per cent. During the same period, the credit portfolio (food and non-food) of SCBs grew from Rs.2,78,401 crore to Rs. 5,89,723 crore, i.e. by 16 per cent. The net profits of SCBs witnessed a noticeable upturn from Rs.6,403 crore in 2000-01 to Rs.11, 572 crore in 2001-02. The extent and coverage of the banking system can be gauged from the fact that the number of branches of SCBs grew from 8045 in 1969 to 66,186 in June 2002. While rural branches constituted 49 per cent of the total in 2002, semi-urban branches accounted for 22 per cent, urban branches accounted for 16 per cent and metropolitan branches accounted for 13 per cent.

As regards the capital market, the resource mobilization from the primary market by non-government public limited companies has declined in the recent past from the high levels witnessed between 1992-93 and 1996-97. Resource mobilization of these companies in the public issues market stood at Rs. 5,692 crore in 2001-02 registering an increase of 16.4 per cent over the amount mobilized during the previous year. The public issues market has been dominated by debt issues both in the private and public sectors in the recent past. In recent years, private placement has emerged as an important vehicle for raising resources by banks, financial institutions and public and private sector companies. Such placements continued to dominate the primary market although the pace of growth of the private placement market has slackened during the last two years. Resource mobilization by mutual funds is an important activity in the capital markets. Although there has been a decline in the net resource mobilization by mutual funds to the extent of 28 per cent during 2001-02, according to SEBI, outstanding net assets of all mutual funds stood at Rs.1,00,594 crore as at end-March 2002. The strong potential of the capital market as an area of resource mobilization needs no emphasis and this segment of the financial sector would continue to play a significant role in the future.

Reforms

The quantum of resources required to be mobilised, as the economy grows in complexity and generates new demands, places the financial sector in a vital position for promoting efficiency and momentum. It intermediates in the flow of funds from those who want to save a part of their income to those who want to invest in productive assets. The efficiency of intermediation depends on the width, depth and diversity of the financial system. Till about two decades ago, a large part of household savings was either invested directly in physical assets or put in bank deposits and small savings schemes of the Government. Since the late eighties however, equity markets started playing an important role. Other markets such as the medium to long-term debt market and short term money market remained relatively segmented and underdeveloped. In the past decades, the Government and its subsidiary institutions and agencies had an overwhelming and all encompassing role with extensive system of controls, rules, regulations and procedures, which directly or indirectly affected the development of these markets.

The financial system comprising of a network of institutions, instruments and markets suffered from lack of flexibility in intermediary behaviour and segmentation of various markets and sets of financial intermediaries. Well-developed markets should be inter-connected to facilitate the demand-supply imbalances in one market overflowing into related markets thereby dampening shocks and disturbances. The inter connection also ensures that interest rates and returns in any market reflect the broad demand-supply conditions in the overall market of savings. But such adjustment of interest rates is delayed when the intermediaries lack flexibility. On account of the historical role of the Government in controlling and directing a large part of the financial activity, such adjustments were slow and the problem needed to be addressed urgently if the financial sector had to keep pace with the reforms in the real sector.

World wide experience confirms that the countries with well-developed and market-oriented financial systems have grown faster and more steadily than those with weaker and closely regulated systems. The financial sector in general and banking system in particular in many of the developing countries have been plagued by various systemic problems which necessitated drastic structural changes as also a re-orientation of approach in order to develop a more efficient and well functioning financial system.

The Indian financial system has been no exception in this respect and the problems encountered in the way of efficient functioning necessitated the financial sector reforms. Recognising the critical nature of the financial sector prompted the Government to set up two Committees on the Financial System (Narasimham Committees) in 1991 and 1998 to examine all aspects relating to the structure, organisation, functions and procedures of the financial system. The deliberations of the Committees were guided by the demands that would be placed on the financial system by the economic reforms taking place in the real sectors of the economy and by the need to introduce greater competition through autonomy and private sector participation in the financial sector. Despite the fact that the bulk of the banks were and are likely to remain in the public sector, and therefore with virtually zero risk of failure, the health and financial credibility of the banking sector was an issue of paramount importance to the Committees.

The Committees proposed reforms in the financial sector to bring about operational flexibility and functional autonomy, for overall efficiency, productivity and profitability. In the banking sector, in particular, the measures have been taken aimed at restoring viability of the banking system, bringing about an internationally accepted level of accounting and disclosure standards and introducing capital adequacy norms in a phased manner. Most of the measures suggested by the Committees have been accepted by the Government. Interest rates have been deregulated over a period of time, branch-licensing procedures have been liberalised and Statutory Liquidity Ratio (SLR) and Cash Reserve

Ratio (CRR) have been reduced. The entry barriers for foreign banks and new private sector banks have been lowered as part of the medium term strategy to improve the financial and operational health of the banking system by introducing an element of competition into it. A Board for Financial Supervision has been set up within the Reserve Bank of India and it has introduced a new system of off-site surveillance even while revamping the system of on-site surveillance. The financial sector reforms have been pursued vigorously and the results of the first set of reforms have brought about improved efficiency and transparency in the financial sector. It is well recognized that reforms in the financial sector are an ongoing process to meet the challenges thrown up on account of the integration of financial markets, both within the country and worldwide.

Future direction of reforms

If the financial sector reforms are viewed in a broad perspective, it would be evident that the first phase of reforms focussed on modification of the policy framework, improvement in financial health of the entities and creation of a competitive environment. The second phase of reforms target the three inter-related issues viz. (i) strengthening the foundations of the banking system; (ii) streamlining procedures, upgrading technology and human resource development; and (iii) structural changes in the system. These would cover aspects of banking policy, and focus on institutional, supervisory and legislative dimensions.

Although significant steps have been taken in reforming the financial sector, some areas require greater focus. One area of concern relates to the ability of the financial sector in its present structure to make available investible resources to the potential investors in the forms and tenors that will be required by them in the coming years, that is, as equity, long term debt and medium and short-term debt. If this does not happen, there could simultaneously exist excess demand and excess supply in different segments of the financial markets. In

such a situation the segment facing the highest level of excess demand would prove to be the binding constraint to investment activity and effectively determine the actual level of investment in the economy. Such problems could be resolved through movement of funds between various types of financial institutions and instruments and also by portfolio reallocation by the savers in response to differential movements in the returns in the alternative financial instruments. In this context, it is very important to identify the emerging structure of investment demand, particularly from the private sector, in order to reorient the functioning of the financial sector accordingly, so that investment in areas of national importance flows smoothly.

A major area that needs to be focused in the context of the country's development policy is investment in infrastructure. Financing of infrastructure projects is a specialized activity and would continue to be of critical importance in the future. A sound and efficient infrastructure is a sine qua non for sustainable economic development. A deficient infrastructure can be a major impediment in a country's economic growth particularly when the economy is on the upswing. A growing economy needs supporting infrastructure at all levels, be it adequate and reasonably priced power, efficient communication and transportation facilities or a thriving energy sector. Such infrastructure development has a multiplier effect on economic growth, which cannot be overlooked.

Infrastructure services have generally been provided by the public sector all over the world for a large part of the twentieth century as most of these services have an element of public good in them. It was only in the closing years of the century that private financing of infrastructure made substantial progress. It may be relevant to point out that infrastructure was largely privately financed in the nineteenth century. The twenty-first century would, therefore, be more like the nineteenth than the twentieth century.

This trend has been visible in India as well where financing of infrastructure was till recently a Government activity. This has been so because infrastructure services are difficult to price so as to fully cover all costs thereby making it unattractive for private sector participation. Also the provisions of infrastructure usually involve high upfront costs and long payback periods and the private investor is often unable to provide the large initial capital required and is not capable of obtaining matching long-term finance. Finally cross-subsidization, which forms an important part of infrastructure provision, is easier done by public sector than the private.

However, there has been a paradigm shift in funding of infrastructure from the Government to the private sector mainly due to budgetary constraints in making available funds to meet the huge requirements of the infrastructure sector. The other contributing factors for the diminishing role of the Government have been the dissatisfaction with the performance of state provided infrastructure, more efficient utilization of resources by the private sector and greater Government emphasis on allocation of budgetary resources to social service sectors such as health and education. The Government's role is perceived as the ability to provide a stable and conducive macro economic environment and carry out necessary regulatory reforms, which in turn would facilitate private sector investments in the infrastructure sector.

The Government continues to play the role of a facilitator and the development of infrastructure really becomes an exercise in public-private partnership. The fact that funding for infrastructure has increasingly to come from the private sector has now been widely recognized and the focus of the debate has been on best practices in reform strategies, regulatory frameworks and risk mitigation techniques. The Government has the challenging task of providing fair, predictable and sustainable framework for private sector participation in infrastructure that will deliver better services with greater efficiency. It has been observed globally that project finance to developing

countries flows in where there is a relatively stable macro-economic environment. However, there are certain other conditions, which must be present. These include regulatory reforms and opening markets to competition and private investment. Liberalized financial markets, promoting the deepening and widening of local markets, wider use of risk management and other financial products, improved legal frameworks and accounting standards and privatization programmes are some of the other aspects which favourably impact on infrastructure project finance.

Infrastructure projects are characterised by large capital costs and long gestation periods. The assets of these projects are not easily transferable and the services provided are non-tradable in nature. These projects are typically vulnerable to regulatory and political changes and are also dependent on supportive infrastructure. There are also politically sensitive issues like tariffs and relocation and rehabilitation of people. For these reasons, the infrastructure projects carry a relatively higher risk profile and, therefore, this funding is different from the traditional balance sheet financing. The characteristics and complex nature of infrastructure projects call for proper risks assessment and mitigation mechanisms. The financing of infrastructure projects is largely cash flow based and not asset based. In fact, in some sectors like telecom, roads, bridges etc. the tangible assets may not even provide adequate cover for the loans. These projects are financed through Special Purpose Vehicles by way of non-recourse/limited recourse financing structures. The approach to such projects is to properly identify and allocate various elements of project risks to the entities participating in the project. The role of sponsors is normally limited to bringing in the contracted equity/contingent equity contribution

The non-recourse financing of infrastructure projects necessitates exhaustive due-diligence process on the part of the funding agencies to ascertain that the project cash flows are adequate to cover the debt service obligations. Risk analysis and risk mitigation mechanisms, therefore, constitute a critical part

of the due-diligence exercise. These risks can broadly be classified into various types viz. Construction risk, Operation risk, Political risk, Force Majeure risk, Market risk and Payment risk. The success of project financing depends in a large measure on good risk management. There are various mechanisms for mitigating these risks such as execution of appropriate contracts, performance guarantees, liquidated damages, purchase/sale contracts, cash support agreements, insurance coverage etc. Financial structuring has to be such that it would help a project withstand a wide variety of risks, both expected and unexpected.

The complexity of the transactions and large funding requirements demand an innovative approach towards financial structuring and the use of a variety of financial instruments. The involvement of project finance lenders in some projects is quite intense, who often take a blend of debt and equity positions in these ventures. Such a blended role includes broad representation and tiered returns and levels of security for various tranches of participation. In India such financing is usually undertaken by the specialized term lending agencies like IL&FS, IDFC, ICICI and IDBI. Commercial banks rarely take equity positions in projects. Infrastructure financing necessarily requires the commitment of long-term funds, both as equity and long-term debt. In the past, since the infrastructure sector was predominantly catered to by public investment, the need to develop appropriate financing mechanisms was not felt. As a result, the Indian financial sector is heavily biased towards short and medium term debt, whether it is the commercial banking sector or the financial institutions. This position needs to be changed and the availability of equity and long-term debt to the private sector has to be increased substantially.

The traditional approach to financing is inadequate to match the risk-return profile and payback periods of infrastructure projects. Financial institutions and banks are constrained by the time profile of their own liabilities. Consequently, they are limited in their capacity to finance long gestation projects. The

Government and RBI are seized of these problems and important steps have been taken to facilitate financing of infrastructure sector like removing the ceiling on a single term loan by commercial banks and relaxing the exposure norms for financing such projects. The modalities of financing in so far as appropriate appraisal, supervision and monitoring mechanism at the operating level are concerned have been spelt out by RBI in addition to the proper exposure and maturity norms at the policy level.

Banks and financial institutions on their part need to lay down internal exposure norms for the infrastructure sector as a whole as also for each sector in the infrastructure area from the risk management point of view. Another important aspect to be viewed is asset-liability management and appropriate policy needs to be formulated for the asset-liability mismatch, which is likely to occur as the resources of banks are essentially short term in nature whereas the maturity requirement for funding of infrastructure projects extends up to 15 to 20 years. There is also need to develop a secondary debt market so that there is liquidity and recycling of funds.

The debt market which is central to infrastructure financing, comprises basically these segments viz. Government securities market which is the oldest and most dominant; PSU Bonds Market, which is basically a development since the late eighties; and Corporate Securities Market, which is growing fast after liberalization. The major focus in the development of debt markets has been the Government securities market because apart from it constituting the principal segment of the debt market, it has a role in setting benchmarks in the financial markets as a whole. The reforms in the debt market have taken the shape of bringing about various structural and institutional changes. The Treasury bill market has been streamlined and with the strengthening the dealers system, retailing in Government securities has been promoted. To widen the participation in the debt market including Government securities, foreign institutional investors (FIIs) have also been permitted to operate. Although significant progress has

been made, a number of rigidities persist and certain issues still need to be tackled. The actions required for this purpose are in areas relating to legal, technological, regulatory and market microstructure, retailing, risk management, standardization etc.

An extremely important issue in infrastructure financing is the availability of funds. The funding is required to be met by the private sector from various commercial sources including banks and financial institutions. According to the India Infrastructure Report, the level of investment in infrastructure needed to be increased from 5.5 percent of GDP to about 7 percent by 2000-01 and 8 percent by 2005-06 to attain a GDP growth of 7 percent by 2000-01 and 8 percent by 2005-06. The funding requirements of various sectors in the infrastructure area aggregate to about Rs.12,00,000 crore by the year 2005-06. The estimated availability of financing from Indian financial institutions and banks for infrastructure is expected to be about Rs.1,20,000 crore. Financing of Infrastructure sector will thus be a major responsibility of the banks and financial institutions in the years to come. However this would still leave a large funding gap, which would have to be met through other sources viz. bilateral/multilateral/Government funding.

Other possible sources for such financing could be institutional, such as pension, provident and insurance funds that have the advantage of providing a better maturity match for infrastructure financing. But in India, the investment patterns of these funds are highly regulated with a bias towards investment in Government securities. There is need to deregulate these long-term fund sources and formulate prudential norms for such financing. To begin with, participation of pension, provident funds etc. can be to a limited extent in projects appraised by the all India financial institutions. These funds could also be allowed to deposit in banks for long periods, subject to banks using them exclusively for infrastructure financing. Banks could also be permitted to float 10

to 15 year tax-free bonds to raise long-term resources specifically for financing of infrastructure projects.

A financial technique that has been successfully used in infrastructure financing in several developed countries is securitisation. This is a process through which illiquid assets are transferred into a more liquid form of assets and distributed to a broad range of investors through the capital markets. The lending institution's assets are removed from its balance sheet and are instead funded by investors through a negotiable financial instrument. The security is backed by the expected cash flow from the assets. Securitisation facilitates better asset-liability management for the lender by reducing market risks resulting from interest rate mismatches. From the point of view of the financial system as a whole, securitisation increases the number of debt instruments in the market thereby providing additional liquidity. It also facilitates unbundling, better allocation and management of project risks. It has the effect of widening the market by attracting new players on account of superior quality assets being available. However, suitable prudential norms must be in place and adhered to, for the process to function smoothly. The RBI encourages banks and financial institutions to securitise the receivables, repackage and offer them to investors at various stages of the infrastructure project.

One of the specific proposals circulated by RBI to banks for hedging liquidity risk and interest rate risk is the concept of Take-Out Financing facility and market making in project debentures, say after a pre-determined period of five years to give comfort to commercial banks which are willing to deploy their funds in infrastructure. However, the RBI would need to monitor the extent of such facilities in relation to the balance sheets of the parties. In any case, the provision of a "liquidity back stop" by the RBI for supporting market making at the end of the pre-determined period has implications for monetary management.

The current Government policy on external commercial borrowings allows considerable flexibility in the case of power and other infrastructure projects. But the use of external financing of infrastructure is being inhibited by the inability to hedge long term exchange risk under current regulations of the RBI. Several measures are being taken to deepen the forward market in foreign exchange but there is a limited forward supply beyond one year. In some cases long-term currency swaps have been used though in a limited way and market participants also run a swap book subject to prudential limits. Of course, the exchange risk issue does not inhibit external financing where there is a natural hedge such as in export-oriented units or where there are foreign exchange receivables.

Government support to infrastructure financing, which is the traditional route, can take several forms. Central and State governments have underwritten the major sources of risk in some infrastructure projects through various kinds of guarantees. The capital that the private sector provides to such derisked projects is analogous to lending to the Government with a risk premium added for any residual risks in the projects. Income tax incentives are often provided to infrastructure projects or to the investors in such a project. Limited tax breaks or tax holidays are methods used in this regard. Governments also use the mechanism of directed credit to infrastructure but this is essentially a pre-liberalisation phenomenon. Other methods like negative license fee and various forms of credit enhancement have been used in different countries to develop infrastructure projects.

These areas of Government intervention in the form of subsidy and credit enhancement would exist as the public sector will continue to have a major role in the infrastructure sector even as its share declines and gives way to private investments principally in the areas of power generation, telecommunications initially and in roads, civil aviation and urban infrastructure thereafter.

In the new paradigm, with the private sector entering into infrastructure services and private capital having to be accessed on competitive terms, the regulatory framework assumes great importance. Such a framework must provide for transparency, clarity of obligations between the participants in the infrastructure projects and should reduce the layering of approvals to bring about a greater degree of certainty in obtaining them within a definite time frame. The rules of the game should not be changed too frequently and without notice, to enable the participants to have reasonable planning horizons. In such an atmosphere, the private sector would be encouraged to participate in infrastructure financing more effectively and the Government need not step in with direct or indirect support to such an extent that the private project really becomes a privately managed but publicly funded enterprise.

Even in a more general sense, for any investment activity to take off, the availability of equity is the starting point and with this end in view, a serious thought needs to be given to the domestic capital markets. While the secondary market is quite well developed, it is the primary market which remains dormant making the equity raising exercise by both new as well as existing companies difficult. While attracting foreign equity to bridge this gap is possible to some extent, there is a strong case for developing a vibrant primary market and instilling confidence amongst the small investors. This can be brought about by ensuring that the transparency and disclosure norms of SEBI are strictly complied with and defaulters are penalised. Further, the tendency to list new issues on the major stock exchanges should be checked and an alternative route of listing on the OTCEI should be encouraged, of course after energising this organisation. With the pricing of shares being left to the respective company boards, institutional improvements in the market are needed to ensure that share pricing is reflective of the intrinsic worth of the company and its potential. The involvement of mutual funds in the primary issues market needs to be encouraged, as this is essential for the healthy growth of industry and revival of investor confidence.

As far as long-term debt is concerned, at present the Government monopolises practically all forms of long term funds, such as insurance, pension and provident funds. With the desired shift in investment responsibilities, it has become necessary for the Government to vacate some of this space for the private sector. Conditions should also be created whereby savers are attracted towards investing in long-term debt instruments. One way is to make much more concerted efforts for the creation of a debt market, for, in the absence of such a market, practically all debt investments are held to maturity and this illiquidity reduces the attractiveness of debt instruments particularly those of longer maturity. Until the secondary debt market becomes sufficiently active so as to absorb debt instruments of various maturities, there is a case for the Central Government to move its debt portfolio towards the shorter end of the maturity spectrum, which would increase liquidity in the debt market. This would be consistent with the recommendation for the Centre to vacate more space in SLR placements in favour of states and PSEs.

The insurance sector has been an important source of low cost funds of long-term maturities all over the world. In the Indian context, however, the insurance companies, particularly in life insurance, apart from covering risk are also committed to repayment of the principal with interest although with long maturities and thereby tend to act as investment funds. One of the reasons that this has happened is that the average premium charged by the insurance companies in India tends to be relatively high due to obsolete and rigid actuarial practices and inefficient operations. There is pressing need to reorient the insurance sector in a manner that it fulfills its principal mandate of providing risk cover. The opening up of the insurance sector to private participation, including banks in August 2000 has been able to instill an element of competition which would in turn promote efficiency and professionalism and enhance consumer choice through product innovation.

The Insurance Regulatory and Development Authority (IRDA) is vested with the power to regulate and develop the insurance and re-insurance business. The IRDA has prescribed stringent licensing criteria and solvency margins, with guidelines for investment of the larger part of resources in Government securities and other approved investments (including infrastructure) and exposure norms for other investments. The liberalisation of the insurance sector impacts the functioning of the financial system through the inter-linkages with the existing financial institutions and financial products. However, a critical issue to be addressed is increasing the insurance penetration to make it comparable to the other emerging market economies, including enhanced coverage of the rural sector.

Banking System

An area of concern which impacts on investment is the relatively high interest rate structure that prevails in the country. Interest rates are no doubt related to inflation in a trend sense but this relationship is primarily with respect to the rates received by the savers. With a decrease in inflationary expectations in the economy the nominal deposit rates should be amenable to reduction without materially affecting the expected real returns to the savers. The Government would have to clearly signal an anti-inflationary stance in a credible manner and also the actual rate of inflation would need to be brought down to its target level and maintained there for a sufficient period of time for inflationary expectations to be adjusted downwards. A beginning has been made by reducing the interest rates on small savings schemes run by the Government as well as on bank deposits. However interest rates paid by borrowers are also dependent on the level of efficiency of the financial system. The spread between the deposit and lending rates in India is high by international standards and reflects both the constraints faced by and the relatively low level of efficiency in the financial intermediation system. Although in recent years there has been considerable liberalisation in the banking sector with tightening of prudential norms and

accounting practices which have led to an improvement in the health of the banking sector, there are some areas of concern which need to be examined.

The banking industry has a high level of non-performing assets (NPAs) to contend with. High NPAs raise the cost of bank operations and thereby the spread and efforts need to be made to bring these down. However, a balance has to be drawn between the reduction in NPAs on one hand and ensuring adequate supply of credit to the economy on the other. Excessive pressure on banks to reduce NPAs is likely to lend to a high degree of selectivity in the credit disbursement process and consequently, a reduction of the total level of credit as dictated by the growth of deposits. The rate of reduction of NPAs will therefore have to be fairly gradual keeping in mind the notional lending risks associated with the Indian economy and the speed at which debt recovery and settlement processes operate. In addition, the factors other than NPAs which affect the level of spread required for the viability of banks would need to be considered in the context of national priorities and policy objectives. To achieve this, action has to be taken on strengthening and professionalising the internal control and review procedures of banks and financial institutions with a view to ensuring autonomy with accountability. Also the process of judicial review and implementation of debt recovery processes and decisions need to be given further impetus and the role of the States is critical in this regard. In this context, the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002 will go a long way in allowing the banks to take control of the assets of willful defaulters without going through cumbersome and time-consuming litigation.

The ability of the banks to increase their loan portfolio is not only determined by a growth in their deposits, but also by the need to conform with prudential norms relating to capital adequacy. Once a bank has reached a level of advances commensurate with the capital adequacy norms, any increase in loan assets has to be preceded by a proportionate increase in capital. This can

be achieved either by tapping the market or by the Government providing the capital in case of public sector banks. It was earlier difficult for public sector banks to raise fresh equity from the market unless the Government subscribed to the issue in order to maintain its majority share. This was limiting the options for some banks to enter the market. With the Government's decision to bring down its stake in banks to 33 per cent, this immediate bottleneck will be removed. The Government is also seized with the need to find remedial measures to improve the health of weak banks, which have poor bottom lines and high costs, principally staff costs. The Government has recapitalised some of the weak banks and restructuring exercises have been undertaken to bring about a turnaround in their health.

Another point of policy intervention by the Government in the operation of the banking system has been the statutory liquidity ratio (SLR) through which banks are compelled to hold Government and public sector securities. The negative effects of SLR have been mitigated to a considerable extent in recent years both by progressive reduction in SLR rates and by having market determined rates of interest on public debt instead of rates prescribed by Government. However in the absence of an active debt market in Government securities, the SLR is characterised by a certain degree of illiquidity with the banks and an interest rate on public debt, which is not determined in a truly competitive market. On the whole, however, the SLR is desirable both as a prudential measure and in view of the need to generate debt resources for the Government.

Priority sector lending by banks in another area, which needs examination. The role that priority sector lending has played in making credit available to sectors which are of national importance in terms of their effects on employment and poverty alleviation, such as agriculture and small scale industries which have strong externalities, cannot be over emphasised. However there is a case for reviewing the system of directed lending in so far as development of specialised

institutions not only on a sectoral basis but also on a regional basis is concerned. In this context, institutions such as NABARD, SIDBI, Local Area Banks (LABs) Regional Rural Banks (RRBs) and cooperative financial institutions need to be strengthened and professionalised and linkages between themselves and with the commercial banking sector established on a firmer and more formal footing. The institutional structure of branch networks which are critical for effective implementation of priority sector lending should, however, not be diluted even with greater autonomy and private participation in public sector banks. Micro-credit, which has been a focus in India and has proved successful in social sector lending needs to be pursued much more vigorously.

The advent of liberalisation and greater integration of the financial architecture globally, major challenges face the financial sector and it is critical that the necessary skills are acquired and upgraded to meet the new demands. Globalisation has brought about fierce competitive pressures on Indian banks from international banks. In order to compete with the new entrants effectively, Indian commercial banks need to possess matching financial muscle, and size has therefore assumed criticality. However in the days of 'virtual' banking, the size of a bank measured by its branch network may not be as important as the size of its balance sheet. Indian banks would therefore have to acquire a competitive size. Mergers and acquisitions route provides a quick step forward in this direction offering opportunities to share synergies and reduce the cost of product development and delivery. There are however legal and social constraints to these moves at present but it is possible that market compulsions will soon force their removal. A beginning has already been made in the area of private sector banking.

There has been a paradigm shift in Indian banking with the absorption of the latest technology and the need to meet the client's expectations in a customised manner. However, the race for customers could lead to adverse selection. To succeed in the changed environment, banks would need highly

efficient assets and liabilities management systems to take care of the need to identify, anticipate, manage and mitigate risks which are known today as well as those which may appear in relation to the products of the future. Growing disintermediation and competition will also put pressure on bank spreads and even fee based and service generated incomes will come under pressure. The way out seems to be compensation through higher turnover without compromising on asset quality, as well as product innovation, which would include relationship banking to a significant degree.

A very important challenge before Indian banking will be to manage the different segments of the economy. Banking services have to be delivered in keeping with the different levels of economic prosperity enjoyed by the population in rural, semi-urban, urban and metropolitan areas, and their relative needs. Providing high technology driven banking in the metros on the one hand to ensuring availability of basic banking services in the rural areas on the other, form the two ends of the spectrum and banks need to manage both equally competently.

Issues in Integration

At present the structure of the financial sector is such that while the different sub-sectors are highly stratified within the sub-sectors, particularly those which do not any more belong to the State sector, there is a high proliferation of constituents of varying levels of size and efficiency. These sub-sectors are commercial banking, investment banking, development banking, asset management, securities trading and distribution, insurance and NBFCs. The current trend worldwide and the present debate within the country, suggests that the end of stratification between sectors and consolidation within sub-sectors would be inevitable. Deregulation of the sector and the lowering of entry barriers would speed up this process. Unification in the shape of cross-over between banking and insurance and the emergence of bancassurance has begun and

shades of universal banking are already evident and the larger of the constituents are expected to adopt this strategy. However regional and niche players will continue to be relevant.

The wide area covered by the financial sector in terms of an array of products and geographical reach makes regulation critical and both institutional regulation and self-regulation assume importance. The regulatory system today is far more conscious and better equipped, institutionally and legally, to demand and enforce necessary disclosures and compliance with laid norms for protection of the users of the system as well as the credibility and efficacy of the system itself. The aim would be to achieve international standards in this area within the shortest possible time frame.

An area, which requires considerable streamlining is the lack of free flow of information within the financial system regarding the credit worthiness of borrowers and solvency of institutions. The high level of NPAs can in some measure be traced to this lacuna. Unless information sharing and early warning systems are instituted, the dangers to the financial system will get multiplied as the level of complexity of financial transactions in the economy increases. The institutionalisation of such an information system has been recognized as a high priority area requiring legislative action to make it credible. The setting up of the Credit Information Bureau is a beginning in this process.

In the field of technology based banking, information technology and electronic funds transfer system have emerged as the twin pillars of modern banking development. Products offered by banks have moved way beyond conventional banking and access to these services have become round the clock . This, indeed, is a revolution in Indian banking but some systemic changes are urgently required. Cyber laws and other procedures which are commensurate with modern technology based banking have to be put in place

immediately and sufficient regulatory mechanism has to be instituted so that the fast strides in banking automation does not go on undesirable lines.

Corporate governance in banks and financial institutions has assumed great importance in India and there is still some ground to cover to making all banking institutions safe, sound and efficient. It is necessary that institutions, which form a part of the financial system, have internal management, governance and accountability structures, which measure up to the highest standards. Some of the issues, which need to be debated are those of compatibility of corporate governance with public ownership of banks and making the system accountable to economic institutions and regulators. It is also imperative that there is complete alignment between the goals of the management of the banks and the goals of shareholders.

The various steps taken by the Government to meet the challenges of a complex financial architecture have ensured that a new face of the Indian financial sector is emerging to culminate into a strong, transparent and resilient system. The situation however is quite dynamic and there would be changes, which we are unable to anticipate now. It is clear, however, that the financial sector players of the future will emerge larger in size, technologically better equipped and stronger in capital base. The regulatory as well as the self-regulatory mechanisms will match up to the best worldwide thereby ensuring that the health of the Indian financial system is not only preserved but improved upon and its ability to withstand shocks, which are inevitable with global integration, remains strong.

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