Indian financial system on a roll despite hiccups

Editorial Team

Yes, the Indian financial sector is not in doldrums as was being recently portrayed by some financial doomsayers. The RBI's Report on Trend and Progress of Banking in India (2003-2003) (RTP), which is one of the two statutory reports submitted by the central bank to the Government, proves all of them wrong.

Of course, there have been bad patches, as in the case of urban cooperative banks and other financial institutions. But commercial banks, which are at the heart of the financial system accounting for nearly 90% of total assets, have stood like a rock against all odds and vast global changes, says RTP's section relating to Scheduled Commercial Banks (SCBs).

Over the year 2002-03, the gross non-performing assets (NPAs), as a percentage of advances, fell from 10.4 to 8.8 and the net NPAs from 5.5 to 4.4. The underlying amounts are, of course, large. However, gross NPAs declined by Rs 2,147 crore.

The good news no doubt comes because of a host of steps taken by RBI to jack up the system, which included legislation on effective enforcement of security provisions. A mix of upgradation, recoveries and write-offs has steadily reduced the gross NPAs of SCBs to 8.8% as of March-end 2003 compared with 15.7% six years ago.

There had also been a fortuitous factor - the realisation of large incomes in trading in government securities, the values of which rose markedly due to the steep fall in interest rates. Trading profits accounted for about 7.7% of the total income of banks and about 33% of their operating profits during the year, says the RBI report.

A series of scams in recent past might have shaken the Indian financial sector but not much was lost. Latest Report on Trend and Progress of Banking in India (2002-03) by Reserve Bank of India brings the tidings that the system is very much in good shape.

It should go to the credit of the banks that they deployed such windfall incomes in making provisions for NPAs. In fact, as the Report points out, the year under review was characterised by strong earnings for banks with all major income categories showing significant growth.

Return on assets (the ratio of profit-to-total assets) saw a marked improvement to 1%, the highest in the last six years.

One significant feature of the financial performance of banks in India during the year 2002-03 was the contribution of "trading" profits. Normally, banks make money on the margin between their cost of raising resources and the interest income received on their loans.

Trading profits accounted for about 7.7% of the total income of banks and about 33% of their operating profits during the year. During the previous two years, the ratio of trading profits to operating profits was lower, varying between 3.5% and 16%, rising to 32% in 2001-02.

The share of trading profits

varied across bank groups. Old private sector banks depended heavily on trading profits at over 50 per cent of operating profits both in 2001-02 and 2002-03.

Foreign banks, surprisingly, registered a decline in such profits, contributing only 13.5% of operating profits. But many banks, for various reasons, did not do so well from trading, with 16 banks not recording any trading profit. The banking system, as a whole, however, gained from trading profits.

The robustness of the Indian banking system has definitely been enhanced, thanks to the careful stewardship of the RBI.

While the overall health of banks is improving, a few salient points need reiteration. Many finance experts are of the view that RBI and the Government should come to an agreement on the question of a unified regulator and auditor for cooperatives.

Divided suzerainty, like diarchy, cannot work. Cooperatives use the loopholes provided by such division of authority for escaping the scrutiny of regulators.

A corollary to the good fortunes of banks in making money in treasury operations is the possibility of capital loss and the need for provisioning, lest security values fall due to any increase in interest rates in the future.

The RBI has been aware that by their heavy investment in gilt-edged securities, banks are riding a tiger. It has advised them to build up an Investment Fluctuation Reserve of a minimum of 5% of investment in the 'Available for Sale and Held for Trading' categories of the investment portfolio within five years commencing from March 31, 2002. At end-March 2003, the actual percentage was 1.8.

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Distribution of NPAs percentage to total assets at the end of March 2003

	2000		2001		2002		2003	
Gross Net	Gross	Net	Gross	Net	Gross	Net	Gross	Net
All Scheduled Commercial Banks	5.5	2.7	2.9	2.5	4.5	2.3	4.0	1.9
Public Sector Banks	6.0	2.9	5.3	2.7	4.9	2.4	4.2	1.9
New private sector banks	1.6	1.1	2.1	1.2	3.9	2.1	3.6	2.2
Foreign banks	3.2	1.0	3.0	0.8	2.4	0.5	2.4	0.8

The spread rose from 2.6% to 2.8% of total assets. This is a result of the fall in lending rates not matching with that in deposit rates and the gain made due to the decline in the Cash Reserve Ratio (CRR).

With the haunting issue of NPAs getting more or less solved, one may expect the spread to fall. Even as it is, it has compared favourably with the spread of 3+ per cent witnessed till recently.

The report says that during the period under review capital levels of the banking sector improved markedly with the overall capital adequacy of the banks rising from 10.4% at end-March 1997 to 12.6% at the end-March 2003. At the aggregate level, out of the 93 SCBs (excluding Regional Rural Banks) only two could not satisfy the stipulated 9% Capital Adequacy Ratio.

The Report says: "Resource mobilisation by mutual funds declined sharply during 2002-mainly due to the substantial net outflow of funds from Unit Trust of India, which was restructured during the year."

Experts say that the RBI is facing the possibility of running out of its holdings of Government securities in its open market operations for sterilisation of the inflows of capital. There has also been some talk about the Bank issuing its own securities.

Several countries like Mexico, Indonesia, Malaysia, Chile, and so on, have resorted to this measure with varying experience. However, some expert voices have cautioned the Reserve Bank of India against the proposal. Over a period of time, the CRR may perhaps become the weapon of the last resort to tackle the problem of excess liquidity! ■