

INTERNATIONAL COMMITMENTS AND TRANSFORMATIONS IN INDIAN BANKING

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Abstract

Banking sector being the crucial among the financial infrastructure has seen several changes in past one decade. The commitments made along with several international recommendations in this sector have brought several important policy changes during the last ten years to strengthen the financial sector in general and banking in particular. There has been a rapid entry of foreign banks into the Indian banking sector which has spurred the competition in the delivery mechanism as well as variety of services. The recommendations of Basel Committee have also been increasingly accepted in India. This has brought several regulatory changes including the most important areas viz. risk management and supervision in banking. With increase in access to foreign banks, deregulation of interest rates, changes in regulatory and supervisory framework etc. have made Indian banking more transparent, resilient and efficient. But it is also found that high level of international commitment made by different countries has not insulated them from banking crisis. So it is imperative on the part of India to ensure a strong regulatory and supervisory mechanism for banking sector for a dynamic and more resilient financial infrastructure.

I

Introduction

Infrastructure development, both physical and financial has a direct bearing on performance of overall economy, which also percolates down to the micro level in the long run. In many of the research studies this linkage with economic development is well documented. Such developments are either offshoot of natural transformations in the entire economic structure or are brought into by deliberate and induced strategies popularly known as liberalisation, globalisation, privatisation, nationalisation etc. The present Indian economic scenario is full of such initiatives which have brought dramatic results in almost all sectors of the economy. Financial sector has been one of the biggest

recipients of several doses of reform initiated by certain domestic compulsions and international changes.

The immediate post 1990 years had been subject to various interventions mainly because of first Narashimham Committee recommendations, which made a wide range of prescriptions for Indian financial sector including banking. The post 1998 scenario is however, is full of various measures on the backdrop of international commitments made under World Trade Organisation (WTO), and Basel Committee recommendations. Adherence to these two international institutions has infused several changes in financial sector in general and banking sector in particular. Keeping in view of the international changes, the second Narashimham Committee on banking sector, S H Khan Committee on universal banking, Birla Committee on corporate governance- all gave their reports in 1998, R.H Patil working group in 2001 and Naresh Chandra Committee (I &II) on corporate governance etc., have made an array of recommendations for best practices.

Among all the constituents of financial sector, banking sector received the maximum impact of all the recommendations and considering the dominance of banking in overall economy. The main focus of this paper is on the international commitments and their impact on Indian banking. Therefore, the objective of this paper is to study India's commitment to WTO and Basel made for the banking infrastructure and to highlight their impact, which has been reflected through the various reform measures undertaken in recent years. The rest of the paper is divided into three sections. Section II, gives a theoretical exposure to financial sector reform and its linkage with economic development. Section III which brings forward India's international commitments, is divided into two sub-sections respectively; general commitments and the specific commitments towards liberalisation of banking service under General Agreements on Trade and Services (GATS), and the Basel recommendations. Section IV highlights the response of Indian banking to them, crystallised through reforms. Section V brings the conclusion.

II

Financial Sector Reform and Economic Development: The Linkage

Financial sector plays a major role in the mobilisation and allocation of financial savings in the economy and hence can be considered as the lifeline of an economic system. It comprises of a network of infrastructure of financial institutions, instruments, markets and services which induce people to hold fewer savings in the form of physical assets like precious metals, currency, real estate etc., and to replace them with financial assets such as bonds, shares and other units of investments. It also directly helps to increase the volume and rate of saving by supplying diversified portfolio of such financial

instruments and by offering an array of inducements and choices to woo the prospective saver.

A financial system helps to increase the volume of investment and raise the level of resource allocation efficiency among different investment channels. It helps to sort out and rank investment projects by sponsoring, encouraging and selectively supporting business units or borrowers through more systematic and expert project appraisal, feasibility studies and monitoring. Thus making it possible for the deficit spending units to command more capital and undertake more investment activity. Further it also encourages investment activity by reducing the cost of finance and risk that raises the level of resource allocation efficiency among different investment channels. And this has helped lower the cost of equity and loan capital on average even if it has also heightened vulnerability to capital flows.

The guiding objective of financial sector reforms in several countries is to improve financial sector efficiency while strengthening the financial stability. The three broad effects of the process of financial liberalization are: (i) it opens the country to new forms and larger volumes of international financial flows, in order to attract a part of the substantially increased flows of financial capital to the so-called "emerging markets"; (ii) to facilitate these inflows it liberalizes to differing degree the terms governing outflows of foreign exchange in the form of current account investment income payments and in the form of capital account transfers for permitted transactions; and (iii) it transforms the structure of the financial sector and the nature and operations of financial firms in a manner that makes the financial system resemble that in countries like the US and the UK (Chandrasekhar, 2004). World wide experience confirms that the countries with well-developed and market-oriented financial systems have grown faster and more steadily than those with weaker and closely regulated systems. In many of the developing countries the financial sector and particularly the banking system have been beset by various systemic problems which necessitated drastic structural changes as also a re-orientation of approach in order to develop a more efficient and well functioning financial system. It is believed that a stable and efficient financial system provide the foundation for implementing efficiency of investments, all of which help in achieving sustainable and higher rates of economic growth. However, an expansion of financial systems may also be induced by economic growth. That is to say economic growth may create demand for more financial services and hence the financial system will grow in response to economic expansion. Further a bank-based financial system tends to promote long term economic growth as banks tend to offer longer term loans to the entrepreneurs (Ang & McKibbin, 2005).

In recent years, the financial system of many economies came under stress when as a result of the economic shocks of the 1980s; many borrowers were unable to service their loans and in some of the developing countries the governments had to assist the trouble-shoot intermediaries. And as a consequence following a programme of financial liberalisation the regulatory authorities have altered rules governing financial intermediation to allow broader range of institutions to provide financial services. The measures were aimed at both domestic as well as external sectors of economy. While liberalisation of external sector involves easing of capital flows restriction with greater flexibility in foreign exchange rate, the programme of domestic financial liberalisation aims mainly at deregulation of interest rate structure and dismantling of directed credit; with aims to reform banking system, improve capital market functions and enhance competition in financial system in general. Hence, it is clear that saving, investment, trade openness and interest rate are important mechanisms in promoting both financial development and economic growth (*Ang & Mckibinn, 2005*). However all these do not entail for rejection of regulation at all, but only a shift from direct control to more of supervisory nature amid its own level of sophistication.

The financial sector has long been an early adopter of innovations in information and communications technology and with continuing globalisation of economic activity one consequence has been the 'internationalisation of finance' with changing facet of one of its most important component, which is the infrastructure of banking services that relate to the fundamental way of banking, which is undergoing a rapid transformation in the world of today in response to the forces of competition, productivity and efficiency of operations, reduced operating margins, better asset and liability management, risk management, anytime and anywhere banking.

III

International Commitments

The transformation of financial infrastructure in India is an offshoot of both domestic led reforms, and international commitments and adherence to best practices followed world wide. In the latter categories international influences like market developments of developed countries e.g. accounting practices under US GAAP, corporate governance principles from Cadbury Committee and Sarbnes-Oxlay Act etc.; monetary policy of dominant economies like USA e.g. change in Federal Bank's interest rate; policy guidelines of International Monetary Fund (IMF) e.g. prescription on macro economic managements of developing economies; and agreements of WTO are prominent. Besides the overall impact on the entire financial sector all of them have also made a dent into the most dominant constituent of Indian financial system i.e. banking sector. In these respect specific commitments in WTO under GATS and adherence to Basel recommendations have far reaching implications. In this section these two are highlighted.

A. Overall Commitment under GATS

Some of the GATS obligations apply all over equally while others are specific in nature and depend upon the commitments made by individual member in specific sectors (Matto, 1998). The most important among them is the obligation relating to Most Favoured Nation, i.e., equal treatment to be given to all member countries on the principle of non-discrimination. But when GATS came into force, a number of countries including India already had preferential agreements in services that they signed with trading partners, either bilaterally or in small groups, and thus felt it was necessary to maintain these preferences temporarily. They gave themselves the right to continue giving more favourable treatment to particular countries in particular services activities by listing "MFN exemptions" alongside their first sets of commitments. However, the exemptions could only be made once and nothing can be added to the lists as they are intended to be temporary and subject to review within five years of the entry into force of the Agreement. They should in principle be eliminated after ten years. As a result India has withdrawn broad MFN exemptions and deleted an MFN exemption based on reciprocity in insurance, banking and other financial services.

The second major obligation which applies across-the-board is that of 'transparency' whereby GATS says that governments must publish all relevant laws and regulations, and set up enquiry points within their bureaucracies so that foreign companies and governments can then use these inquiry points to obtain information about regulations in any service sector. They also have to notify the WTO of any changes in regulations that apply to the services that come under specific commitments. As part of its transparency initiative, the Department of Commerce in the Ministry of Commerce and Industry has decided to put background papers and briefs on important issues that may be negotiated or discussed in the World Trade Organisation (WTO) in the near future on its website (*Ministry of commerce & industry, 2000*).

B. Areas of Specific Commitments in Banking under GATS

The liberalising content of the services depend on the extent and nature of sector-specific commitments assumed by individual members and apply to sectors explicitly included by a member in its schedule of commitments and the limitations thereto. The core provisions of the GATS in this context relate to market access, national treatment and additional commitments. The areas of commitments made by India towards banking and other service infrastructure as per Supplement-4 of 'The Schedule of specific Commitments' released in 1998 are:

1. (i) Acceptance of deposits and other repayable funds from the public.
- (ii) Lending of all types, including consumer credit, mortgage credit and financing of commercial transactions but excluding factoring.

- (iii) All payments and money transmission services including credit charge, and debit cards, traveller's cheques and bankers drafts.
 - (iv) Guarantees and commissions.
 - (v) Trading for own account of money market instruments, foreign exchange and transferable securities.
 - (vi) Portfolio management, custodial and trust services.
2. Participation in issues of all kinds of securities, including underwriting and placement as agent (whether publicly or privately) and provision of services related to such issues.
 3. Stock broking.
 4. Financial consultancy services, i.e. financial advisory service provided by financial advisers, etc. to customers on financial matters, investment and portfolio research and advice, advice on acquisitions and on corporate restructuring and strategy.
 5. Factoring.
 6. Financial leasing.
 7. Venture capital

These commitments are made in accordance with the GATS and the Annex on Financial Services, whereby all the commitments are subject to entry requirements, domestic laws, rules and regulations and the terms and conditions of the Reserve Bank of India, Securities and Exchange Board of India and any other competent authority in India. However it is important to note that each of the above mentioned sectors are subject to commitments made by with regard to market access and national treatment, with no additional commitment made with respect to any of the sectors of banking and other service.

The clearly defined commitments are "bound" and can only be modified after negotiations with affected countries because "unbinding" is difficult. But the Schedule of Commitments in banking and other service infrastructure keeps India unbinding in first two modes of trade in services with exception to mode 3 where specific commitments are given for limitations to market access and national treatment, and mode 4 where commitment is unbinding except for certain exceptions. The specific commitments have brought a sea change in the approach to reforms in banking sector. Opening of this sector for international players is one of the crucial outcomes. A detailed list of commitments is given in Table-1.

TABLE - 1
 Limitations to market access and national treatment in banking sector

Modes	Limitations on Market Access	Limitations on National Treatment
3.	<ul style="list-style-type: none"> (i) Only through branch operations of a foreign bank licensed and supervised as a bank in its home country. (ii) Grant of licence as permissible under existing laws. (iii) A limit of twelve licences per year both for new entrants and existing banks. (iv) Banks are allowed to install ATMs at branches and at other places identified by them. Installation of ATM at a place other than in licensed branches is treated as a new place of business and requires a licence. Licences issued for ATMs installed by foreign banks will not be included in the ceiling of twelve licences referred to in item (iii) above (v) Investments in other financial services companies by branches of foreign banks licensed to do banking business in India individually not to exceed 10 per cent of owned funds or 30 per cent of the invested company's capital, whichever is lower. (vi) Licences for new foreign banks may be denied when the maximum share of assets in India both on and off balance sheet of foreign banks to total assets both on and off balance sheet of the banking system exceeds 15 per cent. (vii) Foreign banks are subject to non-discriminatory resource allocation requirements 	<ul style="list-style-type: none"> (i) Foreign Banks are required to constitute Local Advisory Boards consisting, inter alia, of professionals and persons having expertise in areas such as small-scale industry and exports. The Chairman and members of the Local Advisory Board must be resident Indian nationals except for the Chief Executive Officer who may be a foreign national. The appointment of Chairman and members of the Board requires Reserve Bank of India's approval (ii) Foreign banks are required to publish consolidated financial statements of the Indian branches as at March 31 every year. (iii) Public sector enterprises can invest surplus funds in term deposits only with scheduled commercial banks incorporated in India.
4.	<p>Unbound except for measures affecting the entry and temporary stay of natural persons who fall in the categories of business visitors and inter- corporate transferees.</p>	<p>Unbound except for measures referred to under Market Access.</p>

Source: WTO, Schedule of specific commitments, India. (Kono et. al. 1998)

C. Basel Commitment

In 1988 the Basel Committee on banking regulations and supervisory practices appointed by the bank of international settlements has prescribed certain capital adequacy standards to be followed by commercial banks, entirely addressed by credit risk. The RBI accepted the standard of measuring capital as a ratio of risk weighted assets for implementation in India and is committed to the full implementation of the Core Principles. The components have been defined as per Basel norms and detailed guidelines issued in 1992 prescribing a minimum Capital Adequacy Ratio (CAR) to be maintained by banks in both on and off-balance sheet items. But the arrangements of CAR were different for banks and as per the requirements RBI guidelines:

- All banks except those dealing in gold/silver/platinum, minimum CAR is 8 per cent.
- For banks dealing in gold/silver/platinum, minimum CAR is 9 per cent.
- All banks are required to attain CAR level of 9 per cent by 31st March 2001. (RBI 1999)

For this purpose capital is divided into two tiers:

- Tier I is the core capital comprising of paid up capital, statutory reserves, and other disclosed free reserves; and provide the most readily available support against unexpected losses.
- Tier II is the supplementary capital comprising of undisclosed reserves, cumulative perpetual preference shares, reserves arising out of asset revaluation, general provisions and loss reserves, hybrid debt capital instruments and subordinated debt.

The total of Tier I capital should not be less than 50 per cent of the total capital and the total of Tier II capital be limited to a maximum of 100 per cent of Tier I capital. As a measure for capital adequacy RBI introduced a risk assets ratio system for banks in 1992 called the 'Capital to Risk Assets Ratio'. Under this system each of the on-balance sheet asset and off-balance sheet items were assigned a degree of percentage according to risk weights and banks are required to maintain capital for both credit and market risks. The Basel Capital Accord also defines a third type of capital, referred to as Tier III capital. Tier III capital consists of short term subordinated debt. It can be used to provide a buffer against losses caused by market risks if tier one and tier two capital are insufficient for this. Market risks are risks of losses on foreign exchange and interest rate contracts caused by changes in foreign exchange rates and interest rates. The RBI has not introduced Tier III capital, so does not have any requirements for holding the

same. Compliance with CAR is monitored through quarterly prudential reporting and onsite inspection of banks whereby non-compliance may trigger supervisory and regulatory intervention by RBI.

The infrastructure of banking services has undergone significant changes with reference to risk management practices and supervisory approaches. The integration of on-balance sheet and off-balance sheet exposures into the capital ratio has also promoted risk sensitivity and skills to manage risk and structure balance sheet in a prudent manner. But as per the assessment of the 'Advisory Group on Banking Supervision' formed under the Chairmanship of M.S. Verma for assessing the position of the Indian banking system and its regulation and supervision *vis-à-vis* the principles laid down in 16 different papers brought out by the Basel Committee; the group concluded that "given the level of complexity and development of the Indian banking sector, the level of compliance with the standards and codes is of a high order" (RBI, 2005).

Commercial banks have become fully compliant with Basel I standards by March 2005 and will start implementing Basel II with effect from March 31, 2007 (RBI, 2005). The New Accord rests on the three pillars of minimum capital requirement; supervisory review process; and market discipline. While the current definition of capital and the minimum requirement of 8 per cent of capital to risk-weighted assets have been retained, the new accord will be extended to holding companies of banking groups and will refine the measurement of risks. The new accord also emphasises on measurement of operational risk and credit risk either by the standardised or the internal rating-based approaches. Whereby in the case of former there would be four categories of risk weightage for claims on corporates i.e., 20 per cent, 50 per cent, 100 per cent and 150 per cent; and the later approach will allow using internal estimates of the borrower's credit worthiness to assess credit risk. While the supervisory review emphasises the need to develop sound internal processes to assess the capital adequacy based on a thorough evaluation of its risks, which in turn could be evaluated by supervisors, the New Accord sets out disclosure requirements to strengthen market discipline through enhanced disclosure by banks, in several areas, including the way in which they calculate their capital adequacy and their risk assessment methods. With the implementation of new accord it is expected to develop a healthy market-based infrastructure of already existing banking service.

IV

Implications on Indian Banking

The financial sector reforms undertaken in India in early 1990s was part of overall economic reforms in the country and wide ranging reforms covering industry, trade,

taxation, external sector, banking and financial markets. Internal reforms have concentrated on improving efficiency and the need for increased competition being addressed by gradually reducing the degree of direct government involvement in economic activities. The commitments made by Indian government in several international forums have further infused new dynamism into this sector. The reforms outlined here under are broad in nature and many of them could be well linked to the GATS commitments and Basel prescriptions.

A. Changes in Policy Measures

Banking service has been subject to gradual reform since the early 1990s. And several policy measures have been undertaken due to liberalisation of Indian financial sector. It is very much essential that before opening up the financial sector through GATS commitments India should have proper reform at its domestic level also required to fulfil the commitments of India towards Basel committee. The importance of such requirements is well established in case of Arab countries (*Waliba and Mohieldin 1998*).

- 1) *Interest rate deregulation*: The interest rates in the banking system have been largely deregulated except for certain specific classes. On the deposit side, the rate of deposits has been narrowed. The maximum rate of interest is now payable on deposits of maturities of two years and above. And on the lending side, over a period of time, the maximum rate was brought down from 19.5 per cent to 16.5 per cent and more recently no ceiling rate has been prescribed. This steady process of deregulation has helped the banks to accustom to better pricing of assets and liabilities.
- 2) *Diversification of ownership*: The massive and speedy expansion and diversification of banking has not been without its strains. As part of the reforms programme, initially, there was infusion of capital by the Government in public sector banks, which was followed by expanding the capital base with equity participation by the private investors. The share of the public sector banks in the aggregate assets of the banking sector has come down from 90 per cent in 1991 to around 75 per cent in 2006. Diversification of ownership has led to greater market accountability and improved efficiency.
- 3) *Liberal entry and establishment policy*: As a major step towards enhancing competition in the banking sector, foreign direct investment in the private sector banks is now allowed up to 74 per cent (*Reddy, 2004a*), subject to conformity with the guidelines issued from time to time. Since 1993, twelve new private sector banks have been set up and an element of private shareholding in public sector banks has been injected by enabling a reduction in the Government

shareholding in public sector banks. The liberalisation of branch licensing policies has freed banks to relocate branches, set up specialized branches and open new branches without the approval of Reserve Bank of India.

- 4) **Consolidation:** Consolidation in the banking sector has been another feature of the reform process. While the distinction between short-term and long-term finance provider has increasingly become indistinct over time; the guidelines for mergers between non-banking financial companies and banks, and also for mergers between private sector banks have been issued; whose principles would be applicable, to the public sector banks also subject to the provisions of the relevant legislation. The complexities involved in harmonising the role and operations of the DFIs were examined and the RBI enabled the reverse-merger of a large DFI (ICICI) with its commercial banking subsidiary, to convert into universal banking. Recently, another large term lending institution (IDBI) has been converted into a bank.
- 5) **Institutional reforms:** The Basel guidelines have come into place since 1988. But it is found that it is difficult on the part of small states like India to implement the Basel guidelines in toto. In such cases the participation in WTO forum through GATS could be advantageous (*Grynberg and Silva, 2006*). However, in response to the international requirements in 1994, a Board for Financial Supervision (BFS) was constituted to provide direction on a continuing basis on regulatory policies including governance issues, supervisory practices and also supervisory actions and also ensuring an integrated approach to supervision of commercial banks, development finance institutions, non-banking finance companies, urban cooperatives banks and primary dealers. Recently a Board for Regulation and Supervision of Payment and Settlement Systems (BPSS) has also been constituted to prescribe policies relating to the regulation and supervision of all types of payment and settlement systems, set standards for existing and future systems, authorise the payment and settlement systems and determine criteria for membership to these systems.
- 6) **Legal reforms:** The recent enactment of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act has increased the momentum for the recovery of NPLs. The Credit Information Companies (Regulation) Bill, 2004 has also been passed by both the Houses of the Parliament while the Government Securities Bill, 2004 is under process (*Reddy, 2005*). Certain amendments are being considered by the Parliament to enhance Reserve Bank's regulatory and supervisory powers. Major relate to requirement of prior approval of the RBI for acquisition of five per cent or more of shares of a banking company with a view to ensuring 'fit and proper' status of the

significant shareholders, aligning the voting rights with the economic holding and empowering the RBI to supersede the Board of a banking company.

- 7) *Transparency and disclosures standards:* There have been a number of measures for enhancing the transparency and disclosures standards. Illustratively, with a view to enhancing further transparency, all cases of penalty imposed by the RBI on the banks as also directions issued on specific matters, including those arising out of inspection, are to be placed in the public domain. Prudential norms for income recognition, asset classification, provisioning of delinquent loans, and capital adequacy were introduced and new private banks were allowed to enter so as to induce greater competition.
- 8) *Governance:* Following financial liberalisation, as the ownership of banks gets broad based the importance of institutional and individual shareholders will increase. In such a scenario, banks will need to put in place a code for corporate governance for benefiting all stakeholders of a corporate entity. So they have been asked to ensure that the nominated and elected directors are screened by a nomination committee to satisfy 'fit and proper' criteria. Directors are also required to sign a covenant indicating their roles and responsibilities (Reddy, 2005). The RBI also has recently issued detailed guidelines on ownership and governance in private sector banks emphasizing diversified ownership.

B. Transition in Banking Operations

The infrastructure of banking in India is passing through a period of transition and is getting more and more complex and sophisticated. A new banking environment has emerged whereby the ownership pattern, management pattern and most importantly their business pattern, all are in the process of transition. Some of the transitions in banking operations include:

- 1) *Transition towards financial service:* Banking is no longer confined to acceptance of deposits for the purposes of lending but poised to broaden their product lines into the complete offerings that would go under the rubric financial services. Specialised markets have come into being for each class of financial instruments and banks have to transact business in various segments of the financial market spectrum in the process of their routine day-to-day business.
- 2) *Trend towards off-balance sheet intermediation:* Today, banks operate with a wide variety of financial assets and liabilities, some of which are created by the non-bank constituents of the financial system. Nevertheless, the trend to off-balance sheet intermediation and the complexities that it entails will demand that some managers of the future be equipped with financial skills in a significantly greater measure (Leeladhar 2005).

- 3) **Transition towards capital efficiency:** The Basel-II prescriptions have already been put on track for transition from the traditional regulatory and market measures of capital adequacy. This transition will become a significant factor to estimate whether a bank has found the most efficient use of its capital to support its new business mix, how capital is used and how much capital is needed in return-on-equity strategy for years ahead.
- 4) **Transition towards electronic banking:** The development and use of communication networks have also helped the banking industry to improve the quality of its services. And with the introduction of new instruments such as credit cards, telebanking, ATMs, Retail Electronic Funds Transfer and Electronic Clearing Services, the necessity of developing an effective, efficient and speedy payment and settlement systems are getting sharper.
- 5) **Transition towards technology-driven information:** Most new financial services are based on technology; and technology-driven information transformation is at the center of the even more important management, marketing, and risk transitions. The introduction of electronic technology for transactions, settlement of accounts, book-keeping and all other related functions is now an imperative. So the new generation managers will have to learn how to create and thrive in an environment that embraces change.

C. Future Issues

The changes staring in the face of banking infrastructure relate to the fundamental way of banking, which has undergone a rapid transformation in the world of today in response to the forces of competition, productivity and efficiency of operations, reduced operating margins, better asset and liability management, risk management, anytime and anywhere banking. Despite these improvements, the commercial banking sector continues to face several challenges and needs to be given emphasis at the future coming days by the banks themselves and also by the policy-makers. Some of the issues for future are:

- 1) **Improving profitability:** The major challenge faced by banks is to protect the falling margins due to the impact of competition for highly rated corporates that may exert pressure on already thinning interest spread. Further, huge implementation cost may also impact profitability for smaller banks. Thus falling profit margins call for increasing volumes so as to result in better operating results for banks.
- 2) **Reinforcing technology:** Technology has become a strategic and integral part of banking infrastructure, driving banks to acquire and implement world class

systems. So the introduction of modern technology such as computers and communication network is essential if the growing volume of transactions is to be handled efficiently. Customers are also looking for improved services from the banks both as depositors and borrowers, and these cannot be met if the banks stick to their present manual methods.

- 3) **Risk management:** The institution of sound risk management practices would be an important pillar for staying ahead of the competition. And to enable banks to cope with risks, the Reserve Bank has been engaged in preparing banks for proactive risk management. Increasingly, risk is viewed as multidimensional and banks would need to establish technical system and management processes necessary to identify risks associated with their activities and measure, monitor and control them. Banks can also formulate 'early warning indicators' suited to their own requirements, business profile and risk appetite in order to include better monitor and manage risks (Reddy, 2004b).
- 4) **Sharpening skills:** The banking industry is entering in the new phase in which it will be facing increasing competition both from banks as well as non-banks. And in order to meet increased competition and manage risks, the demand for specialised banking functions and special skills in retail banking, treasury, risk management, foreign exchange, development banking, etc., will need to be carefully nurtured and built.
- 5) **Greater customer orientation:** In today's competitive environment, banks will have to strive to attract and retain customers by introducing innovative products, enhancing the quality of customer service and marketing a variety of products through diverse channels targeted at specific customer groups. On the side of deposit mobilization, the competition is from alternative savings instrument which may offer even more attractive returns than banks. And on the lending side, with increased activity in capital markets, large borrowers may be able to raise their requirements directly from savers.
- 6) **Corporate governance:** Banking as a sector has been unique and the interests of other stake holders appear more important to it than in the case of non-banking and non-finance organisations. Therefore they have to cultivate good governance culture building in appropriate checks and balances in their operations as corporate governance is the foundation for effective risk managements in banks and thus the foundation for a sound financial system (Leeladhar, 2006). And as the ownership of banks gets broad based, the importance of institutional and individual shareholders will increase. In such a scenario, banks will need to put in place a code for corporate governance for benefiting all stakeholders of a corporate entity.

- 7) **International standards:** Multilateral assessments of country performance are increasingly focusing on observance of standards, and in India, we have made considerable progress in the identification of international standards and codes in relevant areas, expert assessment regarding their applicability, including comparator country evaluation and building up possible course of action for the future. The next step is to sensitise all concerned – policy-makers, regulators and market participants – to the issues involved. There are three levels at which action is necessary, *viz.*, legal, policy and procedures, and market practices by participants.

V

Conclusion

Internationalisation of the infrastructure of financial services can help countries build more robust and efficient financial systems by introducing international practices and standards; by improving the quality, efficiency and breadth of financial services; and by allowing more stable sources of funds. Given the present state of institutional development of many developing countries financial systems, these benefits could be substantial. Empirical evidence elsewhere shows that increased competitiveness enhanced through financial sector openness spurs economic growth (*Levine, 2001*). Evidence also suggests that it is the number of foreign entrants in the market rather than their market share that has a positive effect on the service of national banking infrastructure. Increased competition may imply a reduction in domestic bank profits, but banking customers gain through reduced net interest margins, lower costs of fee-based services and the availability of a greater variety of services. Experience shows that it is vital to strengthen the supporting institutional framework in parallel with domestic deregulation and internationalisation: this is particularly true of the regulatory and supervisory functions of the state but it also applies to the use of the market in disciplining financial institutions.

WTO financial services schedules provide a powerful commitment device and a useful tool for assessing the transparency and the development of regulatory policy in the financial sector. India as a signatory of the agreement has made several commitments some of them are general in nature and some of them are specific to different financial services. Similarly, the wide range of prescription of Basel committee and its world wide acceptance has also made India to commit for several changes in banking. The lowering of statutory level of CRR, bank rate and SLR and the adoption of appropriate prudential regulatory, supervisory, and technological framework at par with international best practices were explicit parts in the financial reform programmes that have supported the transition of the Indian economy to a higher growth path while

significantly improving the stability of the financial system. The chief merit of our reform process has been the cautious sequencing of reforms and the consistent and mutually reinforcing character of the various measures taken. We have been strengthening the banking sector to face the pressures that may arise out of globalisation and also the liberalisation of national financial and capital markets, coupled with the rapid improvements in information technology. The Indian financial system is more stable and efficient today as compared to the past. So also now it enjoys better credibility among the emerging economies. However, the gains of the past decade have to be consolidated so that these could be translated to drive the institutions, markets and practices into a mature financial system that can meet the challenges of sustaining India on a higher growth trajectory.

Particularly, during the last ten years several policy measures have been undertaken to strengthen the financial sector in general and banking in particular. There has been a rapid entry of foreign banks into the Indian banking sector which has spurred the competition in the delivery mechanism as well as variety of services. The recommendations of Basel committee have also been increasingly accepted in India. This has brought several regulatory changes including the most important areas viz. risk management and supervision in banking. With increased access to foreign banks, deregulation of interest rates, changes in regulatory and supervisory framework etc. have made Indian banking more transparent, resilient and efficient. But it is also found that high level commitment made by different countries has not insulated them from banking crisis (Valckx, 2004). It is therefore imperative on the part of India to go for wide range of internal reforms and put in place a strong regulatory and supervisory mechanism for banking sector so that as the largest constituents of financial sector it will provide the necessary strength to the overall economic system.

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