CHANGING SCENARIO OF INDUSTRIAL FINANCE & CAPITAL MARKET IN THE NEW MILLENNIUM

Dr. R. H. PATIL

2001

Published by

THE A. D. SHROFF MEMORIAL TRUST

Peninsula House, 2nd Floor,
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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 involving 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.

INTRODUCTION

The late A. D. Shroff was an outstanding Indian, much ahead of his times. His contribution to the country in the fields of Insurance, Banking and Industrial Finance are, perhaps, monumental. It is a tribute to his vision and foresight that the economic policies that he advocated over forty years ago are now being pursued by successive governments at the Centre and in the States.

One of the objects of the A. D. Shroff Memorial Trust, which was set up in 1966 following a suggestion made by Mr. J.R.D. Tata, is to arrange an Annual Public Lecture by rotation on Insurance, Banking and Industrial Finance. A galaxy of eminent authorities have delivered the lectures in this series since inception of the Trust.

We are extremely happy that the current year's lecture was delivered by another outstanding authority, Dr. R. H. Patil. He has been associated with Development Banking and Capital Market for nearly three decades. He became the first Managing Director of the prestigious National Stock Exchange of India Limited and has built up the institution within a short span.

Dr. Patil delivered the lecture on 10th October 2000 on a very important, relevant and topical theme, "The Changing Scenario of Industrial Finance and Capital Market in the New Millennium". We are grateful to Bank of Baroda, and particularly to its Chairman and Managing Director, Mr. P. S. Shenoy, for the keen interest evinced by him in the Trust and for sponsoring this year's lecture and its publication.

It is hoped that this highly educative booklet will be read by all those concerned with Industrial Finance and Capital Market in the country.

Mumbai, **Nani A. Palkhivala**
dated : 7 November 2000 *Chairman*
The A. D. Shroff Memorial Trust

This booklet is sponsored by
Bank of Baroda

A. D. SHROFF
(1899-1965)

A. D. Shroff's achievements in the fields 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."

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CHANGING SCENARIO OF INDUSTRIAL FINANCE & CAPITAL MARKET IN THE NEW MILLENNIUM

by

Dr. R. H. Patil*

I consider it to be a great honour to be asked to deliver this year's A. D. Shroff Annual Public Lecture. Mr. Shroff excelled as a visionary and deep thinker in economic policy matters besides being an eminent industrialist, banker and a founder-architect of several successful institutions and forums. In my student days I silently admired Mr. Shroff for the sincerity of his conviction in the market economy and his tremendous courage to hold on to positions that meant vehemently disagreeing with some of the politically most powerful people of those times. Those were the days when even many bigwigs were shy of openly criticising the shortages, distortions and inefficiencies that the industrial licensing policies and planning process were creating for fear of being branded as reactionaries. As the days passed, it was becoming increasingly clear that the country was paying dearly for the economic policies that strangulated market forces, distorted the economic incentive system and clearly meant missing opportunities for higher economic growth in the context of an open economy.

When an opportunity to set up a brand new institution like National Stock Exchange (NSE) came, we decided to incorporate the essential elements that contribute to the growth of an efficient and truly competitive capital market. During the last six years NSE has almost revolutionised our equities market and brought them on par with the best markets in the world. The tremendous success of NSE in such a short period of time has further strengthened my faith and conviction in the market mechanism, which alone can function as a powerful policy instrument to cleanse economic system and make it functionally more efficient.

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* The text is based on the Annual Public Lecture delivered under the auspices of the Trust on 10th October 2000 in Mumbai. The author is the first Managing Director of National Stock Exchange of India Ltd. He was earlier Executive Director of IDBI Ltd.

As my humble and respectful tribute to the memory of Mr. Shroff I have attempted in this lecture to delineate the advantages of building a strong and vibrant capital market and, in particular, the debt market for meeting the growing needs of finance for industry and infrastructure.

Evolution & Growth of DFIs

In the post-Independence period, our country witnessed birth of a large number of specialised institutions for providing finance to different sectors of the economy. Among these different types of institutions, the well-knit structure of development financial institutions (DFIs) for meeting the requirement of medium and long-term finance of all range of industrial units—from the smallest to the very large ones—occupied pride of place. As a matter of conscious policy, RBI and the Government nurtured DFIs through various types of financial incentives and other supportive measures. The main objective was to provide the much-needed long-term finance to industry, which the then existing banking institutions were not keen to provide because of the fear of asset-liability mismatch. Since deposits were short/medium term, extending term-loans was considered to be relatively risky. The five-year development plans envisaged rapid growth of domestic industry to support the import substitution growth model adopted by the national planners. To encourage investment in industry, a conscious policy decision was taken that the DFIs should provide long-term finance at interest rates that were lower than those applicable to working capital loans. In the early years of post-Independence period, various commodity shortages tended to make trading in commodities a more profitable proposition than investment in industry, which carried higher risk. Partly to correct this imbalance, the conscious policy design was to increase attractiveness of long-term investment in industry and infrastructure through relatively lower interest rates. To enable the term-lending institutions to finance industry at concessional rates, Government and RBI gave the DFIs access to low cost funds through bonds with government guarantee, budgetary support, and allocating sizeable part of RBI's National Industrial Credit (Long Term Operations) funds to IDBI. Through an appropriate RBI fiat, the turf of the DFIs was also protected, until recently, by keeping commercial banks away from extending large sized term loans to industry.

After the opening up of the Indian economy and introduction of financial sector reforms since 1991, the development banks have been deprived of the protective climate in which they operated for long. They have no access to concessional sources of finance and have to compete for business along with commercial banks, whose cost of funds is way below that of the DFIs. Global competition through more liberal imports has adversely affected profitability of several industrial units assisted by the DFIs in the past. Hence the DFIs are now saddled with high level of NPAs. This in turn has adversely affected their fresh business as the demand for term loans has come down sharply. More liberal policy framework has encouraged mergers, amalgamations, restructuring and rationalisation of production capacities, leading to productivity improvements, and consequently less demand for additional capacities in various industries. Greater import availability, which ensures much wider range of choices (and often better quality), has led to lower demand for term finance from industry.

In view of the major changes in the business environment, the development banks have realised that they need to re-engineer and identify new areas of operations if they have to survive as viable and profitable entities. A Working Group set up by RBI under the Chairmanship of Mr. S. H. Khan, the then Chairman of IDBI, recommended that a full banking license be eventually granted to DFIs. However, in the interim, the DFIs might be permitted to have banking subsidiaries while the DFIs themselves might continue to play their existing role. Khan Working Group also recommended that gainful mergers of banks with DFIs might be permitted. The main thrust of these recommendations was that, the DFIs had to search a new role for themselves in commercial banks and/or convert themselves into full-fledged banks.

It may be noted in this context that the conversion of DFIs into banks need not necessarily lead to shortage of finance to industry and infrastructure. This has already been observed from the experience of a number of East Asian countries. Withdrawal of DFIs from the business of term lending did not adversely affect availability of finance for projects in South Korea and Singapore. As the economy of any country opens up, inflows of foreign direct investment get stepped up considerably. This is already happening in India. Since 1992, when the liberalisation process gained momentum, there have been large inflows of foreign investment in industry and infrastructure. Further, most of our commercial banks have also stepped in to meet demand for term loans of industry and infrastructure. However, in order to become more effective players in this area, the commercial banks will have to develop in-house expertise to appraise loan proposals for large and complex projects. Wherever necessary they should draw on the expertise of the DFIs and prefer funding large projects in consortium with them. In any case the DFIs will continue to provide term loans to industry as it will take quite some time for them to diversify in a big way into newer and more profitable activities.

Since their concessional sources of funds have fully dried up, they are not in a position to offer term loans at attractive rates as in the past. Moreover, they are also not in a position to raise long-term funds to match the requirements of large projects, which need funds with much longer repayment schedules. Bulk of the fresh funds now raised by DFIs is of short and medium term maturity. When the DFIs fund long gestation projects they face the problem of asset liability mismatches. A more satisfactory solution to the problem of providing the much needed term finance to industry and other sectors will be to strengthen the capital market as a major source of term finance to industry. The capital market can be relied upon to play this role provided a suitable policy frame for the development of active and highly liquid nation-wide debt and equity markets is put in place. The need for developing a vibrant debt market that also encourages relatively longer maturity instruments, particularly for financing infrastructure projects, has been effectively argued by the widely discussed "The India Infrastructure Report" submitted to the Government in June 1996. This Report, also known as Dr. Rakesh Mohan Committee Report on Infrastructure, has made several important recommendations for kickstarting a vibrant, deep and liquid debt market.

Diversification by Development Banks

The role played by the term-lending institutions in the process of financial intermediation has been declining in our country especially since the early part of the last decade. With the deregulation of the financial system since 1992 and the removal of the artificial policy props earlier given to them, the term-lending institutions are finding that their traditional business is fast disappearing. Sympathising with their fate, Reserve Bank has agreed to consider favourably if they make any proposals to convert themselves into commercial or universal banks. In the immediate future, commercial banking may, prima facie, appear to be an attractive proposition for the term-lending institutions. However, a good medium to long strategy for the DFIs would be to opt in favour of becoming capital market oriented institutions. Even for the commercial banks, their survival as viable and vibrant entities would very much depend on how fast they transform themselves into capital market oriented institutions. Given this, there appears to be little justification for the term lending institutions to convert themselves into pure and simple vanilla versions of commercial banks.

The days of pure development banks or pure commercial banks are fast getting over. Already the term lending institutions are raising bulk of their incremental or new resources through the capital market. Some of them are already reorienting their operations in favour of the capital market. ICICI is boldly moving into a variety of new and innovative areas, which can be briefly described as B2B and B2C activities. It has also plunged into information technology, venture capital, housing and car finance and a number of mass market related activities. Some of the other major DFIs are not yet sure as to what should be the future composition of their business activities. But ICICI appears to have clearly recognized the crucial role of the capital market for earning growing proportion of incomes by venturing into capital market related activities. It has also dovetailed the activities of all its group companies (including the commercial bank and the securities brokerage arm) with potentially more profitable capital market related activities such as holding clients' depository accounts, internet trade, and providing payments gateways.

If survival and healthy growth are considered to be the prime objectives of a good business corporation, no purpose would be served by being sentimental about its original charter or its major activities only a couple of years ago. With rapidly changing times and business prospects, a bold and timely course correction in business strategy should be done as soon as it becomes necessary. With growing economic liberalisation, the global economy will start exerting growing pressure on the domestic economy and with that the competitive advantage of different industries will change fast. India, being a capital scarce economy, should try to exploit to the maximum extent possible the benefits of a service-oriented economy in which it appears to be having a clear competitive advantage globally. Information technology has emerged as the dynamic export sector of the Indian economy, Increasing application of information technology is drastically changing the way business is being done especially in the financial sector, including the capital market. Hence the future is going to reward those who are bold, innovative and imbued with a spirit of experimentation. While taking up the new activities the yardstick of pre-assured success need not be ruthlessly applied. Later, on hindsight, some of the moves may turn out to be wrong. As the old saying goes failure is not a crime if new activities are taken up with a spirit of well-intended adventure. Markets certainly reward those who are calculatedly bold.

While converting themselves into commercial banks may appear to be an attractive proposition for the DFIs, they should not ignore the disadvantages being faced by the commercial banks themselves. As of now it is a "grass is greener on the other side" syndrome, both for the commercial banks and the DFIs. Today, priority sector lending is one area, which the commercial banks are riddled with on account of regional and political pressures. With much smaller size of average account, the operating costs of priority sector advances are very high. These costs would be certainly higher for the newer banks with their market related salary structures. Easy access to low cost retail deposits and freedom to participate in the money market and related areas may be attractions of a commercial bank. But these advantages are accompanied by many onerous responsibilities. Even without becoming commercial banks, the DFIs can get into many investment banking and universal banking type of activities. Having already set up their own commercial bank as a group company, they can derive all the advantages of a commercial bank by suitably dovetailing their activities and developing synergetic business relationships. Even though a DFI cannot be a member of the money market club, it can get most of those advantages once a full-fledged repo market develops. There are plans to set up a clearing corporation, which will act as a counter party to all settlements in debt trading, bilateral repo as also third party repo transactions. Since commercial banks will be operating in both the money market segment as also the activities facilitated by the clearing corporation, the DFI will derive most of the benefits of the money market without actually being its member. For example, they can entrust their cash management activities to the commercial bank in the group. With the exponential growth of Internet, the cost of mobilisation of resources will become affordable for the DFIs. They can also use the infrastructure of the commercial bank within their own group for mobilising funds by way of short-term instruments and bonds. All these instruments should be issued in demat form to minimise issue expenses and transaction costs in the secondary markets, since the depository transactions have been recently exempted from stamp duty. DFIs should also work out arrangements for market making in their debt instruments and providing assured liquidity to investors. If DFIs are able to create an active market for their bonds, they will become as attractive as banks for average household investors. With all these arrangements the DFIs can hope to have best of both the worlds.

Financial Disintermediation

The important role that the capital market can play in the efficient allocation of resources is not adequately recognized in most of the countries including ours. It is generally argued that the capital market facilitates the process of disintermediation and that the capital market establishes a direct relationship between the savers and the users of funds. On the other hand, banks and institutions are supposed to be acting as intermediaries in the process of transfer of funds from the savers to the users of funds. It should be noted that, the capital market also cannot function in a vacuum and certainly depends on the services of a variety of intermediaries, like brokers, merchant bankers, stock exchanges, depositories etc.

Functionally, the main distinction between the financial institutions (including banks) and the capital market is that the capital market crystallizes the risk with the savers while the banks/institutions take the risk upon themselves in the process of intermediation. The banks and institutions charge a fee for their intermediation services, which is basically made up of cost of funds and a risk premium. The primary components of the cost of funds to a institution/bank include interest paid to the savers, minimum desirable return on the net-worth or shareholders' capital of the institution/bank, its administrative costs and staff compensation, etc. The risk premium demanded by a bank/institution from various borrowers would vary depending on the level of risk posed by different borrowers. In the case of the capital market, the risk is supposed to be entirely borne by the investors who choose this mode of investment.

It is thus clear that intermediaries are required in both the processes of transfer of funds from the savers to the users. The only major difference between the two processes is in regard to who bears the ultimate risk when funds are transferred from the savers to the users. It is worth noting that in the case of financial intermediaries including banks, they are really supposed to be bearing the ultimate risk. But the real life situations are not that simple and straight forward. As a matter of fact, the ultimate risk of lending by banks is often borne by the government or, in some way by the central bank of the country (in its capacity as the agent of the government). In the past, Government of India has periodically recapitalized the public-sector banks when their net-worth got substantially eroded because of their bad lending. In the case of the private sector banks they were often merged with some other public sector banks or nationalized. Cases like the Bank of Karad are rare, when the insolvent bank was liquidated and several depositors lost when their deposit amount exceeded the insurable level.

All over the world the governments would not like the financial system to melt down because of the grave risks to the whole economy. Invariably the governments step in to rescue especially when big banks are likely to become insolvent. Recently, for the same reason, Government of India had to step in with bail out package for several public sector banks by re-capitalizing them. Therefore, "the too big to fail" syndrome prevails in most of the modern economies. India is not unique in this respect. A couple of years ago, the US government had to bail out the Savings & Loan Institutions by pumping into them several hundred billion dollars. But for this fall back support extended by the authorities in most of the countries, the banking institutions would have been considered by the average depositors to be as much risky as the capital market.

If ensuring efficient use of capital should be the prime objective or the policy goal of any government, it is desirable that banking institutions are not given any preferential treatment over the capital market. Most of the policy makers may not like to openly admit that the financial sector policies adopted by them discriminate against the capital market. It is also possible that the policy makers are not aware that while giving a preferential treatment to the financial intermediaries they are actually hindering growth of a healthy and vibrant capital market. There is apparently no justifiable reason why the authorities should adopt a discriminatory policy in favour of banks and against the capital market.

The net impact of the overall policy frame adopted by the authorities in most of the countries is to offer concealed subsidies to investors who prefer bank deposits as their first choice. Depositors are sure that their funds are quite safe with banks and institutions because the government will protect these financial intermediaries, at least the bigger ones at any cost. This is the firm conviction of an average depositor, at least in regard to the public sector banks. Otherwise it would be difficult to offer any rational explanation for the continuing growth in the deposits of Indian Bank, the net-worth of which stands almost completely eroded. The government has already recapitalised Indian Bank in the recent past and the depositors believe that government will underwrite all the risks that they shoulder as depositors. Purely on objective principles, the depositors should not be given such a blanket assurance that they do not bear the ultimate risk of their investment decisions. The deposits above the insurable level should carry the normal business risks that any bank/institution is subject to just as investors today have to bear risks in the capital market.

The government should not adopt a policy of underwriting the risks of unwise lending by banks, and deposit insurance should cover, as at present, all the deposits only up to a limit. The insurance premium collected by the insuring agency from the banks should actually vary from bank to bank depending on the level of its risks. The entity insuring bank deposits should study the risk management principles adopted by each bank and the quality of its portfolio thoroughly and charge a premium rate that reflects its risk. This will force the banks to fine tune their deposit rates so that the interest rates paid on deposits that are not insured reflect the risk factors specific to each bank. Simultaneously, the agency insuring bank deposits should be asked to disclose its insurance rates for each bank so that the depositors are also warned well in advance of the risks that a bank carries while depositing their money with it. Except in a grave emergency, the government should not try to bail out banks as the costs of such bail out will have to be ultimately borne by the common citizens of the country. There is no rational justification as to why the common citizen should compensate an unwise depositor who ignores risks of depositing his money in banks that do not care about the safety to other's money and indulge in bad lending. Government policy should not encourage sloth and profligacy in the financial system.

Financial System & The Capital Market

The inexplicable bias against the capital market is also reflected in the general discussion on financial system and the capital market. In most of our discussion on financial system we invariably treat capital market to be a relatively less important adjunct of the financial system. Rarely do we recognize that capital market is increasingly becoming a fulcrum of the financial system in several developed market economies. Banking institutions are deriving growing part of income and profits from capital market related activities. In the US mutual funds command more resources than all the banks put together. Yet standard textbooks on economics continue to assign a limited role to the capital markets in their discussion on the financial system of even the developed countries. These standard textbooks consider that the main function of the primary market is to mobilise funds for the issuers of securities and that of the secondary market to increase attraction of such securities by providing opportunities for exit/entry by facilitating sale and purchase of transferable securities. The discussion on capital markets generally does not bring out properly the significant impact that the capital market has made on the functioning of the major financial intermediaries like banks and other bank-like financial intermediaries. Hence, the role that the capital market has been playing today in transforming the way banks and institutions function is not well recognized.

In the US in particular the banks are radically changed entities. This could be noted from the composition of their incomes. The fact that non-interest income accounts for significant part of the total income of the US banks (about 43% of the total income in 1999) does provide enough evidence that the traditional financial intermediation role played by the banks is far less important today. The incomes of the US banks by way of service fees — basically from capital market related services — are quite substantial in relation to their interest income. Bulk of the service fees and related income that banks derive in the US is directly or indirectly related to their capital market related activities.

The relative importance of banks in the overall financial system of our country also appears to be declining. This is reflected in the falling share of bank deposits in the savings of the household sector, which accounts for about 80% of aggregate national savings. Average investor is now diversifying his asset portfolio by gradually moving away from bank deposits and increasing the proportion of his savings into other less lacklustre avenues. The share of bank deposits in the financial savings of the household sector declined from a high of 35.3% in 1994-95 to 30.8% in 1998-99. Investor either invests directly into the marketable instruments or prefers to entrust part of his savings to the other intermediaries, rather than entrusting the bulk of it to banks. The mutual funds are becoming increasingly popular with the investors. The equity-oriented mutual funds have become highly attractive in view of the tax exemption on their dividend. Besides, the fund managers are providing highly diversified choices. Investors can now choose from a wide range of sectoral funds whose numbers are continually growing. Similarly, investors' options regarding fund managers have also widened with the entry of several new domestic private sector players as also foreign fund managers who have become active in the indian markets, either on their own or in association with domestic partners.

The commercial banks appear to be too slow to grasp the changes taking place in the financial sector after the major economic reforms were launched. Their traditional lending activities are not expanding fast enough to absorb the growing deposits. The non-food credit deposit ratio of banks declined from 60.4% as at end March 1991 to 50.4% at end March 2000. Banks are investing in government securities far in excess (Rs. 85,000 crore) of their requirements. Despite the fact that almost two-fifths of their total deployable funds are locked up in government securities and other capital market instruments, very few of them have shown any awareness about the importance of the capital market as a growing source of their income. For several banks, lending operations have turned out to be unprofitable because of unattractive lending rates as also growing levels of NPAs. Yet they continue to devote far larger part of their managerial and staff time to lending operations at the gross neglect of efficient management of their treasury operations and securities portfolio. Treasury functions, in particular, continue to be highly neglected even in the larger among the nationalized banks.

Deposit mobilisation and lending continue to be the major preoccupations of most of the banks in India. At one stage, the performance appraisal/evaluation of bank managers depended almost exclusively on their success in deposit mobilisation each year. Deposit size, and not profitability performance, was the yardstick for judging staff performance, relative importance of bank branches as also bank as a whole. As a result, growth of the balance sheet size became the major preoccupation of banking personnel. Today, after the adoption of RBI guidelines on income recognition, provisioning and capital adequacy by the banks, the old yardstick of success has become less relevant to them. Consequently, deposit mobilisation at any cost is no longer the magnificent obsession for most of the banks. But the banking personnel is yet to adequately recognize that they need to give much greater emphasis on earning major part of their profits through fee based incomes than through interest income. Fee-based income is a safer option for a bank as it has significantly lower credit risk. The public sector banks, however, are too slow to adjust to the dynamically changing business environment both because of the poor loan appraisal systems and risk management strategies as also de-motivated staff. Banks are losing their best staff due to poor compensation packages, premium on non-performance, and fear of witch hunting by the vigilance mechanism.

In the olden days, financial intermediaries like banks provided the most effective link between those who had surplus money and those who needed it for business and industry. Banks thrived in an age when they had far more reliable and superior information base than others. They had much greater access to credit information and track record of all those who mattered from their business point of view. So long as they could effectively use their credit information, which they collected in the ordinary course of business, they could earn good profits. But as business and credit information became a widely available commodity, the special advantage that the banks enjoyed disappeared fast. Further with the development of active equity and debt markets, the best borrowers in countries like the US found that they could rely on the capital market for cheaper funds. As a result, banks found that they had to increasingly remain contented with not so attractive customers on their books. They gradually preferred to diversify their business in favour of other safe avenues like fee-based incomes. This turned out to be a positively welcome development as it meant that borrowers had to become more credit worthy if they wanted to get funds from banks or the capital market on more attractive terms. In the process, the market forces started putting pressures on borrowers to improve their credit worthiness.

It has been observed that the market is often a far more powerful disciplining mechanism than financial intermediaries like banks. The same bad borrowers cannot continually waste money or cheat the market and easily get away. If the legal framework is not in a position to punish the defaulters the market will punish them by not subscribing to their issues continually. Banks in India, however, have lent to the erring borrowers time and again although they have accumulated huge NPAs in the process. A number of bankers in our country are too soft or are forced to become soft in dealing with well connected borrowers who squander public money. In so far as public sector banks are concerned, their NPAs ultimately become the liability of the common citizen. For preserving faith of the ordinary depositors, the Government bails out the loss making public sector banks through budgetary blood transfusions. Given the unwillingness of the Government to discipline the banks and prevent further erosion of their net-worth it should become imperative that the financial system relies increasingly on financial disintermediation. It would be safer to rely on the market mechanism to discipline habitual defaulters than by the banks/institutions.

Asset Liability Management

There is another justification why the banks need to increasingly move away from their traditional lending activity to investment in rated marketable securities. After the initiation of the era of interest rate deregulation, it has become difficult for the market participants to predict the yield curve with as much reliability as in the past. Both the deposit and the lending rates have become more volatile. Banks have now to increasingly avoid asset liability mismatches given the fact that the yield curve is not stable. Duration risks are becoming too unpredictable. Another reality with which banks have to live is the requirement of extending advances not by way of cash credit mechanism but by way of term loans, especially in the case of large borrowers. Earlier banks could revise interest rate on the outstanding cash credit amount as and when there was revision in lending rates. But the same flexibility is not available with the term loans. Hence the banks have now to worry more about asset liability mismatches. Secondly, for banks to have reasonably satisfactory capital adequacy ratio they need to worry more about their asset composition. Banks need to use funds increasingly for acquisition of assets, which are easily disposable and offer much greater freedom to change their composition in response to changes in the interest rates structure or maturity pattern of their existing liabilities. Banks can have such flexibility only if bulk of their assets could be easily reshuffled through market operations. It would be possible for banks to achieve the same objective if an active market in credit derivatives could be developed. Since it may take quite some time for development of an active market in credit derivatives, banks need to modify their lending policy. Therefore, while extending short term advances, banks should favour accommodating their customers through bills scheme or commercial paper. Similarly, instead of giving term loans, banks should prefer the route of marketable debentures of various maturities.

Marketable assets help in inducing a sense of discipline both among lenders and the borrowers. Since credit rated debt is periodically reviewed from the rating angle by the credit rating agencies, the issuers of debt will be always on their toes. They would be keen that the resource tap remains open by way of renewal/reissue of the existing debt as also for the growing or new activities for which the borrower would like to raise additional debt. The lending agencies will be in a much better position to evaluate quality of their portfolio periodically when their exposure, at least to the large borrowers, is in the form of credit-rated marketable debt. Although many banks have attempted to develop their own versions of credit rating methods, it would always be preferable to have rating of assets by professional rating agencies. Before the RBI issued its guidelines on asset classification and provisioning, several banks were having very vague idea about the quality of their overall portfolio. However, most of them could not have accurately quantified the extent to which their portfolio was contaminated. Once the outside rating agencies start rating at least bulk of their large sized assets banks would have much more dependable assessment of the quality of their portfolio. This would be in the interest of banks themselves as undue extraneous and particularly political pressures would be less on them if the fact about fast deteriorating quality of their portfolio becomes a public knowledge. RBI should therefore make it mandatory for banks to make far greater and more detailed disclosures about the quality of banks' portfolios to ward off unhealthy extraneous pressures on bank management to lend to undeserving borrowers.

Investments in Government Bonds

Average investor is not investing much in the fixed income marketable securities despite the fact he favours fixed income assets. RBI's studies on pattern of household investments indicate that nearly three-fourths of the financial savings (excluding currency holdings) are in fixed income assets while only about 2-3% of investments are in equities. Lack of interest of the investor in the bond market is not because he is not well disposed to fixed income assets. The real problem is, there is scanty supply of good bonds in the retail market. One of the most attractive marketable instruments, both from the safety and returns point of view, are the bonds issued by Government of India. But unfortunately Government appears to have done everything possible to discourage the common investor from investing in these bonds. The routine tax sops available for many other investments like bank deposits or small savings schemes are totally denied to government bonds. It appears, as if the government is more comfortable to raise money only through its traditionally captive investors like banks, LIC and the provident funds. Even the Gilt funds have been treated harshly by slapping a 20% distribution tax on their dividends. There is every thing to be said in favour of popularising government bonds into the portfolio of the common investor. It will help government in bringing down SLR penalty on banks and other captive investors. From the common investor's point of view, the return on these bonds is attractive given the risk reward matrix of the Indian economy. Government and RBI should take suitable measures to develop an active secondary market in these bonds. A committee has recently been appointed to look into measures required to create retail market in government bonds, both among the corporates and the common households. The Committee is yet to submit its report.

It is in the interests of both Government and the financial system of the country to entice common investors into the fixed income marketable instruments. Government would be able to bring down its borrowing costs if it starts raising funds directly from the common investor. The existing tax sops given to bank deposits should also be extended to investments in government securities. It is ideal that the Government brings down the tax on dividends distributed by the pure Gilt funds to its earlier reasonable level of 10%. Alternatively, it should make Gilt funds merely pass through entities as in the past and let the investor pay the income tax as applicable to him. From an overall policy perspective, it is desirable that the level of mandatory SLR ratio is gradually brought down by creating new markets for the Gilts in the households and the corporate sector so as to make the financial system more market oriented. Corporate sector would be keen to invest in the Gilts for managing its liquidity if an active repo market is developed for raising funds whenever required by the corporate entities. Retailing government securities, either directly or through the Gilt funds, would go a long way in achieving the desired objective of bringing down the excessively high level of SLR of banks.

We need to encourage households to invest directly in marketable fixed income securities rather than locking their savings in bank deposits. From a social point of view, financial intermediation by banks has proved to be costly. Huge NPAs of public sector banks have proved to be a major bugbear for the government. Portfolios of several public sector banks like Indian Bank, United Bank of India and United Commercial Bank have been highly contaminated with NPAs. Government has been re-capitalising the weak banks periodically through the budgetary support. Therefore, the ultimate burden of the NPAs of banks is being borne by the common man through the Government budget. The bad lending by banks could be traced to several factors like socially directed lending, political as well as bureaucratic interference with the functioning of the banks, trade union troubles leading to poor discipline and absence of proper work culture among banks, etc. It is difficult to find an easy and quick solution to the problems arising out of the poor quality of corporate governance in public sector banks.

One sure way of keeping check on growth of NPAs of banks is to slow down the growth of bank deposits by encouraging households to shift their asset preference in favour of capital market instruments. This will at least reduce the growth in incremental funds with the banks and consequently their possible bad lending. One more way to contain growth of NPAs in the books of public sector banks is to induce them to increasingly get into rated marketable debt of corporate units rather than extend advances in the traditional way. Short-term advances should be converted into commercial paper/bills and term advances into debt that will be listed on the stock exchange. Since commercial paper and term debt to be traded/listed on the stock exchange will have to be rated, banks get one more reliable credit appraisal/scrutiny of the assets that they would like to have on their books. If any such marketable debt later gets poor rating it will act as an automatic check against the bank further investing in it. External pressures that have forced the banks so far into bad loans will get blunted since the concerned banks will be in a better position to resist unsavoury pressures in view of the poor rating received by such instruments.

Like their American counterparts, Indian banks would also soon realize that instead of raising deposits and then assuming lending risks, it would be more profitable to encourage the savers to assume the credit risk directly. Banks are ideally suited to facilitate this process of disintermediation at a fee. Taking loans directly on the books means adding to possible non-performing assets that are already cluttering books of banks in a large measure. Banks should realise that excessive SLR investments also become problematic. Although, currently the SLR obligations do not appear to be a losing proposition for banks (as returns on SLR investments more or less cover cost of deposits), banks do not like the prospect of their credit-deposit-ratio declining too much because of rising proportion of SLR investments. Nor would the banks like to be seen as working only for SLR investments. The banks should also realise that investments in government securities are not fully risk free. There is no credit risk in the case of central government securities as the central government has the monopoly of printing money. Irrespective of what happens to its budgetary position, central government can print fresh money and service its debt. All the same, the central government bonds do carry price risk due to interest rate variations, which becomes evident when the banks have to mark their investments to the market.

Banks' investment in state government securities is, however, likely to face a potential risk. The day is not very far off when some of the state governments will not be in a position to service their debt effortlessly with their own budgetary sources. Even some of the developed states like Maharashtra are facing a precarious financial situation. Will the banks be in a position to book the loss on account of their investments in state government securities? Even if the states do not actually default, the market value of their debt will fall sharply as soon as RBI starts issuing their debt at rates that will be decided by the market based on the perceived credit risk of each state. Once this happens, interest rates of fresh issues of poorly credit rated states will rise sharply, necessitating downward adjustment in the prices of the bonds already in the portfolio of the banks. One needs to anxiously watch how the government is going to deal with this highly sensitive issue. If the central government decides to bail out the states, it will have to frame some objective criteria, which, of course, are not likely to be very kind to the profligate states. All these are certainly great imponderables at the moment.

Corporate Bonds

As of today, the supply of good corporate bonds is scarce especially for the common investor. Indian corporate entities have not yet shown any interest in tapping the retail markets through issue of bonds. They have found that the private placement market is able to meet their requirements, although the yields on these privately placed instruments may be equally attractive for common investors. The main subscribers in the private placement markets are often institutions like banks, which have large liquidity to spare. The Indian corporate sector is as much to blame as the Government for not having shown any interest in the common investor when it comes to the issues of their fixed income marketable instruments. It would not be certainly unfair if one were to conclude that the Indian corporate sector and the Government are not really friendly to the common investor.

The US experience clearly bears out that the Indian private sector is showing a shortsighted approach by overlooking the advantages of financial disintermediation. It should soon get out of its habit of depending excessively on the banks, institutions, and the private placement market for its funds. Once the investment activity picks up, the costs of borrowing from these traditional sources will go up. The good credit-worthy corporate entities should try to tap the main source of supply viz., the household sector and benefit from the low cost disintermediated funds. Initially, before the retail network can be built up, the borrowing costs from the households may not be much different. It is true that there are hassles in the beginning of dealing with large number of investors. But the success of depository and the spread of the secondary market network of NSE to more than 350 cities and towns across the country provide highly efficient distribution mechanism at relatively low costs. There is no reason why we cannot rely on the secondary market network for retail distribution of debt in the depository form especially when the clearing corporation of NSE can provide financial guarantee for all these operations. Corporate entities with very good credit rating will be able to eventually bring down their cost of borrowings if they tap the retail market directly. An active secondary market can also be developed since ownership transfer in depository mode is completely exempt from stamp duties. With the disappearance of the physical securities, handling costs of depository mode have been significantly brought down. The process of ownership transfer is also now much safe, quicker and cheaper. It does not require great deal of innovation to exploit the secondary market infrastructure for the distribution of any depository-based security instrument. In order to make their bonds attractive the issuers should appoint market makers, which give two-way bid and offer quotes continually on the secondary market screen so that the investors enjoy the benefit of continuous liquidity. Banks can play a major role in market making if they provide working capital finance to the brokers of their choice against the security of the debt instrument itself. They can perform this role without any risk if they become depository participants and hold the bonds in custody.

Vast Potential Debt Market

The Indian financial system is not yet well developed and diversified. One of the major missing elements is the absence of an active, liquid and large debt market. In terms of outstanding issued amount, Indian debt market ranks as the third largest in Asia, next only to that of Japan and South Korea. In terms of the fresh or the primary issues, Indian market is very large. The government continues to be a large borrower unlike in South Korea where the private sector is the main borrower. If we compare the size of the Indian GDP with the outstanding size of the debt flotation, Indian debt market could be considered as fairly well developed. However, several objective parameters indicate that our secondary debt market is the least developed.

The RBI's annual study on savings clearly brings out the overriding importance of *fixed income assets* in the savings pattern of the households sector, which accounts for nearly 80% of the aggregate financial savings in the Indian economy. Indian households have great appetite for debt instruments provided they are packaged properly. The main fixed income instruments popular with household investors are bank deposits, provident funds, and national savings schemes. The share of fixed income instruments that could be traded in the secondary markets is next to nil. The main missing element in all this is the absence of an active secondary market in debt instruments that explains the lack of investor interest in tradable debt. It is typically a case of "chicken and egg problem". Since there are not enough number of issues and the floating stock in the secondary markets is miniscule there is hardly any trading in them. But, until an active secondary debt market develops the issuers in the private corporate sector may not venture to issue tradable debt. Currently, almost 99% of the traders in debt instruments in our secondary markets relate to government securities, treasury bills, PSU bonds and small amounts of commercial paper. The quality of secondary market debt trading in India is abysmally poor if we compare it with quality of our secondary equity markets. Debt markets are totally devoid of transparency, liquidity and depth. By the standards of every yardstick that could be chosen to define efficiency of a secondary market in financial instruments, Indian debt market would not score more than 20% of the marks that the Indian equity markets would score.

The US has one of the most active secondary markets in both government and corporate bonds in the world. The size of the US secondary debt market in terms of daily trading turnover is nearly ten times the size of the equity market. In India, the size of the secondary debt market is barely one-tenth of the size of the equity market. These comparisons indicate the long journey we have to travel if we want to develop active secondary debt market. The secondary debt market suffers from several serious infirmities. It is the most non-transparent market compared to the equity market. It is highly fragmented since the ownership titles (SGL accounts) of government securities are fragmented city-wise. A buyer from Chennai or New Delhi cannot trade in the Mumbai market since securities held in SGL accounts with RBI's offices in Delhi or Chennai cannot be easily transferred to Mumbai and vice-versa. Treasury bills cannot be traded outside Mumbai. Since the order book is geographically fragmented the quality of price discovery process is very poor. A settlement system is not efficient unless the buyers and sellers have both SGL and cash accounts with RBI. Since RBI provides these account facilities to only a limited number of entities, non-transferable city-wise settlement facilities are available only to these entities. One just cannot dream of having nationwide trading and settlement facilities in government debt as one can do with such tremendous ease in equities.

The retail and wholesale secondary markets in equities are tightly integrated as there is only one order book for both retail and large sized orders. With the depository facility accounting for over 99% of the settlements (by value) a large sized buy order for an equity stock may get matched with numerous small orders. The settlements are done through the process of netting and novation and the clearing corporation of NSE becomes counter-party for all settlement obligations. NSE's clearing corporation also extends full financial guarantee for all settlements. Such an arrangement does not exist for the settlements in government securities, which account for nearly 90% of country's secondary debt market. The Real Time Gross Settlement (RTGS) system which, RBI is in the process of implementing will be able to resolve the settlement problems of only those who have a fund and a SGL account with RBI. But if we are keen to develop a nationwide market for all debt securities including all government bonds and treasury bills it may be necessary to have a trading, clearing and settlement infrastructure similar to the one we have for the equity market. It is only through such a mechanism that it would be possible to do away with the unfortunate fragmentation of the debt market, which is split city-wise and among market participants of various sizes. It is essential these infirmities in the government bond market are removed as early as possible.

We need to accord very high priority for the development of an active and deep market in GOI securities so that the market can throw up a dependable bench mark yield rate.

Power of the Retail Savers

Banks and institutions who are the active players in the debt market have failed to appreciate the power of a nation-wide trading system that can bring into a single order book the huge potential liquidity that will help in creating an efficient and highly liquid debt market. Before NSE's nationwide trading system was put in place the aggregate value of trading on all the stock exchanges of the country averaged around Rs. 150-200 crores per day. Currently even on some of the dull trading days NSE alone is logging Rs. 6000 crore or more of trading volume. This surge in volume has come about by the magic of the nationwide trading system that has aggregated the order books originating from over 6100 trading terminals located in more than 350 cities and towns across the length and breadth of the country. One of the significant factors that has contributed to the growth of the secondary equity market is the magic of the retail investors. The Indian banking system is another good example that testifies to the power of the retail depositor base.

Nationalisation of banks was perhaps one of the prime causes for unhealthy political interference leading to extensive contamination of the portfolios of banks and their downhill journey. But one good thing it did was the extensive spread of rural and semi-urban branches that unlocked the power of the retail depositors and integrated the barter economy into the mainstream financial system. However, for quite a long time, the public sector banks have ceased to be innovative. They have not cared to exploit the huge untapped potential of the retail customer base for the development of the debt market. Instead of taking on so much of the government debt on their own books the banks should have used their extensive branch network to encourage depositors to get into bond habit. Banks have not realised that long-term deposits are really expensive especially if we keep in mind the fact that the banks often get into asset liability mismatches on account of high interest they have to pay on longer-term deposits. Recently one major foreign bank is reported to have consciously encouraged the long-term depositors to divert their deposits into open ended debt funds floated by its associate entity. Today, long-term deposits have become real liabilities of the banks for the reason that they are relatively high cost funds in which banks get locked in. Unless the banks are able to lend funds for similar maturities, in which the borrowers are also willing to get locked in and do not have the option of pre-payment, long-term deposits tend to be a burden. Further, given the obligation of the banks to maintain reasonable credit deposit ratio they have to lend more irrespective of the quality of the borrowers. The competitive obsession to raise more and more deposits has been in no small way responsible for the accumulation of huge NPAs. Once the banks collected more deposits they had to lend more to abide by the minimum desired level of credit-deposit ratio especially in states where lending has proved to be putting money down the drain.

According to the latest Annual Report of RBI, banks are investing heavily in the government securities although the demand for credit has picked up from industrial and other borrowers. During the last year, the share of government securities investments in the incremental deposits of banks was significanly higher at 55.6% despite the fact that banks already held SLR securities far in excess of the requirements. Currently, the banks' investments in SLR securities in relation to their net time and demand liabilities stood at 34.5% as against the requirement of 25%. Thus banks' excess holdings of SLR securities amounted to Rs. 85,000 crore as at end March 2000. One of the main reasons why banks continue to invest heavily in government securities is the capital adequacy requirement of 9%. If banks lend Rs. 100 they need to increase their capital base by Rs. 9 whereas similar need does not arise in the case of government securities investments.

The excess SLR investments offer a good opportunity to banks to widen the investor base. The banks should encourage average investors to invest in government securities rather than add to the deposit base of the banks. They can use this technique to augment their fee-based incomes. Banks can provide depository services in respect of the average investor's holding of government securities. They can also earn suitable commission on each sale and repurchase of government securities by the investor so that the average investor enjoys liquidity for his investment while at the same time earning a return that would be higher than what he currently earns on bank deposits. It is of particular advantage to both the depositors and the banks to convert the long-term deposits into investments in government securities. Banks could also minimize their asset liability management problem through this mode. Secondly, as the growth in their deposit base slackens, the embarrassing situation faced by banks due to their declining credit-deposit ratio will get resolved to some extent.

Pension Funds as Long-term Investors

One of the major yardsticks generally used to evaluate maturity level of any capital market is the extent to which the insurance and pension funds have developed and the relative importance they enjoy in the financial system. These two sets of institutions are the major long-term sources of funds for industry and infrastructure in most of the developed countries. The absence of all round growth of the insurance sector in India has been due to the absence of competition and lack of innovation. On the life insurance side, LIC has been enjoying monopolistic position for over four decades. In the general insurance area, the presence of four subsidiaries of the GIC has not necessarily meant competitive market conditions. The users of insurance products/services are not happy with the current situation as several types of products/services are either not available or the service standards are highly unsatisfactory. In this context the opening of the insurance sector to the domestic private sector and foreign investment is a welcome development. On the pension side too the situation is highly unsatisfactory. Millions of self-employed persons do not have access to pension facilities, as the current tax and regulatory frameworks do not favour any other facilities other than the provident fund schemes or the PPF. Recently, an expert committee under the chairmanship of Dr. Dave has made several useful recommendations in this regard. The Government is yet to take a decision in the matter.

As of today, bulk of the funds at the disposal of the insurance companies and the provident funds are cornered by the governmental sector. The process of liberalization of the investment guidelines for insurance companies and the pension funds has already begun. However, the rate of progress in this area is significantly constrained by the budgetary position of the central and the state governments. It is hoped that with speedy deregulation of these two sectors, the kitty of funds they would come to manage should grow. This should enable government to liberalise the guidelines further ensuring thereby much larger availability/supply of long-term funds for industry and the infrastructure sectors. In this context, it should be noted that more than the banks or the DFIs, it is the pension funds and insurance companies that would eventually emerge as the major purveyors of long-term funds. In the new environment increasingly characterised by financial and interest rate deregulation, banks and DFIs will have to operate in such a way that they avoid serious asset-liability mismatches. Their long-term lending will always be severely constrained by their relatively limited access to funds by way of long-term liabilities. On the other hand, bulk of the funds with insurance companies and pension funds will be of long-term nature. Hence they will eventually emerge as the major sources of long-term funds in the Indian economy.

Resistance to Transparent Banking

All over the world, financial intermediaries, by natural disposition tend to zealously preserve and protect profits that spring from non-transparent business practices. They have, therefore, been found to be too slow to accept changes and new technology that lead to greater transparency in the way they do their business. The foreign exchange market, for instance, in the beginning, grudgingly welcomed entry of the computer screen for dissemination of information. Today the screen is facilitating small order execution but many foreign exchange dealers are not very happy about it. They still go on talking in glowing terms about the advantages of negotiating deals on the telephone. These dealers claim that they are able to negotiate much better terms for their customers through the telephone. It is difficult to understand how a negotiated deal can be beneficial to both the sides simultaneously. It can be beneficial to both sides only if the broker negotiating the deal pays to both sides rather than charges a brokerage! A negotiating broker is never in a position to charge his customers less than what a computer matching would cost. Recently, a consortium of 13 global banks has decided to set up a computer trading/matching system in foreign exchange products called FXall. These banks command nearly 30% of the global market in various foreign exchange products, the daily turnover of which is estimated at around $1,300 billion. In response to this challenge three major banks viz., Citibank, Chase Investment Bank, and Deutsche Bank and the Reuters Group Plc. are working on a multibank online dealing service to rival that of the FXall. This rival proposal is expected to go live sometime during 2001. It will allow customers to trade currency products and access bank research through the Internet. The proposal envisages use of Internet as the communication backbone for order execution. These developments indicate that competition does force financial intermediaries to discard their non-transparent ways. Market observers expect competition to become intense since the new entrant is likely to be more aggressive in pricing.

While the global financial markets are becoming increasingly competitive and transparent most of the Indian banks appear to be unwilling to give up their nontransparent and anti-competitive methods that are susceptible to unethical business practices. In so far as the developed financial markets are concerned, even though negotiated deals still dominate the scene, all the major market players install a variety of checks to sanitise their trading practices. They have voice recorders and other mechanisms that provide full audit trail of the transactions so that their dealers are kept under close scrutiny. In India the dealing rooms of several major market players do not have most of these surveillance facilities which can keep under check the possible misbehaviour of their dealers. Possibility of unholy nexus between some of the brokers and the dealers in banks and institutions cannot be ruled out, since such telephone deals are highly non-transparent. Janakiraman Committee, that investigated innumerable transactions relating to the securities scam of the early 1990s, provides numerous examples of unethical practices adopted by the brokers and banks' dealers. Those who emotionally argue in favour of negotiated deals also do not put forth any convincing logic as to why a transparent, automated, and anonymous order matching system is inferior to the negotiated dealing system.

To give benefit of doubt to banks and institutions that do not frown upon the negotiated dealing system, one could point out that their fear of transparent dealing systems may be due to their unfamiliarity with new systems, including the possible reason that the staff is resistant to re-training. The public sector banks in particular have been the slowest to change because of the tightly regulated system under which they have been working. Internal autonomy is largely absent in all the public sector banks and with that the spirit of innovation and entrepreneurship is almost absent. Another important reason why they resist change, more than the fear of the unknown, is the concern that their business margins may shrink further. Already small shift towards automated screen for foreign exchange transactions has resulted in business moving away to competitors who would undercut their charges. Today, banks try to frighten their customers by arguing that there is counter-party risk in automated screen trading. But NSE has tackled this problem effectively by setting up National Securities Clearing Corporation (NSCC) that provides settlement guarantee with the help of a large settlement guarantee fund of over Rs. 2000 crore. One should not therefore rule out a day when a financially sound entity may set up an automated global screen for foreign exchange transactions and also provide a settlement guarantee. Such settlement guarantee can be made available for a fee that would be significantly lower than the hefty profits that the banks are making as their commissions. Even at low fees it may prove to be a highly profitable business.

Fierce competition for business has forced the US banks to embrace information technology in a big way. Unlike the Indian banking system, which has been tightly regulated for long in the areas of branch expansion, interest rate structure, personnel policies, etc. the US banking system has enjoyed deregulated and liberal policy framework. Competitive conditions have encouraged extensive application of information technology both for risk management and reducing operating costs and improving profit margins. Similar competitive conditions are unlikely to be witnessed in India in the near future as the public sector banks dominate the banking scene. The more recently set up nimble banks like the ICICI Bank and HDFC Bank are creating major waves in the banking industry through an extensive use of information technology. But these banks are not yet large enough to seriously threaten the turf of the bigger nationalized banks. The level of competition from them may not force the older and bigger banks to make serious attempts to absorb modern banking technology. But the same result can be achieved through appropriate policy intervention. The financial intermediaries especially in the public sector need to be woken up from their slumber. They should be forced to absorb modern information technology that minimises operating costs, vastly improves quality of customer service and strengthens risk management strategies.

Transparency Needed in Bond Deals

In our country regulatory fiat is needed to enforce transparency in all the financial deals so that the unfortunate events of the early 1990s, when the major scam hit the banks, do not recur. It may be clarified that transparency does not mean that names of all those who trade need to be disclosed on the trading screen. Transparency in this context means only real time disclosure of all the unexecuted buy and sell orders, matched trades and their respective quantities and prices. Such disclosures help in ensuring efficient price discovery and protection of investors from possible fraud. At the end of each day all the details of the matched deals should be passed on to the Clearing Corporation that is responsible for clearing and settlement by providing an iron clad settlement guarantee. If all the deals that took place in the early 1990s had been brought on a transparent screen and settled the way NSE's clearing corporation settles all equity transactions today by offering settlement guarantee, the scam would not have taken place and the banks would not have lost thousands of crores. It is strange that even today several active market players refuse to accept the proposition that, modern financial markets with huge daily turnover should adopt transparent practices and that they need to be closely monitored to prevent possible frauds.

Despite the huge losses incurred by several banks from their non-transparent treasury operations during the 1991 securities scam, they appear to have learnt precious little from this disastrous experience. Very few of them have tried to discourage their dealers from conducting non-transparent telephone deals through brokers that provide scope for adoption of unethical practices. Most of the banks have not bothered to draw appropriate lessons from the highly transparent screen trading that has almost revolutionized the Indian equity markets. NSE's automated screen based equity trading system is an anonymous order matching system that has put an effective end to the malpractices that were earlier noted in the floor trading and negotiated dealing systems. In the system adopted by NSE, although the stockbroker places an order into the trading system, he has no control over the order-matching algorithm as the mainframe computer matches all the orders on a price-priority basis. At a given price, the orders that get registered in the memory of the mainframe earlier get a priority in matching. As a result of this objective order matching system, stockbrokers cannot manipulate prices, nor can they overcharge their clients like the way they used to do earlier when the deals used to be concluded through the telephonic negotiations or on the physical-trading floor. Despite all the attempts made by NSE to encourage banks and institutions to use the anonymous order matching system for executing their transactions in debt securities they have shown little interest in the system.

In this context, it is worth noting the significant observations of Mr. Arthur Levitt, Chairman of the US Securities Exchange Commission (SEC). One of the important goals that Mr. Levitt has placed before himself for his second term as Chairman of SEC is to enforce maximum possible transparency in the US bond market. He observed, "Investors have a right to know the prices at which bonds are being bought and sold. This will help them to make better decisions, and it will increase confidence in the fairness of the markets.....Technology is revolutionising how business is conducted.....debt market still remains one of the last major markets in the United States to not have some type of electronic price disclosure system. I think it is fair to say that the recent volatility in the markets underscores the need for greater price transparency in this market....If we continue to be vigilant in the dissemination of market information to all investors, our nation will remain the envy of the world. You can be sure the SEC will do its part. I expect all our markets to do theirs." It is highly significant to note the great importance that Mr. Levitt attaches to market transparency and disclosure of information to all the investors on as near real time basis as possible. Therefore, if we want our debt markets also to become "envy of the world" we should, as in the case of the equity markets, introduce screen based anonymous limit order matching system that provides real time price and trade information to all the market players. Fully transparent trading systems can protect the markets from ethical lapses that the dealers or brokers may be tempted to commit.

Portfolio Disclosures

From the viewpoint of borrowers there is great advantage to raise money through loans from banks and institutions rather than through the market. For the borrowers it is easier to convince a limited number of people who appraise and approve loan proposals in banks and institutions rather than raise the same funds from the market. When the borrowers are in difficulty the lending institutions invariably try to accommodate them by revising repayment schedules. In short, the rigour to which a borrower is subjected to is much tougher in respect of the market borrowings than loans from banks and institutions. If there is any sort of non-performance in respect of market borrowings the news spreads fast and the creditors are kept on their guard. The credit rating agencies also are ever on the watch and announce their revision/reaffirmation of ratings periodically. A major attraction for the borrowers from banks and institutions is that, under the present laws, the lenders are prevented from disclosing names of the defaulters to the general public. Hence, the borrowers can go on merrily raising more and more loans from several other institutions although their repayment performance may be very poor vis-a-vis the existing lenders. Given the highly unsatisfactory credit information infrastructure in India, most of the lenders are, more or less, totally in the dark about the track record of existing as well as new borrowers. Thus, in our country there is systemic bias in favour of bilateral loans as compared with borrowings from the market. This bias in favour of loans vis-a-vis funds raised from the market could be minimized to a significant extent if the disclosure requirements for loans are brought on par with the disclosures that happen automatically in respect of borrowings from the market. Therefore, strong disclosure requirements need to be introduced in respect of all loans whereby banks/institutions are compulsorily required to report wayward behaviour of their borrowers to a designated central information gathering body that is specifically set up for the purpose. Such centralized information base will help all lenders in assessing credit record of the existing as well as new borrowers.

Recently, some discussion has started on the need to disclose names of defaulters to public. It has been pointed out that the present legal framework does not permit such disclosures since the relationship between the lenders and borrowers is governed by the provisions of confidentiality. It is being pointed out that any disclosures about the names of the defaulters and details relating the amount of default etc. are a breach of contract and a defaulter can sue the lender in the court. Whatever be the current legal provisions in regard to confidentiality of information relating to the borrowers, the lenders can get over this predicament by inserting suitable provisions in their loan documentation. The lending bank can insist that all new loan agreements as well as renewals of existing loans should incorporate a clause that gives full freedom to the lenders to disclose names of borrowers in case they default in servicing their loans.

An avoidable controversy has been raised in this area about making distinction between willful and non-willful defaulters. The discussion on this subject is centered on need for disclosures only about willful defaulters. It should be noted that the definition of a willful defaulter is purely judgmental in nature and a defaulter can file suit against the lender that the lender has caused irreparable damage by declaring him as a willful defaulter. In real life situations the line between a defaulter who has willfully defaulted and one who has been forced to default because of cash-flow constraints is very thin and often subjective in nature. For example, promoters of a project may give undertaking to finance any cost over-run when the loan is drawn. But well before the current project is completed they may take up another project for which they may take loan from another institution. If the first project gets into cost over-run and the promoter cannot find money to finance cost-run as already agreed and the project gets into a default mode, is the default willful or otherwise is judgmental. Some of the glaring defaults during the recent times have taken place because the promoters went on implementing new projects before the earlier ones were completed. It is, therefore, desirable to adopt purely objective indicators for disclosure of default and the lending institution should also not have discretion in this regard. The moment there is a default it should be disclosed and if the lending institution is really convinced that the default is due to factors beyond the control of the borrower it could be disclosed along with its own analysis. The matter should, thereafter, be left to the capital market and the financial fraternity to come to their own reasoned assessment/ judgement. Along with these new arrangements in place, concrete steps should be taken to get the existing laws amended so that all lending agencies are free to disclose names of defaulters without any constraints. Once such arrangements are in place there will be much higher level of discipline among the borrowers. The borrowers who attach a great deal of importance to their credit standing in the market will be very careful in all their financial dealings and use of funds. Such good borrowers will come to command respect of the market and the financial fraternity. They will be able to raise funds at very fine rates both from the market and from the banks/institutions. Such an arrangement will put the habitual or willful defaulters at a great disadvantage and they will be increasingly denied the opportunity to waste community's scarce resources.

It is difficult to understand why there is so much hesitation amounting to unwillingness to have suitable legal framework for empowering lenders to disclose defaulters' names. The resistance of the lending institutions to making such disclosures appears to be due to their worry that the defaulters' names may give rise to various interpretations including the extent of their "faulty credit appraisal" mechanism as also possible nexuses with the borrowers. More than anything else, this unwillingness also appears to be largely due to their prefixed mindset that such disclosures may not be desirable. Habitual defaulters are exploiting the weaknesses of the system, which enables them to raise more loans from other unwary lenders who may not have any idea about the defaults committed by the intending borrowers. Unless we draw a clear distinction between the borrowers who take repayment obligations seriously and the borrowers who are habitual defaulters there is no disincentive to default. However, there should be tight obligations on the lenders to maintain confidentiality about borrowers who scrupulously stand by their commitments. Unfortunately, the current arrangements put the well behaved and the culprits on par.

In countries like the US, disclosures about loan defaults are not considered to be great secrets. In the US there are several well-known agencies that provide information on creditworthiness of business entities for a fee. Providing information on credit standing of different parties has become a commercially profitable activity in many countries. The information available with such agencies is of considerable use to lenders as also to others who have financial dealings with other business entities. The US system therefore provides an in-built check for prolonged frauds. Human greed to dupe others can be effectively contained through forced disclosures all round. Therefore, it is said, "sunlight is the most powerful disinfectant."

Plurality of Market Players

There have been frequent complaints about narrowness of the secondary market in equities and the excessive influence of the foreign institutional investors (FIIs) in our domestic markets. In this context, it should be noted that the narrowness of our secondary market and the over-dominance of a small number of institutional players is not a new problem. In fact, after the entry of the FIIs the problem of limited number of players having excessive influence on secondary market prices has become less important than in the past. There was a time when the UTI could almost dictate the level of the market and push it up if it felt necessary. Because of its large money power in relation to the floating market liquidity, UTI's market operations often used to have considerable influence on market prices. As a result, it did play the so-called stabilising role in the market. In reality it meant that the UTI could push up market prices whenever the market was found to be excessively depressed in response to some not so adverse news/developments. The major market players could also, therefore, attempt to manipulate the market by making too much noise about the market having gone down excessively. In those days, there used to be occasionally market rumours about the Government having asked the UTI "to come to the rescue of the market". On rational grounds one might debate as to whether any authority should try to influence market trends just because it was undergoing an irrational corrective phase in response to certain economic or political developments. Even if it is argued that the stabilizing role is important if the market is behaving irrationally, it is difficult to justify policy intervention to influence the market in any particular direction. If the market is behaving irrationally at certain points of time it is a good opportunity particularly for the large institutional investors to make handsome profits by moving against the trend at such times.

The need for having large number of players to ensure plurality of views in the market and prevention of market manipulation by any group of market players cannot be denied. But at the same time, should there be specific official intervention to introduce new players into the market even though they may not be well suited to play this role? Recently, commercial banks have been permitted to invest 5% of their incremental deposits in equities. After the grant of this permission some banks have invested in equities although these investments are reported to be relatively small in relation to the banking system as a whole. The skills required for equity investments differ from the skills needed for lending by a commercial bank. Unfortunately, most of the public sector banks have not set up their in-house equity research departments. Many of them have not been able to build specialized skills in this area partly because of their HRD policies, which lay emphasis on frequent staff rotation and not assigning specially trained personnel for specific jobs on a long term basis.

It is unlikely that the public sector banks will be able to drastically alter their HRD policies. Nor do they have the freedom to recruit skilled persons by paying market-related salaries.

In the absence of their own in-house good equity research departments, often their equity investments are based on the advice offered by brokerage houses, whose advice cannot always be relied upon or taken at face value. Market reports indicate that some brokerage houses have their own axe to grind and do not always offer unalloyed investment advice. Several brokerage houses take proprietary positions in the market with the intention of doing front running. They acquire certain stocks at lower prices, prepare motivated equity research studies and unload their holdings at high prices to unwary investors. It is reported that some of the investments of banks have not turned out to be good in relation to their acquisition costs. It is a well-known fact that a number of public sector banks have got into serious problems with respect to their assured return mutual fund schemes. Some of them have already paid and a few more may have to pay out eventually large sums by eroding their net-worth to honour the terms of their contractual commitments. The very fact that they were emboldened to make such rash commitments about assured returns does prove that their perceptions of the equity market are not based on market realities.

It is desirable that banks should not normally invest in market instruments unless they are rated as investment grade. If banks are keen to invest in equity they should be encouraged to float arms length mutual funds by staffing them with persons having requisite skills and experience and compensated at market related salaries. RBI has been rightly laying great emphasis on asset liability management by the banks. If asset liability management is to be taken seriously by the banks it may not be advisable for them to have equity on their books except when they get into it because of say, their underwriting obligations. But they should try to unload it in the market at an appropriate time as early as possible. Banks will be faced with serious asset liability mismatches if they convert fixed income obligations like deposits into equity, which is not rated and carries various types of risks, and in particular the price risk. A half-hearted approach to asset-liability management problem may prove to be costly to the banks, which are already suffering from relatively high level of NPAs It is not safe to clutter balance sheets of banks with risky assets like equities. The Indian equity market is undergoing rapid transformation and market valuations are going topsy-turvy too frequently. A limited number of stocks are attracting excessive attention of major market players and too much churning is taking place in these stocks. Some are arguing that this is a global trend. But it appears that market players in India have become hyperactive. In the process, unwary investors, who do not understand the games big market operators play may lose heavily. This may not, therefore, be the right time for banks to venture into risky areas like equity investments. Since the ultimate responsibility of bailing out public sector banks is going to fall on the government it is preferable that equity investments are undertaken through the route of mutual funds where the ultimate risk is clearly borne by the investor.

If we need more players in the equity market the right course would be to encourage banks and others to float arms length mutual funds. It is also necessary to ensure that the right type of competent banks get into this area. The boards of such banks should deliberate fully before they permit the management to float mutual funds and ensure that they are managed well. All those who argue in favour of banks investing in equities in a big way also need to worry about banks' large NPAs and whether banks are the right type of institutions to invest in equities directly so as to add to the plurality of the market. Whatever be the merit of this argument, it does not appear to be a good idea to encourage banks to transform deposit liability into a risk-bearing asset like equity in which the banks have, so far, not acquitted themselves very honorably.

Flight into the Future

Let me now venture into the not so distant a future, so to say, by sitting on H.G. Well's time machine. Given the current state of the Indian financial institutions and banks, it appears that most of them will take quite many years before they get integrated into the capital market framework. It is only thereafter that the artificial gulf that exists today between the capital market and the institutions will get substantially bridged, as it has already happened in the US. Some of the newer private sector banks and ICICI, in particular, have travelled almost half way in that direction. It appears that public sector banks will continue to be the real laggards.

We should not lose sight of the fact that the basic function of the institutions/banks and the financial/capital markets is to facilitate transfer of funds from the surplus to the deficit pockets. Although institutions and banks charge a fee and thereby impose a cost on the system for intermediating funds, they do serve a useful role if they really take upon themselves the credit risk of their borrowers. Financial markets (including the capital market) demand much lower fees for performing intermediation function because investors themselves assume all the risks of investment decisions. On account of the significant progress achieved by the information processing industry and the rating agencies, it has become possible to measure risks much more efficiently and cost them with greater degree of accuracy. There has been a tremendous growth and diversification in the exchange traded derivatives in equities, debt instruments and foreign exchange products. Similarly, skills in designing more complex tailor made derivative contracts in the OTC markets are growing continually. With all these developments, financial risks are not only being effectively insured but that the costs of such insurance through the market mechanism are coming down rapidly. As a result, the financial/capital markets are becoming more cost effective for those who need funds. Consequently, demand for funds from banks and institutions, is declining almost continually in countries like the US. To remain relevant to the economic system and earn reasonably good profits, banks and institutions have to redefine their roles and functions.

In so far as our country is concerned, the derivative markets are not yet well developed and the information processing industry is still in its infancy. Hence, market is not in a position to provide most of the insurance products to those who currently assume risks and want to get themselves insured in the exchange traded or the OTC derivative markets. Hence, our banks and institutions, as yet, do not face competition from the cash or the derivative markets. But, as and when the financial markets become more efficient, competitive conditions will force the banks and institutions to redefine their strategies. It would be in their interest to develop symbiotic relationship with financial markets just as their US counterparts have been continually doing during the last couple of decades. When this happens, near seamless linkages will emerge between the financial institutions and banks on the one hand and the financial and the capital markets on the other.

During the last five years the capital market has gone way ahead of the institutions and banks in terms of its ability to infuse information technology and its sophistication to handle credit and market risks. During the next several years, the capital market institutions are expected to move much faster to handle rapidly growing business volumes and manage risks. This is made possible, to a significant extent, through the absorption of bigger and bigger dosages of information technology. With the help of modern information technology, the capital market institutions are undergoing rapid transformation and radically changing the way they function. NSE has remained in the forefront of all these major changes. NSE has been acting as a change agent and has made significant impact on the functioning and business practices of capital market intermediaries like brokers, merchant bankers, custodians, and other stock exchanges as also on some banks in so far as they deal with the capital market intermediaries. However, the major part of the financial system comprising the public sector banks, insurance companies, money markets, and the government securities markets are still operating in the antediluvian age.

RBI has taken a decisive lead in building up a telecom backbone for the nation-wide payments system. It is expanding its VSAT network and linking up all the major banks and their important branches to facilitate quick transfer of funds across the country. Along with this, RBI is also in the process of putting in place Real Time Gross Settlement (RTGS) system similar to the Fed-Wire system in the US. RTGS will facilitate real time settlement of all high value transactions among the major players in the financial system like banks, institutions and primary dealers. RBI is also keen to push the banks to computerise all their operations so that they are ready to effectively participate in the financial sector reforms that it is continually introducing. As banks put information technology to better use in most of their business operations, financial and the capital markets would continually build and strengthen seamless bridges with them.

Main Policy Thrusts

The main thrust of the policy should therefore be to build seamless linkages between DFIs/banks and the financial/capital markets so that they facilitate the process of transfer of funds from the ultimate savers to the ultimate users at minimum costs. The policy stance should however be neutral between DFIs/

banks and the capital market by doing away with the fall back support currently being extended to DFIs/banks in distress. In the changed circumstances, DFIs/banks also need to reorient themselves to undertake more of agency functions and encouraging the savers to shoulder investment risks directly. This would improve resource allocation efficiency while at the same time infusing the much needed discipline among the users of funds.

The two main segments of the capital market, namely the debt and the equity markets along with their derivative products need to grow hand in hand. The debt market is yet to graduate from its current stage of the "negotiated deal" and geographically fragmented telephone market to automated nationwide screen trading as in the case of the equity market. Nationwide screen trading has distinct advantages as it enhances transparency and competitive market conditions. It facilitates more reliable price discovery, improves efficiency of trade execution, introduces equality among all classes of market players and minimises trading and settlement costs. The four key principles of efficient market structure anonymity, price time priority, nationwide equal access to trading and settlement system with settlement guarantee — should be introduced in the debt market also. Integration of these four principles into debt market would enhance its efficiency significantly and free it from most of the pernicious market practices and possible ethical lapses on the part of the market players. SEBI has taken the right step in banning negotiated deals in all equities and listed corporate debt. Similar prescription is needed in respect of all other debt instruments. Now that RBI has been recently vested with necessary statutory powers in respect of all government securities, treasury bills and money market instruments, one would expect an early switch over to screen based trading in all these instruments.
