# Outlook for Indian Financial Sector

## Executive Summary

A thriving and vibrant banking system requires a well developed financial structure with multiple intermediaries operating in markets with different risk profiles. There will a segregation of financial intermediation among banks, resulting in competitive efficiency, depth and resilience to the financial system.

Other types of financial intermediaries will complement banks and act as counter-parties, in syndications and co-financing strategies, as also in the sharing of risk. Markets will acquire greater depth and liquidity, especially in the money and debt segments. Rigidities in the market microstructure will be removed so that prices of financial instruments will respond flexibly to different phases of the business cycle. The spectrum of financial institutions will bring about financial deepening and broad based intermediation, encouraging financial saving in the community.

While the direction in which reforms will be carried forward is reasonably clear, the pace of reforms will be uncertain. This stems from the need to balance the many diverse opinions on the role of Government in development and the role of public policy.

# 1 Introduction

India's Financial Sector Reforms can be characterised as slow, careful steps and avoidance of "shock therapy". The reforms have focussed on five areas key to the financial sector:

1) Money, capital and debt markets
2) Financial Intermediaries (banks, NBFCs, DFIs, Insurance etc)
3) Supervisory, regulatory systems for reducing systemic risk
4) Decoupling the monetary from fiscal policy by deregulating interest rates, scaling down of interest rate subsidies, SLR, CRR and mandatory credit allocation
5) External sector reforms

The performance of the financial sector and the health of the economy are intertwined and this is to be taken into account while the outlook for financial sector is investigated. For instance, care is to be taken that as the financial sector moves forward, credit creation slowdown does not occur because of supply problems or due to rationing of credit.

I look at the financial intermediaries (primarily banks), markets, regulatory & supervisory framework, infrastructure and the evolving role of RBI to paint a picture of what the Indian financial sector might look like.

# 2 Banking Sector: The Future Landscape

The economic differences between the participants of banking sector (SCBs, UCBs, RRBs, PCARDBS, StARDBS etc) were not accentuated. This was because of external inflexibilities ('public sector nature', administered interest rates, pre-emption of bank resources, less developed markets, social responsibility) and internal inflexibilities (inefficient operations, incentive problems, govt. nominated management, hiring & firing restrictions). The DFIs were a different segment altogether.

In a practical world while intermediaries will always have overlaps, theoretically in a simple scenario they should compete in different market segments, targeting different depositors and investors, and have different risk profiles. I define such a scenario as multi-tiered.

For want of a better word, I characterise the current Banking system as pseudo multi-tiered and expect it to become multi-tiered in the true sense of the word.

### 2.1 First Tier: SCBs and DFIs- Emergence of Bundling of Services

The most fundamental issue is the question of the balance between government and free markets. It is necessary to tackle the following poser by Governor Jalan:

> "The crucial issue that the country has to debate is whether Corporate Governance is compatible with public ownership…? Could we have public ownership without Government or political control or do we need to change to a corporate structure?"

Banks in India operate with social/developmental objectives and form the backbone of rural/agriculture credit. The Government will preserve the public nature of banks. Large scale privatisation in the short-medium term will not take place. When e*quity offerings happen, they will be widely diffused*.

The factors in the development of this tier are:

1. Need for capital and emergence of shareholders
2. Operational challenges and right pricing of credit
3. Role of banks in priority sector lending, and
4. Consolidation in the industry.

#### 2.1.1 Need for Capital and Emergence of Shareholders

If the risk weighted assets of some strong banks grow in line with the economy, additional capital to the extent of Rs.10,000 crores will be needed. Currently minimum government shareholding legislation (RBI in case of SBI) gives them a headroom of Rs.1000 crores[1]. Government has drawn up the necessary legislation for lowering the minimum shareholding requirement to use market access.

With regard to weaker banks, developing countries experience shows that the government cleans up the balance sheets of banks before offering their equity. Depressed market conditions and lack of enthusiasm for weak bank stocks would impede in approaching the market. The govt will infuse capital needed due to stricter provisioning and higher CAR norms. Eventually these weak banks will also tap the market.

Banks will become answerable to shareholders. Shareholder pressure will require more freedom for banks to operate within a well regulated framework and an incentive structure that goes with a private enterprise.

### 2.1.2 Operational Challenges and emergence of Right Pricing of Credit

By January 2007 the Basel Committee intends to replace the current Capital Accord with a New Framework, built on a three-pillar approach - *minimum capital requirement*, *supervisory review* and *market.* Though non G10 countries have the freedom to customise it, India will implement it, at least for the top banks with complex operations and having a market share greater than 1% or with substantial foreign operations.

BIS proposal requires regulators to ensure that banks' capital positions are consistent with their overall risk profiles and strategies. These new norms mean that skills will have to be acquired for the development, testing and validation of internal rating and credit risk models used by the banks. Practices will have to be developed for generating accurate risk profiles. Sophisticated MIS tools, risk management systems and competences of risk appraisal and management personnel will need to be developed.

Accounting and disclosure standards will have to fall in line with the international best practices.

Apart from above and the NPA overhang, banks are increasingly facing challenges in ALM expertise, rapid integration of technology requiring huge investments, emergence of a buyers market, increased competition, rooting out inefficiencies and high growth in customer expectation. Proper addressing of these challenges, especially in risk-management, will give banks the expertise to price credit optimally in order to maximise risk adjusted returns. This will prevent large scale misallocation of funds.

### 2.1.3 Priority Sector, Infrastructure And Banks

I don't visualise priority sector lending to be done away with. It will be imperative for banks to manage credit risk in this sector. They will do so by teaming up with NGOs, SHGs and using microfinance innovations and improving the quality of their loan assets; thus improving the productivity of loans in the rural sector. If and when securitisation, takeout financing, sound debt markets dominated by public issues are in place, banks could also proceed with infrastructure financing, especially at the shorter end. Additionally banks will start playing a more active role in the market for term funds as they start compiling data on maturity gaps and interest rate gaps to be complied under ALM discipline. Difficulties in collection of data from hundreds of rural and semi-urban branches will be combated on a war footing and computerisation in these branches to facilitate data compilation progressively will occur.

### 2.1.4 Banking Sector Consolidation

These challenges and concerns of shareholders will drive banks towards *market driven consolidation* (in-market mergers and market-extension mergers) to improve the inefficient industry structure, as opposed to government led consolidation. Evidence exists that, globally, consolidation of financial institutions has been driven by shareholder value maximisation (increase in efficiencies, revenues, market power) and massive investments in technology. This scenario is likely to repeat in India.

Apart from few sporadic cases the M&A route has not yet caught the fancy of SCBs. Though there have been no over hints from the RBI and government, the general line of thinking is clear. When the RBI says that it will not even consider licensing more than 2-3 private banks till 2004, it has in mind the potential of M&A to restructure the banking sector. Simply put, when there are so many PSBs waiting to be taken over, why create new entities?

The banks will also start focussing on generating more fees based income and concentrating on retail & consumer banking, giving a boost to more diversified financial intermediation, which started in the 80's when banks were allowed to undertake leasing, investment banking, mutual funds, factoring, hire-purchase activities through separate subsidiaries. This will give rise to *Financial Conglomerisation* and bundling of financial services. DFIs have already been allowed to set up banking subsidiaries, enter the insurance business along with banks and are allowed to undertake working capital financing and to raise short-term funds within limits. Through a viable transition path, the DFIs will become universal banks.

### 2.1.5 Caution

By definition, an in-market merger will necessitate closing of branches and reduction of workforce for reduction in costs, requiring a paradigm shift in the public policy towards banks. For instance, public sector banks have a large number of branches in backward areas and hence it may not be feasible in a socio-economic sense to permit closure or sale of these branches, whenever a merger takes place. If 20 per cent of branches of public sector banks account for 80 per cent of business and if the only objective is profitability and shareholder wealth maximisation, will they close the 80 per cent?

Far reaching radical changes in the organisation and management of banks (incentives based flexible wages, good governance, transparency, concern for shareholders etc) will be required.

These admittedly are a tall order. As and when market forces take over, they should lead to the emergence of a socially responsible, efficient and a profitable banking industry at SCB level, which I call the first tier.

**2.2 Second Tier**

The second tier of banks will comprise of the UCBs, StCBs, DCBs, local area banks with not much retail reach. They will be excluded from the purview of Basel New Accord. As these banks get pushed out of the top end of the market by the first tier banks, they will concentrate on lending to SMEs, not very high rated corporates, working capital lending and to local customers. They will not be present significantly in retail and consumer banking (like credit cards). They will slowly and steadily build expertise in SME, low rated companies, rural and agricultural financing.

At some point in time, regulations might permit the first tier banks to complete their priority sector lending through these banks. However this will take place if and only if the second tier banks have significant number of branches in the rural areas. Currently, the branches of deposit taking institution per capita is very low in India and this ratio needs significant improvement.

**2.3 Third Tier**

This third tier will include RRBs, StARDBs and PCARDBs, rural based NGOs and microfinance organisations. This tier will cater exclusively to the rural and agricultural sector. This sector will see many micro finance innovations to rein in the NPA problems and to improve credit risk.

## 3 Supervision/Regulation/Governance

As the banking crises in many developed and emerging countries have demonstrated, a free-market based banking system seldom works without an efficient supervision and regulatory framework. Progressive strengthening, deepening and refinement of the regulatory and supervisory system for the financial sector have been important elements of financial sector reforms. Further progress will play a crucial role in establishing incentives and transparency required for shareholder wealth maximisation and financial stability.

Financial sector supervision will become increasingly risk-based and concerned with validating systems rather than setting them. The emphasis will be on evaluating the quality of risk management and the adequacy of risk containment. Credibility assigned by markets to risk disclosures will hold only if they are validated by supervisors. Supervision will be critical in the effectiveness of capital requirements and market discipline.

We will see rapid strides in the areas of consolidated supervision, country and transfer risk monitoring, inter-agency co-operation and cross-border supervision.

## 4 Market Development: Increasing Financial Disintermediation

There have been impressive developments in the repo, call, debt and stock markets. The development of a corporate debt market is important. Due to underdeveloped pension arrangements a major source of potential capital market activity is absent. The insurance sector will provide liquidity to these debt markets. For pricing of loans to be market-based, development of Government securities market is crucial since all the rates in the rest of the markets are priced off the zero-risk yield curve.

Issues like an development of an auction calendar; lack of trading structure suitable for direct access by potential participants; lack of arbitrage between separated wholesale and retail government bond market segments leading to reduced quality of prices in the retail market will have to be addressed.

More importantly, there is a perception that as long as RBI has leverage in adjusting quantities to set rates, either through change in notified amount or by accepting a devolvement, a market-related rate is difficult to achieve.

Significant pricing errors exist when Government bonds are priced using the term structure alone[2]. Residual maturity, time since issuance, current yield and issue size are security-specific attributes that account for most of pricing discrepancies. Setting up of an independent public debt office function will be imminent and RBI is moving towards it.

The issue of fragmentation of outstanding govt securities also exists. Since 1999, RBI has been following a policy of passive consolidation of loans through re-issuance and re-opening of existing issues.

Bond markets, by their very nature, are OTC. Even developed countries like Germany and US, have entirely negotiated markets and have minimal retail activity. Encouraging retail participation will have to be done by setting up exchanges, improving post trade transparency and arbitrage.

Only the US has a well developed market for high yield corporate bonds. In India, only AAA rated companies have been successful in tapping the bond market[3]. As financial intermediaries learn to price credit suitably, even low rated companies should be able to tap the market.

Structured partial credit guarantee deals (e.g. IFC and Ballarpur Industries) raise the credit rating of the issuer company . Its emergence will provide a momentum to non AAA companies to tap the bond market, thus deepening it.

## 5 Role of RBI and Decoupling of monetary and fiscal policies

With support of government, RBI is contemplating separation of its roles of debt manager, supervisor/regulator, owner and formulator of monetary policy. It is shifting towards using indirect signals for monetary policy, by building a strong money market. Measures like LAF, WMA, pure inter-bank call money market, strong repo market all point to this. India will find that external sector linkages will remove the ability to pursue economic policies that are not consistent with those of the other major economies. RBI will have to adopt a longer-term approach towards monetary policy. This will be achieved by a publication of a stable outline policy which will be "tweaked" to affect short-term circumstances.

The monetary policy will be increasingly decoupled from fiscal policy. This could give rise to a conflict in the RBI objectives of price stability and credit availability.

## 6 Conclusion

The policy of adopting free market models after customising them to the Indian conditions has paid rich dividends till date. Now there is an urgency to give legitimacy to international pressures brought about by financial global integration and more linkages to the external sector. The sheer size, structural problems, legacies, complexity and multi-faceted nature of India make this urgency necessarily more fraught with uncertainties and possibly more divisive internally. This dilemma can be summed up by a poem by Lady Sarashina, who lived in early 11th century Japan :

Cross it, trouble lies ahead,

Do not cross, and you are still trouble-bound

Truly a troublous place

Is the Ford of Shikasuga

## Notes:

[1] Finance and Development – Which Way Now? by Bimal Jalan at the Administrative Staff College of India, Hyderabad

[2] G. Darbha and S. Dutta Roy (2001), "Is There an Independent Yield Curve? Evidence from the T-Bill Market"
G. Darbha, S. Dutta Roy and V. Pawaskar (2000), "Term Structure of Interest Rates in India: Issues in Estimation and Pricing"

[3]Developing Bond Markets in Emerging Economies : Issues and Indian Experience by Dr. Y.V. Reddy at the Asian Conference on March 11, 2002

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2. www.rbi.org.in
3. www.adb.org
4. www.bis.org
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7. Ajay Shah and Susan Thomas (Various articles)