Functions of Banks: Some Current Concerns

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It is a great privilege to be asked to deliver the first Convocation Address of the Post- Graduate Programme in Banking and Finance. My association with the National Institute of Bank Management goes back to the days when it was set up in 1969 and started operating from Vasant Vihar in Mumbai. After 1982, my association became more intimate. I saw the transplantation of the Institute from Mumbai to Pune. I literally witnessed the building here at Pune grow stone by stone. I recall that one meeting of the Governing Board was conducted in one of the buildings when it was under half construction. National Institute of Bank Management has emerged as a leading institution of training and research in banking and other related financial services. Banks are multi-faceted organizations. A good banker requires skills in various areas. Not only does he need to know about the core functions of banking, but he must also be able to manage an institution which is people intensive. Professionalism is the key to successful banking and NIBM has played a notable role in enhancing the skills of the people working in banks. It has tried to do so through organizing teaching programmes, conducting research and offering consultancy. This full time Post-Graduate Programme in Banking and Finance is another important milestone in the achievements of NIBM. This intensive full time programme trains people for positions in banks and other financial institutions. I do hope that the financial sector in India will take full advantage of this unique programme offered by NIBM. I congratulate all of you who are graduating today. A challenging career awaits every one of you.

Global Developments

Banking has undergone a sea change world over. Innovations spurred by deregulation and liberalization have been the marked feature of this transformation. Rapid strides in technology in the areas of telecommunication and electronic data processing have helped to speed the changes. A major consequence of these changes is the blurring of the financial frontiers in terms of instruments, institutions and markets. The distinction between banks and non-banking financial institutions has become thin. Restrictions imposed earlier on banks regarding the activities that they can undertake have been removed one by one. Effectively, universal banking has become the trend. Another feature of the market is the interlinking of

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different national markets. With the dismantling of exchange controls and the rapid developments in communication systems, funds have started moving rapidly from one country to another. Important financial institutions are present in all the leading market centers and markets are in operation on a twenty-four hour basis. Deregulation has meant the dismantling of regulations relating to entry and expansion; it has also meant the removal of all direct controls over interest rate wherever they existed. The integration of markets, both functionally and spatially, has led to a more unified market for the allocation of savings and investment among the participating countries.

Anyone can recognize the very fast growth of the financial sector in almost all countries, both developed and developing. A question that is being asked increasingly is whether the financial sector today is inherently more fragile and vulnerable than before. The very factors that have contributed to the growth of the financial sector may well have contributed to the increased fragility. Financial institutions have become more sophisticated; the volume of transactions has increased phenomenally and competitive pressures have grown. As a result of the very rapid changes in technologies, a dramatic expansion in financial flows both cross-border and within countries has emerged. Along with these changes, consolidation, increased geographic spread of banks and other financial service providers, and the blurring of the distinctions between various financial institutions as mentioned earlier have also occurred. Developments in technology and in the pricing of assets have enabled innovations and financial instruments that allowed risks to be separated and allocated to parties most willing and able to bear them. Thus the menu of financial products has expanded enormously. For example, in the case of debt instruments, investors can now choose among structured notes, syndicated loans, coupon strips and bonds secured by pool of other debt instruments. Another dramatic development is the growing use of financial derivatives. All these changes have undoubtedly created new opportunities, but they have also magnified risks. In fact, it has been remarked that the increased complexity of new instruments makes it harder to understand the risks to which the institutions concerned are exposed. Close inter-dependencies among markets and market participants have increased the potential for adverse events to spread quickly. They have increased significantly the scope for and speed of contagion. Globalization of banking operations has also raised several concerns for the supervisory authorities. Globalization of banking operations requires that the prudential standards are uniform across countries; otherwise there can be "regulatory arbitrage". Cross country harmonization in accounting and auditing standards and in disclosing information becomes essential in this context. Globalization of banking operations also raises some interesting questions regarding which central bank should come to help when a bank which has a worldwide coverage runs into a difficult situation. The other aspects of the same issue are : Who should bear the cost of the safety nets and when should they be activated?

Apart from these factors, sometimes a fear is expressed that the financial system may be prone to instability because of its inherently pro-cyclical character. Asset prices move pro-cyclically. So too is the ratio of credit to GDP. However, if these normal behavioural patterns reach abnormal proportions, they become the cause of financial distress. For example, asset price booms in property markets when they come to an end cause serious distortions since they constitute the collateral for various loans. Hence, the old adage "Bad loans are sown in good times". The financial system may not always be able to build sufficient cushions in good times which can act as effective shock absorbers in bad times. Therefore, the search for early warning signals of financial imbalances. The critical thing to identify is the timing of when 'exuberance' turns into "irrational exuberance", so that imbalances do not build up.

The Indian Scene

The banking scene in India has undergone dramatic changes in the last three decades. The nationalization of the 14 major commercial banks in 1969 was an important landmark in the evolution of the banking system in our country. The major impact of nationalization was a spectacular expansion in the coverage of the banking system. The total number of commercial bank branches increased from 8,262 in 1969 to 60,190 in 1991. Apart from this impressive increase in the number of branches, more than

50 per cent of the bank branches were located in the rural areas. Besides, the period saw a rapid increase in the bank deposits and credits. The system also operated under a regime which regulated interest rates on both deposits and credit. Dispensation of credit was subject to many prescriptions and regulations. Financial sector reforms were initiated in the early 1990s as part of the overall structural reforms aimed at improving the productivity and efficiency of the economy. Financial sector reforms recognized the fact that the Indian banking system had over the years grown and that the geographical and functional coverage of the banking system had been truly impressive. However, it also recognized that questions had been raised from time to time on the viability of the banking institutions as also about the quality of service provided by them. It is with a view to finding solutions to these problems that financial sector reforms were initiated. The broad objective of the reforms has been to create a banking system that is both viable and efficient. There are four building blocks which have formed part of the banking sector reforms. These are: *(a)* modifying the policy framework with a view to eliminating or reducing the external constraints on the banking system, *(b)* improving the financial soundness and credibility of banks through the introduction of appropriate prudential norms, *(c)* creating a competitive environment, and *(d)* strengthening the institutional framework. The various aspects of financial sector reforms have been analyzed in depth and it is not my intention to go into them today.

Quite clearly, judged by certain indicators, the banking system today is much stronger than what it was in 1991. The capital to risk weighted assets ratio, despite many limitations, is a reasonable measure of the ability of the banking system to withstand shocks. At the end of March 2003, capital to risk weighted assets ratio of public sector banks stood at 12.6 per cent which was well above the stipulated level. As percentage of total assets, operating profits for all scheduled commercial banks stood at 2.4 per cent in 2002-03 as against 1.25 per cent in 1993-94. Also, the percentage of net profits to total assets of scheduled banks which was negative at -1.08 in 1992-93 touched a positive figure of 1per cent in 2002-03. The most notable area of improvement was in non-performing assets. Non-performing assets of public sector banks constituted 23.2 per cent of the gross advances in 1992-93. These have declined to 9.4 per cent in 2002-03. Net NPAs of public sector banks as a ratio of net advances stood at 4.5 per cent in 2002-03 as compared to 10.7 per cent in 1994-95.

The challenges before the Indian banking system have also been addressed by various analysts and policy makers. Banks need to learn to operate in a more competitive environment. This competition will not only be among banks but also with other financial institutions. Specialization by banks in different niches of the market such as retail, agriculture, export, the small scale industry and corporate sectors may become necessary. Technology upgradation has to be a continuous process to enable banks to perform more effectively their various functions. They must also be able to manage risks better. The prudential framework can only provide an enabling environment. Banks face a wide range of risks such as credit, interest rate, foreign exchange, liquidity and operational risks. These risks remain hidden in completely regulated regimes. They surface once restrictions are removed. While the various types of risks can analytically be separated, they are highly interdependent and events that affect one area of risk can have implications on other risk categories. As a consequence, it becomes necessary for banks to adopt various types of risk evolution tools such as value at risk models to assess risks.

Financial Sector and Economic Growth

As we look at the future of Indian banking, it may be of some interest to go back to the fundamental relationship between financial sector development and economic growth. It is well recognized now that the financial sector plays a critical role in the development process of a country. Financial institutions, instruments and markets which constitute the financial sector act as a conduit for the transfer of resources from net savers to net borrowers, i.e., from those who spend less than they earn to those who spend more than they earn.

The financial sector performs this basic economic function of intermediation essentially through four transformation mechanisms :

(i) Liability-asset transformation (i.e., accepting deposits as a liability and converting them into assets such as loans);

(ii) size transformation (i.e., providing large loans on the basis of numerous small deposits);

(iii) maturity transformation (i.e., offering savers alternative forms of deposits according to their liquidity preferences while providing borrowers with loans of desired maturities); and

(iv) risk transformation (i.e., distributing risks through diversification which substantially reduces risks for savers which would prevail while lending directly in the absence of financial intermediation).

The process of financial intermediation supports increasing capital accumulation through the institutionalization of savings and investment. The gains to the real sector of the economy, therefore, depend on how efficiently the financial sector performs this basic function of financial intermediation. Banks form the core of the financial system in most countries. Thus, whether a country's financial system is efficient or not depends in large part on the efficiency of its banking system.

In the early theories of growth, advocated by classical economists, finance was largely ignored as a factor explaining economic growth. While growth was seen to be predominantly influenced by real factors, the missing link in these frameworks was the lack of an explanation on how savings were transformed to investment in the economy. The Keynesian school, while revolutionizing the thinking on the role of public policy in promoting economic growth, focused attention on the objective of maintaining short-run stability of output around the full employment level. The financial sector was assigned some role in this analysis to the extent that it incorporated an interest rate effect to support the investment activity in the economy. As a consequence, a regime of low interest rate, as the means to promote economic growth, gained ground. This provided the major motivation for institutionalization of financial repression in a number of developing countries, throughout the 1950s and 1960s.

The neo-classical growth theory also lacked a solid foundation on finance, as it assumed that as long as saving continues, it takes the form of real investment. The impetus for long-term growth in this analysis was postulated to come from continuous improvement in technology and the growth of population. Although fairly convincing as an analytical tool to explain the growth process, the neo-classical literature failed to recognize the importance of financial innovation as a major endogenous source of productivity growth in an economy.

The importance of the financial sector in the growth process emerged as a major point of policy emphasis in the financial liberalization literature in the early 1970s. The positive impact of financial liberalization on growth is traced to the fact that financial development increases the allocative efficiency of capital by channelling credit to the sectors where returns are the highest. It was argued that elimination of financial repression leads to an increase in savings and the realization of a higher investment rate in the economy. It was also highlighted that liberalization of the financial sector promotes financial deepening by encouraging savings in financial assets and by increasing the volume of credit flow in the economy. The relationship between financial development and economic growth received a new impetus from the rapidly growing "endogenous growth" literature, which provided a framework for the integration of the financial system into the theory of growth. In sum, financial development can affect growth by acting both on capital accumulation and productivity.

Focus of Banking

Keeping in the background the relationship between economic growth and financial sector development, three roles of banking in India need to be stressed. These are :

(i) operation of the payment system, *(ii)* repository of savings, and *(iii)* provision of credit.

(i) Efficient Payment System

An efficient payment mechanism which is a crucial component of any well functioning economy, is a basic function of the banking system. Efficiency of the payment system can be judged in terms of speed, security and stability of the financial flows. Much has been done in our country to improve the operation of the payment system. From the induction of MICR cheques to the introduction of real time gross settlement, the Indian banking system has come a long way. Nevertheless, it is not clear whether the time taken to collect outstation cheques has been brought down even today considerably. Electronic funds transfer has not become universal and we continue to operate paper based payment system. Apart from speed and security, the integrity of the payment system depends upon payment obligations being honoured on time. Banks in India need to give focused attention to an improved functioning of the payment and settlement system.

(ii) Repository of Savings

Bank deposits continue to remain a major form of savings in a country like ours. Of the savings in financial assets held by households, bank deposits constitute close to 40 per cent. Obviously, households have today a much wider choice with respect to financial assets. Banks are, however, still in a position to provide a broad range of options to the savers in terms of maturity and convenience. In this context, an aspect to which banks must pay attention relates to the rate of interest. Despite controversies relating to the impact of interest rate on savings, it is obvious that the real rate of interest, i.e. nominal rate of interest adjusted for inflation at the minimum must be positive to savers. The level at which it should be kept is an important decision variable. Also the real rate of interest in a country which wants to grow at 7 to 8 per cent per annum must necessarily be higher than countries which treat 2.5 to 3 per cent as the potential. There can be equality only in the extreme case of completely free mobility of capital and funds. While over a period of time, nominal interest rates must move in tandem with inflation, it is necessary to have a view on the appropriate level of real interest rate on deposits and loans. These must have a relationship to the expected rate of growth of the economy.

(iii) Provision of Credit

Provision of credit is one of the fundamental functions of a bank. The very definition of banking is "Accepting for the purpose of lending or investment of deposits of money from the public". The effective discharge of this function is part of the intermediation process. For long, there have been two views on how monetary policy impacts the economy. These are : 'the Money View' and 'the Credit View'. While the 'Money View' traces the impact of monetary policy through changes in aggregate monetary demand, the 'Credit View' studies the impact of changes in the availability of credit on output. The two in a sense are not contradictory. They are two separate but inter-related channels. Without going into the issue of which channel is more important for monetary policy, it can very well be stated that banks and other financial institutions have the major responsibility to ensure that adequate credit is available for the productive and service sectors to function effectively. Credit is thus a lubricant. Obviously in meeting credit demands, different institutions will specialize in different segments. However, taken together, they must be able to meet the legitimate demands of various sectors of the economy. The sectoral deployment of credit will change according to the change in the structure of the economy. The banking industry in India needs to keep this in mind and equip themselves to be able to assess and meet the credit needs of the emerging segments of the economy.

In this context, several concerns have been expressed regarding the decline in credit to agriculture in recent years. This has happened despite several initiatives. In fact, the very purpose of bringing down the Cash Reserve Ratio was to enable banks to provide a larger amount of credit. The policy makers had taken a number of steps in the 1990s to strengthen the finances of NABARD which was the apex institution of rural credit. The General Line of Credit provided by the Reserve Bank of India was increased from Rs. 3,350 crore in 1991-92 to Rs. 5,500 crore in 1996-97 and currently, I understand, it stands at Rs. 6,500 crore. While the allocation out of Long Term Operations Fund of the Reserve Bank of India was stopped, the capital base of NABARD was considerably expanded. In addition, another important source of funding for NABARD was the Rural Infrastructure Development Fund which was set up in 1995-96 and which is being continued. At an aggregate level, the total flow of credit to agriculture by all agencies increased from Rs. 15,170 crore in 1992-93 to Rs. 31,956 crore in 1997-98 and further to Rs. 70,810 crore in 2002-03. This amounts to an annual compound rate of growth of 16.7 per cent. This would imply that in real terms, the compound rate of growth was 10.2 per cent. This, of course, is lower than the required growth rate estimated in the Tenth Plan.

Credit for agriculture and allied activities is not a single market. Provision of credit for high-tech agriculture is no different from providing credit to industry. Provision of credit to farmers with surplus is also of a similar nature. Commercial banks in particular should have no hesitation in providing credit to these segments where the normal calculation of risk and return applies. It is only with respect to the provision of credit to small and marginal farmers that special attention is required. They constitute the bulk of the farmers and account for a significant proportion of the total output. In this context, a relook at the organizational structure of our rural branches is called for. Apart from the need for empathy, the rural branches must go beyond providing credit and extend a helping hand in terms of advice on a wide variety of matters related to agriculture. They must also establish links with input suppliers. We must perhaps go back to the model of Agricultural Development Branches which State Bank of India had promoted. Such branches had agricultural experts attached to them to give advice to farmers. This model was not pursued vigorously later in the hope that such advice and help would come from state governments through their extension agencies. That has not happened. We may have to rethink in terms of restructuring the rural branches of commercial banks so that credit will be supplemented by expert counselling.

All in all, banks need to organize themselves to meet effectively the credit demands of several sectors.

Conclusion

Financial institutions are judged normally by the two criteria of operational efficiency and allocative efficiency. While the former relates to the transaction cost, the latter deals with the distribution of mobilized funds among competing demands. Sustained improvement of economic activity and growth is greatly enhanced by the existence of a financial system that rates well in terms of both operational and allocative efficiency. In the period following nationalization of banks, the emphasis was on allocative efficiency, determined largely in terms of the social productivity of credit. In the period after liberalization, there was perhaps much greater emphasis on operational efficiency because of the concern for the viability of banks. We really need to move to a stage when the emphasis should be both on operational and allocative efficiency. The Indian banking system must also keep in focus the need to play effectively its role in the payment system, as a repository of savings and as a provider of credit. These have to be performed within a framework of viability and stability.

May I wish everyone of you who is graduating today the very best in life. May you contribute to the strengthening of the financial system which is a necessary platform for accelerated take off.