INDIAN BANKING IN INTERNATIONAL PERSPECTIVE

Dr. Y. V. REDDY

2002

Published by
THE A.D. SHROFF MEMORIAL TRUST
Peninsula House, 235, Dr. D. N. Road,
Mumbai-400 001.

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OBJECTIVES

(i) Publication of one or more books in English, Hindi and regional languages annually on some of the great builders of Indian economy aimed primarily at educating the younger generation in high standards of building the national economy as practised by those great entrepreneurs and placing the example of their lives for emulation by India's youth.

(ii) Organising one or more public lectures annually on subjects, which were of interest to the late Mr. A. D. Shroff, namely, banking, insurance, and industrial finance, the subject to be chosen in rotation, and the lectures to be delivered by persons eminent in these fields.

(iii) Awarding annual scholarship or scholarships to outstanding student or students in the field of management.

(iv) Instituting a prize to be known as The A. D. Shroff Memorial Prize for the student standing first in Banking at the Sydenham College of Commerce and Economics, Mumbai.

(v) Doing all such acts, matters and things as are incidental or conducive to the attainment of the above aims or objects or any one or more of them, and

(vi) Without prejudice to the above charitable objects or any of them, the TRUSTEES shall have the power to spend, utilise and apply the net income and profits of the TRUST FUND for the TRUST FUND for the charitable object of education or such other objects of general public utility not invoiving the carrying on of any activity for profit as the Trustees may think proper. It being the intention of the SETTLOR that the income and/or corpus of the Trust Fund shall be utilised for all or any of the aforesaid charitable objects without any distinction as to caste, creed, or religion.

A. D. Shroff
(1899-1965)

A. D. Shroff's achievements in the field of business, industry and finance were many and varied. A large number of enterprises owe their origin and development to him. As an economist, his predictions have proved right over the years. Through the Forum of Free Enterprise, which he founded in 1956, as a non-political, educative organisation, he sought to educate the public on economic affairs. It was his firm conviction that a well-informed citizenry is the foundation of an enduring democracy.

George Woods, former President of the World Bank, paid the following tributes to A.D. Shroff :

"In every age and in every society men must express anew their faith in the infinite possibilities of the human individual when he has freedom to develop his creative talents. For this is in large part how the message of freedom is passed from generation to generation. A. D. Shroff spoke eloquently in a great tradition, and thanks to him we can be sure that other great men of India will continue to speak this message in the unknown context of our future problems."

Published by M. R. Shroff, Managing Trustee, on behalf of the A. D. Shroff Memorial Trust, 235 Dr. D. N. Road, Mumbai 400 001, and printed by India Printing Works, 42 G. D. Ambekar Marg, Wadala, Mumbai – 400 031.

ACKNOWLEDGEMENT

The Trust is grateful to Bank of India and particularly its Chairman & Managing Director, Mr. K. V. Krishnamurthy, for their kind gesture in sponsoring the Annual Public Lecture delivered by Dr. Y. V. Reddy and subsequently publication of this booklet for public education.

The A. D. Shroff Memorial Trust

INTRODUCTION

The A.D. Shroff Memorial Trust was set up in 1966 in honour of the late A. D. Shroff who made a remarkable contribution to public life in India, particularly in the field of Banking, Insurance and Finance. As a tribute to his memory the Trust arranges Annual Lectures on subjects in which he was deeply involved.

This year's Lecture was on Banking delivered by Dr. Y. V. Reddy, Executive Director, International Monetary Fund, and ex-Deputy Governor of Reserve Bank of India. The theme selected by Dr. Reddy was "Indian Banking in International Perspective."

Dr. Reddy is yet another addition to the galaxy of eminent speakers the Trust has invited over the years to deliver these Lectures. Apart from his vast experience as Finance Secretary of the Government of India and Deputy Governor of Reserve Bank of India for over six years, he is an erudite and prolific writer. He has contributed numerous articles on different facets of monetary and credit policies and has played a notable part in the management of India's foreign exchange reserves.

It is very noteworthy here to briefly recount Mr. Shroff's contribution in the field of Banking. Mr. Shroff had been seriously considered for the post of First Indian Deputy Governor of the Reserve Bank of India in 1936, but was rejected because he had aroused the ire of Sir James Grigg, Finance Member of the Viceroy's Executive Council, who felt he had strong nationalist liens. He made a remarkable contribution as a non-official delegate to the Bretton Woods Conference where he very successfully handled the issue of India's Sterling Balances. He was appointed Chairman of the Reserve Bank of India Committee on Finance for the Private Sector which made far reaching recommendations, some of the notable being the formation of Industrial Development and Finance Corporations and Unit Trusts for accelerating industrial growth. Mr. Shroff particularly played a significant role in the formation of ICICI Ltd.

The text of Dr. Reddy's Lecture is being published to give it wide circulation amongst scholars and students of the subject, and I am sure it will make refreshing reading. It is most appropriate that the Lecture and this little booklet should have both been sponsored by Bank of India, of which the late A. D. Shroff was Chairman for several years, before he passed away in 1965. We are grateful to Bank of India for their generous gesture, and particularly to its Chairman and Managing Director, Mr. K. V. Krishnamurthy.

Mumbai,
31st October, 2002

Minoo R. Shroff
Managing Trustee
The A. D. Shroff Memorial Trust

INDIAN BANKING IN INTERNATIONAL PERSPECTIVE

Dr. Y. V. REDDY*

I am grateful to the organizers for giving me the honour and privilege of delivering this year's A.D. Shroff Annual Public Lecture. I accepted the invitation primarily because my generation, in its early years, was witness to and a beneficiary of the intense debate generated by the Forum of Free Enterprise, founded by Mr. Shroff. As students, we were privileged to hear the free-enterprise ideas propounded by Mr. Shroff in contrast with the socialism-oriented declaration of official policy. The spirit of speaking freely, so eloquently advocated and practiced by Mr. Shroff, left an indelible memory on us. There is no need to speak about Mr. Shroff's life and achievements as these are well documented, *inter alia*, in the volumes of the history of the Reserve Bank of India (RBI), of the International Monetary Fund (IMF), of The World Bank etc. For a concise reading, there is the pamphlet by Mr. Minoo R. Shroff titled "A.D. Shroff: The Liberal and the Man" while for a more comprehensive and insightful account one could refer to Ms. Sucheta Dalal's book "A.D. Shroff: Titan of Finance and Free Enterprise".

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* The author is presently Executive Director, International Monetary Fund and is a former Deputy Governor of the Reserve Bank of India. The text is based upon the Annual Public Lecture delivered under the auspices of the A. D. Shroff Memorial Trust on 25th October 2002 in Mumbai. The lecture was sponsored by Bank of India.

Let me, however, narrate three interesting episodes relevant to the context of today's lecture. First, at one stage during the negotiations relating to initial Quotas of International Monetary Fund, the Indian delegation had to seriously contemplate withdrawing from the deliberations, in view of the low level of Quotas being proposed for India. In this matter, Mr. A.D. Shroff, along with Sir R.K. Shanmukham Chetty provided strong support. Second, the name "International Bank for Reconstruction and Development" (IBRD) for what has come to be known as World Bank in popular parlance was first suggested to the drafting committee by the Indian delegation, of which Mr. A.D. Shroff was a member – along with Mr. B.K. Madan, who was later India's Executive Director in the IMF. Third, Mr. A.D. Shroff was one of the leading architects of the Bombay Plan, truly a national endeavour of great vision. I thought these three issues are worth recalling to emphasize that devotion to national upliftment and prosperity has to go hand in hand with an international perspective and active participation in multilateral bodies. The subject, "Indian Banking in International Perspective", is thus in consonance with the intellectual inclinations of Mr. Shroff.

Indian Banking: A retrospect

The Annual Public Lecture arranged by the A. D. Shroff Memorial Trust covers, by rotation Banking, Insurance and Industrial Finance. This is in the fitness of things, in view of late A. D. Shroff's significant contribution in each of these areas. An illuminating way of obtaining a retrospect on Indian Banking would be to trace the main messages of the memorial lectures on Banking since their inception in l967. The first lecture in the series, which incidentally was on banking, was delivered by Mr. H.V.R. Iengar and was titled "The Role of Central Banking Authority and Commercial Banks in a Planned Economy". Incidentally, Mr. Iengar delivered the lecture after he had demitted office of Governor of RBI, while I am delivering this lecture after having left RBI. I would urge the Trust to continue this tradition of preferring retirees to give Annual Public Lectures, since they can combine insight with some element of detachment!

In the inaugural lecture, Mr. Iengar mentioned that "the first preoccupation of the Bank (RBI), was to see that the public have confidence in the banking system"(p.11). He narrated the stern actions taken by RBI after the mushrooming of institutions in the course of World War II "to get rid of these institutions and to see that the banks that remained after this operation were sound and run in such a manner that the public felt secure about their deposits." And he added, "this has been a major task and has taken several years. I do not know that it has yet been done, but I believe that the bulk of the job has been carried out". Secondly, he addressed the issues of flow of credit and lamented at the inadequate flow to small scale and unorganized sectors. He expressed his concern at the failure of cooperative movement and added "it is necessary frankly to point out that the responsibility lies to a very large extent in the hands of non-officials, including politicians." (p.18). Commenting on the proposals for nationalization of commercial banks he observed, that "without going into other arguments many of which are quite valid, such as the degree of control vested in the Reserve Bank, but sticking for the moment to the pure and simple matter of administrative competence, I regret to say that not only do I not see any possibility of improvement as a result of nationalization, but I foresee the intrusion of politics into a field in which politics ought to have no place." (p.18/19). The interesting point he alluded to related to the issue of control vested in RBI in the context of nationalization. The major concerns expressed in 1967, viz., public confidence in banking, restructuring of banks, flow of credit to small and unorganized sectors, government ownership including its relationship with regulation, and weaknesses in cooperative movement are found to be valid even today.

The second lecture by Mr. B.N. Adarkar, who was also at one time Executive Director at the IMF, was delivered in 1971 and was appropriately on "Commercial Banks in India after Nationalization". Having stated that "bank nationalization was a historic event associated with a political crisis" (p.2), he added that "structurally the banking system in India has gained distinctly in strength and cohesion after nationalization."(p.3). He insisted that the return on investment would continue to be an important yardstick for measuring the performance of banks and financial discipline was the essence of banking. The enormity of the tasks before the commercial banks, and difficulties arising, *inter alia,* from staff relations were reflected while pleading for "a better understanding on the part of the public of the need for credit restraint and credit discipline." It is again interesting to note that the political economy dimensions, the need for financial discipline and the enormity of the tasks mentioned appear to be relevant even now.

Mr. R.K. Talwar, a legendary figure in the post-independent banking community and himself a practicing banker, delivered the next lecture titled "Banker and Corporate

Customer" in I974. His major focus was on greater involvement of the banker in the customers' operations and he advocated no exception for the joint or the public sector as part of what has been described by him as "enlightened proximity". As it turned out, close involvement did take place over the years, but perhaps selectively with questionable benefits to both the banks and the customers. Consequently, reform-process in the recent years provides greater choice and freedom to banks and customers rather than continued proximity.

Mr. J.N. Saxena, another professional banker who also headed the Industrial Development Bank of India delivered the I977 lecture on "The Changing Profile of Indian Banking". The lecture provided ample evidence of the emergence of public sector banking on commanding heights, the innovations through Regional Rural Banks, quantitative expansion in branches, deposits, advances etc., He concluded his address by posing the problem of attitude to work and said " "Have we done anything so far to tackle this problem? I know the answer is `No'. But it is time that this matter is now given urgent attention. May be the solution may lie in the answers to improving productivity as well as quality!". (p.22). While no serious attention was given for several years, many public sector banks appear to be now addressing this issue of attitudes to work while some of the new private sector banks seem to be avoiding the problem.

The lecture by the then Exim-Bank Chairman, Mr. R.C. Shah in I983 on "Internationalization of Indian Business-Role of Financial Institutions", was the first sign of outward looking policy initially attempted in the I980's. A part of the address was devoted to Indian banks abroad. Noting that the Indian banks have offices mostly in developed countries with significant business opportunities provided by ethnic groups, he made extensive comments on the working of Indian banks overseas. He noted that first, unlike trans-national banks, Indian banks overseas have been very largely bypassed in the recycling process of petro dollars. Second, they had to continue addressing retail business in host countries and servicing business emanating from India. Major developments in international business like merchant banking, wholesale banking, leasing, fiduciary operations, money and capital market operations, eluded Indian bank branches overseas. Third, overseas branches of Indian banks had not been a force in the promotion of Indian exports. (p.l8). It may not be far from reality to hold that the overall functioning of Indian banks overseas has remained well behind their counterparts and thus the weaknesses remain largely unattended.

Mr. N.N. Pai's lecture on "Commercial Banks in India – A Performance Review", as the title indicated, gave a detailed and factual account of priority sector lending, especially credit to agriculture and small industry, impressive branch expansion, the functioning of credit policy which remained restrictive particularly during the decade of l970s, and of Credit Authorization Scheme, etc. He, however, identified the significant fallout of the expansion and advent of social banking, namely deterioration in quality of customer service, of lending, poor follow up on lending, and the daunting issues relating to human resources development. In the light of these issues, Mr. Pai made several suggestions relating to banking operations.

The attention of the nation thus shifted to qualitative aspects of banking and Mr. N. Vaghul's lecture in 1989 was appropriately titled "Quality in Banking". To enhance quality in banking, attention to quality of assets and public disclosure of bad loans with clear definition of non-performing assets was advocated, while at the same time attending to customer service and house keeping – mainly by enhancing systems and technology. The message was to replace the obsession with numbers by obsession "in favour of quality – reverence to a new trinity of gods or goddesses, knowledge, welfare and quality". (p.19).

As one of the architects behind the financial sector reforms since 1991, Mr. M. Narasimham in the Lecture in 1993 focused on what he described as "Financial Sector Reforms: The Unfinished Agenda". The lecture presented very wide sweep of the logic of reform, the need to pursue with it inspite of the "Scam" and noted several measures already taken to implement reforms, especially in regard to policy-environment. The unfinished agenda referred to, among others, constituting of an Asset Reconstruction Fund, limiting of priority sector lending, deregulation of interest-rates, improving internal organization and methods of banks, providing greater operational flexibility and internal autonomy to banks, instituting greater degree of professionalism. Some concern was also expressed on the design of supervisory arrangements over banks while emphasizing the role of RBI. "Financial sector reform would not be complete without restoring to the Reserve Bank its rightful pre-eminence and giving it full operational autonomy and control over the financial system." (p.17)

Finally my distinguished predecessor in RBI and respected economist Mr. Tarapore gave the last lecture on "India's

External Sector – Agenda for reforms". As is well known, a Committee under his chairmanship emphasized the importance of reform in the financial sector, particularly in the banking sector, as a precondition to significant liberalisation of capital account in external sector. Subsequent events in East Asia have demonstrated the prophetic nature of the Committee's Report. In this lecture, he elaborated, in a sense, the unfinished agenda in reform of external sector; and on the pace he said, "While serious observers all do point to the need for caution in the process of liberalisation it is essential that we in India appreciate that caution on proper sequencing of reform is not an advocacy of total paralysis and a do-nothing approach. The danger in a country like India is that the path embarked on is already extremely cautious and under the weight of the advice of international experts, of impeccable standing, we could put a total cessation to the reform process." (p.I3).

What do we make out of these reflections in retrospect? First, restoration of public confidence and restructuring with a view to consolidating the banking sector were achieved in the first two decades after independence with considerable success. Second, inspite of serious doubts, banks were nationalized and quantitative objectives in terms of expansion and penetration took place in the banking industry in the next decade. Third, the fourth decade viz. 80"s, witnessed the recognition of serious pitfalls of banking in India which has been equated with public sector banking. They included mainly qualitative issues, of assets, of service, of profitability, of supervision, of attitudes to work, of professionalism and indeed transparency. No discernible actions were taken for several years to correct these anomalies. Some mention was made of the possible role of overseas offices of banks in promoting India's exports but subsequent experience has shown that their operations were neither commercially as profitable as they should have been nor contributory to export growth. Fourth, the decade of 90s witnessed a fairly well set out agenda for financial sector reform focused on banking. In fact, unlike in most other countries, financial sector reform commenced early in the reform process in India. Even though the agenda was clear cut and many impressive reforms were carried out, there has been acute consciousness of the unfinished agenda. Fifth, while inviting attention to the slow pace of reform in some respects and the need to position the financial sector in the overall reform process, especially the real sector, the external orientation of the economy and its link with the state of financial sector reform were clearly recognized. Finally, it appears to me that the logical next step in viewing the reform process, now in 2002, is to take the deliberations forward to the issue of financial sector, in particular banking, in an international context. Banking is no longer a matter exclusively of domestic concern and in the context of evolving interest of multilateral bodies in these issues, there are dangers in ignoring the international dimension of banking while embarking on liberalisation, especially by opening up the economy. Indeed, our banking can not afford to lag behind international standards nor remain unaffected by global developments in banking.

Why International Perspective Now?

There are several reasons why policy regulations, human resource, technology and operating environment for banking in India have to focus on an international perspective at this stage. The assured future of the Indian banking industry can be secured only by bringing both the attitudes and actions to match the emerging global needs. Broadly speaking, there are three sets of reasons for such a perspective at this juncture viz. competition is global; concerns relating to banking are global, and the standards as well as codes governing financial sector getting to be increasingly universal even if there are some differences among countries in matters of detail given the stage of evolution in each country.

Competition in most, if not all economic activities is no longer confined to nations and is getting to be more and more global. First, presence of foreign banks, either as branches or even subsidiaries will grow, at least in accordance with our own commitments to the World Trade Organisation (WTO). Second, recent experience has shown that foreign-owned non-banking financial companies in India do compete both for deposits mobilization and asset-creation, mainly through investments. Third, even in regard to cross-border payments, organizations such as Western Union and other Money-Changers who are licensed by RBI, are spreading their reach. Fourth, as multi-nationals expand their operations in India, they could justifiably continue their banking ties of the home country, even if the range and quality of service of Indian banks are equally good. Fifth, many Indian companies are tending to become multi-nationals and they legitimately expect banking services to be on par with best international standards. Sixth, as disinvestment progresses, the link between large business units and public sector banks could get diluted unless their services are as competitive. In fact, even in regard to services to governments, both central and state governments, a beginning has been made by the Governments allowing privately owned banks also to undertake the business of banker to government as agents of the RBI instead of confining to Public Sector Banks. Seventh, in respect of business in activities related to financial markets, the expanding presence of foreign banks and their subsidiaries, particularly in the government securities market, is all too evident. Eighth, the business in overseas branches of Indian banks in the recent years is perhaps not growing as rapidly as their counterparts and possible threat to their continued profitability, and hence their presence should not be ignored. Finally, the relatively strong and growing presence of foreign banks, especially in the transactions of non-public sector organizations is too obvious to be missed. The business of remittances of non-resident Indians (NRIs) was largely with public sector banks as long as the transactions emanated from West Asia. With the emergence of the more enlightened metropolitan or urban centered NRIs, particularly those in the USA, and hailing from metropolitan and urban centres in India, the large business-opportunities associated with them are tending to drift towards foreign banks.

The second set of reasons relate to the public policy concerns associated with banking getting to be increasingly global. The Bank for International Settlements (BIS) was the first institution to come up with principles relating to capital-adequacy (Basel norms). Though their adoption is voluntary, events have shown that a country can only differ in details but not in regard to destination or broad direction which have to be in harmony with such principles. India is actively participating in the evolution of the Basel Accord. In fact, the BIS has been issuing several advisories as well as guidelines on wide ranging subjects, say from role of auditors or debt-markets, to corporate governance in banks and the regulators. In fact, India has joined the exclusive club of members of BIS, thanks to the initiatives of the then Governor, Dr. C. Rangarajan, RBI, and the banking industry in India can ill afford to ignore the analysis or guidelines or accords emanating from BIS. Second, the World Trade Organisation (WTO) is driving towards increasing liberalisation of the financial services. Those countries which do not have competitive strength could and in fact do resist such liberalisation. Even assuming that the reach of WTO is constrained through domestic public policy, clearly the medium to longer term solution for any country lies in being competitive in banking for the simple reason that technology and financial innovations make it possible for market participants to bypass relatively excessively regulated banks. Third, the IMF, which in the past was mainly concerned with exchange rate, balance of payments and overall macro policy framework, is now focusing on the health of the financial sector, especially banking system, since threat to global financial stability could originate in banking crisis from any single country. The structure and health of the banking system has thus, become, a part of surveillance of the Fund. India is a member, indeed a founding member and important shareholder in the IMF. In view of the global concerns in regard to financial stability, a demonstration of continued health and resilience of the banking industry or banking soundness on a continuous basis may be desirable even though borrowing from the Fund may not be contemplated and one may not agree with some of the policy advices of the Fund. The issues are not only one of improving competitive strength of Indian banks to international standards but also the stability of the banking system with reference to both macro-prudential and micro-prudential indicators. Fourth, World Bank has been involved in programs of reforms in financial sector. In view of their interest in structural aspects, continued association and in some ways joint Fund-Bank assessment of the soundness of the system and longer term efficiency has to be reckoned with. Fifth, there are several other fora, including G20 of which India is currently the Chair, which are focusing on, among other things, efficiency of the banking sectors in various countries. In brief, while country-specific circumstances will no doubt prevail, the concerned global institutions will need to be convinced that the framework in which banks operate in any country are not inconsistent with global financial stability.

Finally, there have been international standards and codes of best practices in several areas in the past also, but more recently there is a concerted effort to view some of them relating to financial sector in an integrated fashion and make assessments. India has rightly taken the stand that such standards are yet to be proven to be convincingly and universally valid; their significance in enhancing stability yet to be established in terms of empirical evidence; and their adoption to suit each country should be at the pace considered appropriate by each country and must be totally on a voluntary basis. Their relevance, even as part of domestic reform has been, however, recognised. Consequently, there is a whole set of assessments made domestically, but by independent non-official advisory groups on what are termed as 'core' set of standards and codes. These reports along with an over-arching synthesis have been finalised and published by Reserve Bank of India and these clearly bring out the state of Indian financial sector *vis-à-vis* current international standards and suggest possible courses of action in regard to legal, policy and procedural frameworks. In many areas, there is demonstrable progress in policy as well as procedural actions towards implementation. They do, however, focus more on actions in the realm of public-policy leaving considerable room for the banking industry itself to identify actions that are essential on their part to meet the changing policy environment in India, consistent with growing competition, stress on stability and international standards and codes as they are evolving. Thus, while global competition pushes banking industry towards more operational efficiency, global concerns compel the industry towards stability, and striking a balance is no easy task, both for regulators and regulated and this applies as much to India as to any other country. In any case, a vibrant and sound banking system is essential for an economy to ensure both growth and welfare.

The IMF and financial sector issues

It would be useful to appreciate why the IMF got involved in financial sector issues and how it performs its role, whether one is in full agreement with its approaches or not. Financial instability or crises with an impact of global contagion is fairly a recent phenomenon, especially after the East-Asian financial crisis, and therefore, it was not a major policy at the time the Fund was set up and hence the Fund surveillance under Article IV discussions or the conditionality packages rarely focused directly on financial system related issues. In the post I970s, however, there was a visible tendency towards market-based financial systems, which appeared to be associated with a relatively higher degree of risks and volatility. Though the Fund expanded its operations in the I980s by helping countries improve their financial systems, the initial emphasis was on strengthening the instruments of monetary management as well as identifying ways to deepen and integrate markets for money, government securities and foreign exchange. These issues continue to be important even today, but the series of emerging market financial crises of the 1990s have altered significantly the scope and dimension of the Fund's involvement in financial sector issues. The experience of financial crises in the recent past has brought to the fore the importance of the links between banking system soundness and the effectiveness of macroeconomic policy. The recent international concern on preventing the abuse of financial systems for money laundering and terrorism finance has added a new dimension to the Fund-Bank's involvement in strengthening, *inter alia*, the banking and financial systems.

How does the Fund get involved? The main focus is on the essentials of banking supervision and restructuring of banking systems. Together with the World Bank, it started supporting country authorities in major bank restructuring programs. Second, a Fund-Bank decision in May 1999 resulted in the launch of the Financial Sector Assessment Programme (FSAP), which has emerged as the key instrument to identify financial system strengths and vulnerabilities and to reduce the potential for crisis in its member countries. While the Fund's involvement in the process primarily emphasizes the linkages between soundness and operations of the financial system and the macroeconomic performance, the Bank focuses on the role of financial sector in achieving the goals of development and poverty reduction. Third, while the conventional Article-IV surveillance focused primarily on macroeconomic environment, assessments under FSAP are very wide in their scope, encompassing legal, institutional, policy, risks, prudential and procedural aspects of financial systems. The Fund, in consultation with its members and other international organizations, is working towards establishing the "rules of the game" for the global financial system through universally acceptable standards and codes. In the FSAPs, a country's compliance with international standards is assessed on a priority basis which gets reflected in the Report on the Observance of Standards and Codes (ROSCs). The Fund has also expanded its scope further through surveillance of offshore banking centres and on measures for combating money laundering and the financing of terrorism in order to contribute to the integrity of the international financial system. Fifth, the Fund makes periodical assessment of financial markets, particularly in its reports on Global Financial Stability and to the World Economic Outlook which together do take cognizance of the role of and implications for banking systems in different countries especially the systemically important countries, for global financial stability.

India has been closely associated with the Fund in designing these approaches and Indian experts do participate in several of the exercises even in other countries. India has been subjected to, indeed volunteered to be assessed under FSAP at a very early stage and also under the ROSC initiative. Thus, whether one concurs fully with the Fund's extent or nature of involvement or not, its role cannot be ignored and indeed, India has a stake in enhancing the quality and appropriateness of Fund's role in the banking sector. The World Bank is also involved in structural aspects of banking and its work is closely coordinated with the Fund in FSAP. In terms of financial support, World Bank's involvement in banking sector was essentially a subset of its strategy in regard to the financial sector as a whole. The World Bank approved in mid-1995 a Financial Sector Development Project Loan for India which contained a component of assistance to six Public Sector Banks in India.

BIS and Banking

Bank for International Settlements (BIS), established in 1930, was mandated to facilitate reparation payments imposed on Germany by the Treaty of Versailles. Though effecting cooperation among the central banks was a secondary objective of BIS at the time of inception, very soon this function became the focal point of the BIS. Subsequently, the major pursuit of BIS has become international monetary and financial stability and over and above cooperation among central banks, BIS is also coordinating with other agencies for achieving this goal. In addition, BIS acts as a banker to central banks. Currently 50 institutions comprising of central banks/monetary authorities of different countries (including India) have voting rights and representation in the General Meeting of BIS. In 2001, 107 central banks attended the Annual General Meeting.

Banks generally assume a position of crucial importance in the financial and monetary system of most of the countries but in the recent years, they have also assumed key role in international capital movements. Therefore, banking policies and conduct of banks are of profound importance in shaping the international monetary and financial scenario. BIS devotes a considerable portion of its resources to evolving a prudential framework for the banking system and tries to achieve this through five broad ways. First is the promotion and discussion and facilitation of decision making between central banks and other national and international authorities associated with banking regulation and supervision. Second is the undertaking of policy oriented research having a direct bearing on conduct and performance of the banking sector. Third is the collection and dissemination of data relating to the banking sector. Fourth is the technical assistance and selective training so as to enhance the skills of the personnel associated with regulation and supervision of the banking systems in different countries. Fifth, BIS has also taken considerable initiatives to improve coordination and evolution of prudential framework in other segments of the financial sector such as in insurance activities.

What is widely known in the banking industry is Basel Accord and Basel Core Principles. The BIS focuses on principles that govern handling of specific regulatory and supervisory problems of the banking sector and tries to evolve minimum standards and common codes to be implemented by the respective central banks. Basel Capital Accord, 1988 is one of the most prominent contributions of the BIS, which aimed at a sound and stable international banking environment by improving the standards of banking supervision especially in relation to solvency. BIS also issued the "Core Principles for Effective Banking Supervision" in 1997. In the light of experience with the Capital Accord and in response to the changes that have taken place since the introduction of the Accord, BIS is currently consulting on a new capital adequacy framework, popularly known as `Basel II'. BIS keeps a close watch on the developments of the financial markets at the global, regional and national levels. In order to provide inputs to policy formulation and also to strengthen market discipline, BIS also disseminates various financial information.

Reserve Bank of India has been closely following developments in BIS and has adopted the Basel standards; India is also associated with Working Groups to formulate Basel, and RBI contributes its expertise to the work of BIS in several ways. It must also be recognised that there are certain reservations expressed in regard to some of the initiatives. The Basel Accord did not prevent banking crises and some feel that it might have encouraged some excessive risk taking by banks. The Accord might have operated in procyclical fashion. Further, the Economist (October 5-11th, 2002, p.69) comments on Basel 2 as follows:

> "A complex financial regime such as Basel 2, and financial regulations such as the EU's Investment Services Directive, appear to be designed not so much to serve users of financial services as to prolong the survival of institutions and ways of doing business that are no longer trusted by the public. The regulators in Basel and Brussels might bear that in mind."

India has a stake in not only trying to take account in its public policies of the international developments such as in BIS, but also in influencing the international perspectives on banking issues.

WTO and Banking Sector

Negotiations under the General Agreement on Trade in Services of WTO have officially begun in early 2000. It is well known that there is a divergence of interests and motivations among different countries in respect of all trade related matters, but particularly so in financial services. Most of developed countries seek gains for their large financial firms while most of the developing countries would prefer import of capital for financing their development while access to foreign firms, especially banks is viewed with circumspection by many. The fact remains that some commitments have been made in the past and some more may be considered in the future by all countries, including India. For example, in the negotiations that took place in June, 1995 India increased the number of bank licenses, while excluding ATMs in such computation; investment in other financial services was permitted with certain restrictions and some limits were put on their aggregate market share. Unlike in some other countries, branches of foreign banks are permitted to conduct business in both local and foreign currencies, and undertake almost all banking activities with no discrimination barring a few on priority-sector lending and business of public sector lending. There are two developments that should be considered in this regard, in assessing impact on domestic banking in future. First, since subsidiaries of foreign banks are now permitted, how far would it be possible to have a differential treatment between domestically incorporated banking companies on the basis of extent of foreign ownership? Second, the ongoing WTO negotiations may also imply further opening up of the economy in terms of liberalisation of financial services which would impact on the level of competition for banking industry in India. Incidentally, the issue of liberalising cross border delivery of financial services is linked to convertibility on capital account and has a potential impact on the totality of financial intermediation in India including banking services.

Some Lessons From International Experience

The variety of circumstances in the countries, especially initial conditions, size of the economy and institutional environment make any generalization, on development in banking in the context of either financial sector reform or broader economic reform, extremely difficult. Some generalisations based on international experience on factors relevant to soundness of banking sector in emerging economies are, however, attempted here.

First is the developments governing the real economy, particularly those relevant to sectors to which banks have large exposures, whether structural or cyclical.

Second is the financial market risks to which banks get exposed, be they credit liquidity, interest rate, foreign exchange, settlement, operational, legal, regulational, political and systemic such as contagion.

Third is the policy environment including the extent of financial repression, public ownership and its conduct, relationship between large corporates and banks, growth and treatment of banks versus non-banks that compete with banks in some of their business etc., arrangements for credit-recovery.

Fourth is the relationship between governments and banking sector in terms of financing, exposures, contingent-liabilities etc. recognising that bank losses, be they in public sector or otherwise, have a tendency to result in quasi-fiscal deficits.

Fifth is the institutional arrangements especially regulatory and supervisory environment and their credibility, domestically and internationally.

By all accounts, India stands out as one of the very few who have managed the reform so far reasonably smoothly. Support from exchequer, relative to most other countries, has not been high, though the headroom available from fiscal side to meet larger obligations in future may be somewhat constrained as compared with many other countries. The issue for India, therefore, is really one of moving from a relatively stable system to one which is relatively more vibrant and efficient system that sustains a far higher growth-rate in real economy of the country at a time when the economy is seeking to obtain large inflows of foreign capital. In a way, therefore, the challenge is to ensure domestic banking sector that would cater to both domestic financial intermediation and a larger as well as more open capital account transactions in future.

It is essential to recognise the impressive initiatives taken so far in a wide-ranging areas the recent years. These include restructuring of banks, progress towards universal banks, approaches to non-performing assets, asset reconstruction, deposit insurance, technological infrastructure, governance, corporate debt restructuring, regulatory and supervisory environment, financial markets and international standards/codes. The half-yearly statements of Monetary and Credit Policy, especially under the leadership of Governor Jalan, are a mandatory reading for those who want to perceive the sensitivity of the authorities to the emerging challenges. No doubt, there are some matters relating to the legal framework, structural aspects of public sector banks, debt recovery systems etc. which are still under process.

Issues

A review of banking developments in India clearly shows that analysis of problems and approaches to reforming banking sector have been very clearly articulated in several fora, including in the series of A.D. Shroff Public Lectures. However, the actual policy-response to emerging issues appears to have been delayed even when acted upon, and such a process may not be entirely justifiable on the grounds of gradualism. First, therefore, is what should be done to bridge the gap between thinking right and doing-it-right and above all doing it at the right time?

Second, there is a recently observed criticality of international perspective for domestic-banking which applies equally to India. How such international perspectives could fully factored-in by the public policy, banking-industry and regulatory regimes especially in terms of concerted responses.

Third, several multilateral institutions are now actively involved in promoting sound practices, assessing stability, seeking as well as enforcing agreements to access etc. and these include in particular, IMF, World Bank, BIS and WTO.

India is an important shareholder/member and has thus a dual role of being a party to their activities and a subject-matter of their monitoring. What are the arrangements by which India makes a contribution to and benefits from the increasing role of such multilateral institutions in an optimal way?

Fourth, in the light of increasing global competitive pressures in financial services, should there be greater attention to strengthening stronger banks, in terms of resources as well as operational freedom, as compared with the weaker banks? Similarly, as Dr. K.B.L. Mathur and Prof. T.T. Ram Mohan ably argue, is privatization by itself a solution to the existing problems in view of the state of governance structures in general? Moreover, does the continued uncertainty in regard to the institutional reforms in public sector banks erode their competitiveness by adding uncertainty to the lack of level playing field in banking operations? Does imposing of social obligations on banking sector in the face of competition act conducive to the health of the banking industry and more generally of the economy? These are some of the substantive issues relevant to the future of domestically owned banks in India and it must be noted that most large economies, developed and developing, have spared no policy-effort to nurture and develop strong domestically owned banks.

Fifth, how the study of banking developments in India should, in addition to analyzing the industry over time and by categories such as public, private, foreign owned, benchmark with international banks with reference to performance as a first step to determine where we stand and how far we need to go?

Conclusion

To conclude, there is ample evidence to show that in the recent years there has been an effort to view Indian banking in a globally competitive perspective. For instance, the valedictory address to the 19th Bank Economists Conference in 1996 stated "Our objective of reform should be equalling global standards to compete effectively and soon after excelling global standards to make a respectable place for ourselves in the fast progressing global financial sector."

More important, Governor Jalan had articulated eloquently and in greater detail when he said, at the same forum, in January, 2001, in his lecture titled "Banking and Finance in the New Millennium"

> "The long-term vision for India's banking system to transform itself from being a domestic one to the global level may sound far-fetched at present. However, it is not beyond our capacity, provided we have the will and the determination. Taking the banking industry to the heights of international excellence will require a combination of new technologies, better processes of credit and risk appraisal, treasury management, product diversification, internal control and external regulations and, not the least, human resources. Fortunately, we have a comparative advantage in almost all these areas. Our professionals are at the forefront of technological change and financial developments all over the world. It is time to harness these resources for development of Indian banking in the new century."

"In such a milieu of general acceptance of international perspective, a legitimate question is the need for such a detailed articulation of the subject today. For answering this, the following statements from the book "India – Emerging Power" by Stephen P. Cohen would be useful:

"Officials of Northrop once mused that they could build an Indian light combat aircraft more cheaply and better simply by using their own Indian-American employees than by collaborating with India's Hindustan Aircraft."(p.118)

"Today, there is some risk that India's achievements in software development will aid the rest of the world but not India. Indian-developed software is widely used in the world's banks, but Indian banks cannot take advantage of it." (p.I05)

In brief, while there is proven merit in the Indian graduated approach to financial sector reform, there is a need to put in place a strong system of incentives/disincentives, and to take prompt and decisive actions encompassing all stake holders in banking sector in India, keeping in view the emerging international perspectives on competition and stability.
