Bank Economists' Conference – 1998

The Changing Dimensions of Supervision and Regulation

(Presentation by S.P.Talwar, Deputy Governor, Reserve Bank of India)

It is indeed a great pleasure and honour for me, as a Central banker, to be in the midst of practising bankers and economists today.

2. Traditionally, the underlying theme of discussions of any meetings of economists used to centre around core economic or monetary policy issues. However, in the context of the South East Asian financial crisis, the importance of an effective framework for regulation and supervision of banks and financial institutions has become a crucial element in any discussion on financial stability. This is more so because in an integrated world economy, banking crisis in one country can have its contagion effect even on well developed banking systems as had happened recently to Japan. This has resulted in monetary policy issues giving precedence to the more core issues relating to strengthening of the financial systems. Central banks around the world have therefore, started working towards strengthening prudential norms and enforcing transparency in financial reporting and accountability on the part of decision makers in financial institutions to avert any future international financial crisis.

3. After international banking crises involving many countries, it has been recognised that effective regulation and supervision by the central bank of the country is crucial for promoting a sound and strong banking system. The regulatory and supervisory framework for banks and other institutions in India have also undergone significant changes keeping in pace with the reforms introduced in the financial sector.

4. **Regulatory framework for banks**

The focus of the statutory regulation of commercial banks till the early 1990s was mainly on licensing of banks, branch licensing, administration of minimum capital requirements, pricing of banking services, reserves and liquid asset requirements, and solvency issues.

4.1 *Prudential Norms:*

I may state that after evolution of BIS prudential norms in 1988, RBI has taken a series of measures to realign its supervisory and regulatory standards almost on par with the international best practices. While adapting the international norms, one needs to take into account the socio-economic conditions of the country. The prudential norms have been introduced in India in a phased manner, taking into account the business practices, payment systems prevalent in the country and the predominantly agrarian nature of the economy. As this august audience will observe, the recent measures introduced in the Mid Term Review of the Monetary and Credit Policy for 1998-99, such as,

- enhancing the CRAR to 9% which is to be achieved by all banks by 31 March 2000,
- prescribing provisioning requirements even on Government guaranteed advances,
- risk weight on Govt. securities to take care of the market risk,
- provisioning norms for standard assets and shortening the period for categorisation of NPAs, and
- improvements in disclosure standards in line with the international best practices are being introduced gradually, over a period of time.

4.2 *Valuation of investment portfolio*

The prudential norm of marking the entire investment portfolio of banks to market is also being achieved in a phased manner. The proportion of permanent category of investments has been brought down from a high of 70% in 1992-93 to 30% for the year ended 1998-99 and the intention to mark 100 per cent of banks' current investments to market over the next 3 years has been announced. It is worth mentioning that the banks on their own have prudentially utilised the excess available depreciation provisions to mark to market a higher proportion of their securities than that prescribed by RBI.

4.3 *Autonomy*

With the deregulation of interest rates, banks have the freedom in pricing their services. The Government of India has also accorded autonomy status to 14 out of the 27 public sector banks (in the matter of recruitment, promotion, creation of posts, etc.) which have fulfilled the criteria of minimum owned funds of Rs.100 crore, positive net profits for the last three years, capital adequacy ratio of more than 8%, and net NPA level below 9 per cent of the net advances. As a conscious follow-up to these measures, the Reserve Bank has delegated more powers to the Boards of banks in the areas of opening/closing of branches, hiring/renting of premises and other matters incidental thereto, payment of donations, management fees to the Directors of private sector banks, etc. It is the expectation of the Reserve Bank that the Boards will exercise their powers more diligently in the best interests of the depositors of the bank.

5. **Supervision of banks and other institutions**

The thrust of supervisory framework for banks in India till the setting up of the Board for Financial Supervision (BFS) in 1994 was mainly on the solvency of banking institutions. The central bank's supervision over all India development financial institutions was confined to monitoring through financial reporting. Similarly, NBFCs were supervised with the limited intent of verification of their compliance with RBI Directions for deposit acceptance.

5.1 The entire supervisory mechanism has been realigned since 1994 under BFS directions to suit the demanding needs of a strong and stable financial system. The supervisory jurisdiction of RBI now extends to the entire financial system barring the Capital market institutions and the insurance sector. Supervisory system is always now on its toes and timely and appropriate measures are taken to ensure that the serious weaknesses of one bank or NBFC does not degenerate into a systemic risk.

The supervisory intervention is normally triggered by the deterioration in the level of capital adequacy, NPAs, credit concentration, lower earnings, and larger incidence of frauds which reflect the quality of control.

5.2 The periodical on-site inspections as also the targeted appraisals by the Reserve Bank are now supplemented by off-site surveillance which particularly focuses on risk profile of a bank, its capital adequacy, asset quality including credit and investment, level of NPAs, credit concentration and group exposures, connected lendings, management changes, etc. A process of rating of banks on the basis of CAMELS in respect of Indian banks and CACS (Capital, Asset Quality, Compliance and Systems and Control) in respect of foreign banks has been put in place from the current year's cycle of inspections. Though the rating will remain confidential, it will be communicated strictly for the eyes of the Board of directors so that the bank will know where it stands in the assessment of the Reserve Bank in regard to its financial strength and methods of operation. I earnestly hope that the banks will strive hard to remedy the weaknesses conveyed in the RBI Inspection Reports and to improve upon their earlier ratings till they reach the best supervisory rating and maintain the status thereafter.

5.3 *External Audit*

External auditors of banks play an increasingly vital role in the maintenance of overall soundness of banks. External audit has emerged as an important tool of supervision of banks. Over the period, the responsibilities of auditors have been delineated not only to make the system of audit more detailed but also to make them accountable. The RBI's role in the selection of auditors and in defining the responsibilities cast on the statutory auditors, branch auditors and concurrent auditors is to ensure that the transparency and accountability practised by bank's management is backed by scrutiny by independent external auditors. The methodology and processes used to generate available data as certified by audit profession would improve the reliability of financial statements as regards their conformity with international accounting and disclosure standards.

6. **An assessment of banks' performance**

It would be appropriate at this juncture to evaluate the grounds covered by our banks so far and identify what needs to be done further to improve their financial health and to bring them on par with the best in the world.

6.1. *Profitability*

It is now commonly acknowledged that the banking sector has, as a result of the reforms, emerged strong and resilient. The public sector banks suffered losses of Rs.3,293 crore in 1992-93 and Rs.4,349 crore in 1993-94 as a result of the introduction of prudential norms. In 1994-95, the public sector banks turned the corner, with a net profit of Rs.1,116 crore. The net profits of the public sector banks have shown an increasing trend since then and for the year ended March 31, 1998, the public sector banks have posted a net profit of Rs.5027 crore. However, this should not lead to any complacency as pressures on earnings are quite visible in the current period.

6.2. *Non Performing Assets*

After the implementation of the BIS norms, the gross NPAs of public sector banks increased from about Rs.18,000 crore in 1991-92 (prior to introduction of prudential norms) to Rs.39,253 crore as at the end of March 1993 (as a result of introduction of prudential norms) and to Rs.45,652 crore as at the end of March 1998. The quantum of gross NPAs as a percentage of total advances of public sector banks declined from 23.2% in end-March, 1993 and 24.8% in end-March, 1994 to 16.02% in end-March, 1998. Provisions have been made for one-half of gross NPAs of public sector banks. The net NPAs as a percentage of net advances also declined during the period: from 10.7% in end-March, 1995 to 8.2% in end-March, 1998. As a percentage to total assets, net NPAs of public sector banks amounted to 3.3%. I may mention that the concept of gross NPAs is unique to Indian banking as compared to other countries, for Indian banks find themselves more comfortable in providing for Doubtful and Loss Assets rather than writing them off, as is the common practice in other countries.

On the banks' level, there is scope for reducing NPAs to more reasonable levels and in this context, concerted efforts need to be made for bringing down the levels of NPAs. It is high time banks evolve an appropriate strategy to manage their NPAs which should comprise:-

- a an effective and speedy approach for compromise and settlements which should be transparent;
- b initiatives for making use of the existing legal machinery for speedy recoveries through DRTs;
- c strengthening of the credit appraisal and post-disbursement supervision; and
- d tightening of the loan review mechanism.

Banks need to have a hard look at their existing credit appraisal techniques. The Credit Policy document should not be a static and one-time affair but should be responsive to dynamic changes in the system. The Credit Policy approved by their Boards, should also cover policy in regard to placement of experienced and well trained

Officers in Credit Department. Officers should be posted to Credit Department after they have put in certain minimum number of years of service and after acquiring sufficient exposure in credit appraisal techniques. Further, there should be a committee approach in sanctioning of credit at different levels right from branches to zonal office and head office. The bank's market intelligence should be well tuned and focussed. Better MIS and Credit Investigation set up in banks would go a long way in preventing the defaulters of one bank from moving to another branch or bank in the same or another geographical area.

6.3. *Loan Review Mechanism*

The bane of Indian banking system has been the high level of NPAs, some of which have been on account of certain unscrupulous borrowers being allowed a free hand to siphon off and divert the funds. The banks have to find appropriate ways and means to ensure the end-use of funds, particularly in respect of large borrowers. It is in this context that the importance of an effective loan review mechanism in banks needs to be appreciated. The banks should initiate early steps to put in place a loan review committee to independently monitor the advances sanctioned over a cut off limit, from day one on an on-going basis and monitor the weaknesses developing in the accounts for initiating corrective measures in time.

6.4. *Non-SLR investments*

Besides credit risk, another area requiring immediate attention on the asset side of the Balance Sheet, which has now emerged particularly in the context of deregulation of interest rates, is market risk. As Investments form 40 to 50% of the total assets, it is time that banks start paying equal attention to market risk attendant on their investment portfolio and more so, in regard to Non SLR Investments. Data indicate that a sizeable portion of such investments of banks is in unquoted instruments. The banks must therefore put in place appropriate policies approved by their Boards on Non SLR investments and keep a close watch over the valuation and liquidity of such investments.

6.5 *Internal control systems*

Another area that is of crucial importance is strengthening of internal control systems in banks. The Reserve Bank has, over the years, emphasised the need for having an effective internal control system in banks. The Reserve Bank has issued comprehensive instructions to banks to tone up their internal control systems and procedures. Public sector banks are now required to set up Audit Committees to follow up on the reports of the statutory auditors and inspection by RBI. Immediate action of banks is warranted on reconciliation of inter branch accounts which if left unreconciled, is fraught with grave risks. Banks should put in place a separate fast track system for reconciliation of large entries, particularly in respect of TTs/MTs, remittances etc.

7. **Certain Critical Issues** :

Any discussion on the Indian banking sector will not be complete without examination of certain crucial issues affecting the earning capability of banks. With the tightening of the prudential and capital adequacy norms, banks would need, not only increased capital requirements but higher internal accruals to meet the additional provisioning requirements. Public sector banks cannot continue to look to the Government for the additional capital contributions. The additional requirements of funds for meeting the enhanced capital adequacy ratios will have to come from banks' own internal accruals or by raising resources from the capital market. There is, therefore, greater need for increasing the internal accruals of banks. These can be further augmented by bringing about operational efficiency, efficient treasury management, paying attention to fee-based businesses, reduction in the cost of funds, control over revenue and capital expenditure and by adopting prudent risk management practices.

Banks need to further improve their interest spreads which is possible only by more efficient use of funds, competitive and efficient pricing system for their services and control over overhead costs. The ratio of wage bill to total income of the public sector banks is very high as compared to the banks in the private sector. This needs to be brought down to more reasonable levels to improve banks' profitability. Similarly, the return on assets of the public sector banks in India is low as compared to that of the banks in the private sector and foreign banks.

There is also an immediate need for establishing appropriate Risk Management Systems and Practices in banks. The Mid Term Review of the Monetary and Credit Policy for the year 1998-99 has advised banks to introduce effective risk management systems to cover credit risk, market risk, liquidity and operational risk on a priority basis. The Reserve Bank would be issuing guidelines on risk management to banks shortly.

8. **Agenda for future growth**

The South-East Asian crisis has brought to sharp focus, the importance of a strong and vibrant financial system, of which banks are an integral part. Globally, banks have moved towards consolidation by the process of mergers and acquisitions. The mergers abroad have taken place amongst some of the strongest banking institutions and the underlying motivation has been to provide synergy to the operations and exploit core competencies for optimal earning and profits.

The old private sector banks have low capital base. With the enhancement in the capital adequacy ratios, there is an urgent need for these banks to augment their capital base. One alternative is to issue fresh shares to their shareholders. If these banks are unable to enhance their capital base, it may be necessary to think in terms of mergers between the private sector banks, to start with.

8.1. *Asset Liability Management*

One of the major deficiencies in the Indian banks had been the absence of an appropriate MIS for sustaining an appropriate Asset - Liability Management system. With the liberalisation in financial markets and greater integration of domestic and external markets, the risks associated with the banks operationally have become complex and call for strategic initiatives towards their management. Banks need to put in place comprehensive framework for measuring and monitoring risks associated with liquidity, interest rates, forex etc.

In recognition of this, RBI has since circulated draft guidelines (with the final guidelines becoming operational from April 1, 1999), for a broad framework for asset-liability management taking into account the variance in the business profile of banks in the public sector and private sector as well as the data/information base available to banks in India. Seminars have been conducted for the banks in our Bankers Training College so that the initial difficulties in information compilation and installation of appropriate systems are taken care of.

8.2. *Disclosure requirements*

Another area where RBI has moved ahead, is to impart greater transparency to the balance sheets of banks. This was a logical step after the adoption of prudential norms, with the banks in India coming under greater international scrutiny.

During the last couple of years, the range and extent of disclosures has been gradually increasing so as to provide a clearer picture to informed readers of balance sheets. The banks are now required to disclose the break-up of the provisions made towards NPAs, depreciation of investments, capital adequacy ratio and the level of net non-performing assets. Additionally, with effect from 1997-98, banks are required to disclose accounting ratios relating to income heads like, operating profit, return on assets, business per employee and profit per employee.

It has also been recently decided by the Audit Sub Committee of BFS that from year ending 31st March 2000, the following information, among others, should also be disclosed in the published accounts:

- Maturity pattern of loans and advances, Investment securities, deposits & borrowings,
- Foreign currency assets and liabilities,
- Movements in NPAs & Provisions,
- Lending to sensitive sectors as defined by RBI from time to time.

Instructions will be issued by RBI on the aforesaid disclosure parameters shortly.

Summing up

While concluding, I would like to reiterate that the days of soft options are over. We have reached a stage where a hard look at some of the basic issues will have to be taken to improve banks' general capabilities and to meet the prudential requirements which are already delineated for adoption by the industry over the next 5 years in the recent Mid Term Review of the Monetary and Credit Policy.

In my view, the management strategy for future of any bank should have a three-pronged approach:

- Effective Credit Management and recovery of NPAs,
- Introduction of adequate Risk Management Systems, and
- Improving Internal Control Mechanism.

I would like to stress that the banks, particularly those in the public sector, have to respond with speed and effectiveness to certain core issues for survival like,

- Control over costs;
- Issues in regard to closure of non-viable and loss making branches and staff redeployment arising therefrom;
- Technology improvements;
- Solutions for Y2K problem by March 1999 with appropriate contingency plans;
- Preparation for meeting Euro deadlines and redesigning forex dealing systems to manage Euro risk.

Increased capital requirements, further tightening of prudential norms to bring our banks in line with international best practices, declining spreads and highly competitive environment are bound to put pressure on banks to seriously examine measures like introduction of VRS, reducing rate of interest particularly on short term deposits, closure of loss making units etc.

I expect that the Conference will earnestly address and deliberate upon these issues in great detail and length and find specific answers to these problems which as I have said, if not tackled now will over a period 4 to 5 years, gather a form which will be formidable. I am sure, the Indian banking system will rise as an effective and robust financial instrumentality to meet the challenges lying ahead in the coming times.

I thank the Organisers of the Meet for providing me an opportunity to share my feelings with the senior bankers and Participant Economists. I also would like to appreciate the excellent initiatives taken by Mr. Sridharan, Chairman of Canara Bank in organising the Meet.

I wish the Conference all Success.