Chapter I

Perspectives

The unprecedented measures taken by central banks and governments have worked appreciably so far in supporting economic recovery. However, the fading away of the fiscal stimulus, limitations on future monetary measures and the ongoing deleveraging and repairing of balance sheets continue to clog the recovery process in developed economies. Meanwhile, multipronged initiatives have been undertaken by standard setting bodies and national authorities to reform the regulatory architecture of the financial system in areas ranging from enhanced capital prescriptions and regulatory perimeters to improved oversight and supervisory practices and orderly resolutions of financial institutions. In the Indian context, strengthening of regulatory and accounting frameworks for ensuring financial stability and improvement of allocative efficiency of financial markets will be the core agenda for the regulatory authorities. Special efforts will have to be made by the banks to manage non-performing assets and liquidity besides improving customer service through business process re-engineering. With regard to financial inclusion, there is a need for collaborative efforts from all stakeholders to leverage technology to bring more people into the banking fold.

1. Introduction

1.1 The global economy is recovering from the worst financial crisis since the great depression. The recovery, however, has been fragile and uneven. The financial crisis has brought a number of lessons to the fore. First, financial regulation needs to stay ahead of the curve to avoid falling behind financial innovations and emerging new business models. This requires continuous sharpening of regulatory and supervisory skills and instruments. Second, there is need for inter-agency coordination which calls for understanding the respective roles of central banks, regulators, supervisors, and fiscal authorities with regard to financial stability. The agencies need to share information/data and sit together to resolve the overlapping issues devolving on more than one regulator. The third lesson points to the need to study the implications of large scale bail-out packages for the regulatory architecture of the financial system and for the fiscal health of countries. The rescue packages of one country may have worldwide repercussions through financial channels, adding costs to macroeconomic management even when countries in question are far removed from the epicentre of the crisis. To mitigate the effects of contagion and its impact on the domestic financial system, relevant issues regarding the methods and scope of deposit insurance and the feasibility of extending guarantees to financial institutions may need to be explored. The fourth lesson calls for better understanding of the weaknesses of structured products and derivatives in the credit markets which have implications for financial stability. In this respect, the relative superiority of different modes of trading and settlement practices need thorough examination to address the shortcomings inherent in the “originate-to-distribute” models. Finally, regulators should remain vigilant while striking the right balance between moderating risk-taking and economic growth since markets and institutions have the tendency to succumb occasionally.

1.2 Keeping the current global and Indian banking trends in view, Section 2 deals with the emerging perspectives from global banking developments. Section 3 discerns the emerging perspectives in Indian banking including issues relating to financial stability.

2. Perspectives from Global Trends

1.3 The global banking and financial system is currently undergoing structural transformation with standard setting institutions and national authorities framing new regulatory paradigms to address the weaknesses of the global financial system that surfaced to the fore during the crisis.

Regulation of Financial Markets – Global Initiatives

1.4 The consultative document on 'Strengthening the Resilience of the Banking Sector' issued by the BCBS in December 2009 deliberated on a package of proposals for improving the resilience of the global financial system. The Committee's reform proposals were part of the global initiatives to strengthen the financial regulatory system that have been endorsed by the FSB and the G-20 countries. Through its reform package, the Committee aims to improve risk management and governance as well as strengthen banks' transparency and disclosures.

1.5 Based on the BCBS's proposals of December 2009, the Group of Governors and Heads of Supervision - the oversight body of the BCBS reached broad agreement pertaining to the definition of capital, the treatment of counterparty credit risk, the leverage ratio, and the global liquidity standard in July 2010. The major features of July 2010 agreement are set out in Box I.1.

Box I.1 : The Capital and Liquidity Reform Package, July 2010 - Major Features

(1) *Definition of Capital*

(i) Prudent recognition of the minority interest

(ii) Elimination of counterparty credit restriction on hedging of financial institutions investments.

(iii) Limited recognition of investments in the common shares, mortgage servicing rights, and deferred tax assets for calculating common equity component of Tier I capital.

(2) *Counterparty Credit Risk*

(i) Modification of bond equivalent approach to address hedging.

(ii) Elimination of excessive calibration of credit valuation adjustment.

(iii) To subject banks' mark to market and collateral exposures to central counterparties (CCPs) to modest risk weights in the range of 1-3 per cent.

(3) *Leverage Ratio*

(i) Uniform credit conversion factors (CCF) for off-balance sheet exposures.

(ii) Basel II netting plus a simple measure of potential future exposure based on the standardised factors of the current exposure method.

(iii) Testing the proposal of minimum Tier I leverage ratio of 3 per cent during the parallel run.

(4) *Regulatory Buffers, Cyclicality of the Minimum and Provisioning*

(i) Capital conservation and countercyclical buffers to be finalised by end 2010.

(ii) Findings on cyclicality of the minimum requirement to be dovetailed with those from quantitative impact study to develop a set of supervisory tools to assess the adequacy of banks' capital buffers.

(iii) Dialogue with International Accounting Standards Board (IASB) to develop expected loss approach to provisioning.

(5) *Global Liquidity Standard*

(i) Revision of definition of liquid assets so that they remain liquid in periods of stress.

(ii) Introduction of 25.0 per cent outflow bucket for custody of clearing and settlement activities, as well as selected cash management activities.

(iii) Treatment of all sovereigns, central banks and PSEs on par with corporates with 100 per cent roll-off rate for unsecured funding.

Source: Basel Committee on Banking Supervision.

Countercyclical Capital Buffers

1.6 The agreement of the Group of Central Bank Governors and Heads of Supervision set out in its press release of 7th September 2009 also put forward the commitment to introduce a framework for countercyclical capital buffers over the minimum to address pro-cyclicality. The aim of this approach as mentioned in the BCBS in the December 2009 Consultative Document 'Strengthening the Resilience of the Banking Sector' is to (i) dampen any excess cyclicality of the minimum capital requirement, (ii) promote more forward looking provisions, and (iii) increase capital buffers as to serve the goal of protecting the banking sector from periods of excess credit growth. In July 2010, the BCBS finalised the proposals on countercyclical capital buffer regime according to which capital distribution constraints would be imposed on the bank when capital levels fall aside the indicator range. The Committee felt that credit-to-GDP gap was the best performing indicator among the range of variables that could be used to calibrate capital conservation buffer requirements.

1.7 While the concept of making countercyclical provisions and buffers has intuitive appeal, its operationlisation would face several challenges namely, (i) identification of inflexion point to begin building capital and usage, (ii) choice of economic indicator for good and bad times, (iii) difficulty in defining an economic cycle in a global setting as economic cycles are not globally synchronised, (iv) implication of rapid emergence of distress and abrupt release of capital, (v) determining the right size of capital, and (vi) ensuring that the scheme of capital buffers is simple and transparent, entails low implementation costs and as rule based as possible.

The Enhanced Basel II Regime

1.8 At its meeting held in September 2010, the Group of Governors and Heads of Supervision, announced a substantial strengthening of existing capital requirements as set out in Table I.1.

1.9 The revised capital standard will be implemented in a phased manner allowing long transition period. With a supervisory monitoring period up to end December 2012, the phased implementation would start from January 1, 2013 (Table I.2). Along with the global liquidity standards, these reforms which are expected to fully meet the core requirements of the global financial reform agenda will be presented to the Seoul G-20 Leaders Summit in November 2010. In the

Table I.1: Strengthened Capital Framework: From Basel II to enhanced Basel II

In percentage of risk-weighted assets	Capital requirements							Additional macro-prudential overlay
	Common equity			Tier 1 capital		Total capital		Counter-cyclical buffer
	Minimum	Conservation buffer	Required	Minimum	Required	Minimum	Required	
1	2	3	4	5	6	7	8	9
Basel II	2			4		8		
Enhanced Basel II definition and calibration	4.5	2.5	7.0	6	8.5	8	10.5	0-2.5

Source: Bank for International Settlements.

Table I.2 : Phase-in Arrangements (figures in bold indicate transition periods) (all dates are as of 1 January)

	2011	2012	2013	2014	2015	2016	2017	2018	As on 1 January 2019
Leverage Ratio	Supervisory monitoring		Parallel run 1 Jan 2013 – 1 Jan 2017 Disclosure starts 1 Jan 2015					Migration to Pillar 1	
1	2	3	4	5	6	7	8	9	10
Minimum Common Equity Capital Ratio			**3.5%**	**4.0%**	**4.5%**	4.5%	4.5%	4.5%	4.5%
Capital Conservation Buffer						**0.625%**	**1.25%**	**1.875%**	2.50%
Minimum common equity plus capital conservation buffer			**3.5%**	**4.0%**	**4.5%**	**5.125%**	**5.75%**	**6.375%**	7.0%
Phase-in of deductions from CET1 (including amounts exceeding the limit for DTAs, MSRs and financials)				**20%**	**40%**	**60%**	**80%**	100%	100%
Minimum Tier 1 Capital			**4.5%**	**5.5%**	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum Total Capital			8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Minimum Total Capital plus conservation buffer			8.0%	8.0%	8.0%	**8.625%**	**9.25%**	**9.875%**	10.5%
Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital				Phased out over 10 years horizon beginning 2013					
Liquidity coverage ratio	Observation period begins				Introduce minimum standard				
Net stable funding ratio		Observation period begins						Introduce minimum standard	

Source: Bank for International Settlements.

interim, the communique of the G-20 meeting of Finance Ministers and Central Bank Governors held on September 2010 at Gyeongiu, Republic of Korea reaffirmed committment on fully implementing the new capital and liquidity framework within the agreed time frame.

Assessment of Macroeconomic Impact of enhanced Basel II Capital Standards

1.10 The assessment of macroeconomic impact of new capital rules is varied depending on model assumptions. The FSB-BCBS Macroeconomic Assessment Group concluded that if higher requirements are phased in over four years, each one percentage point increase in bank's actual ratio of tangible common equity to risk-weighted assets will lead to a decline in the level of GDP relative to its baseline path by about 0.20 per cent after implementation. This implies that the annual growth rate would be reduced by an average of 0.04 percentage points over a four and a half year period, with a range of results around these point estimates. On the other hand, a 25 per cent increase in liquid asset holdings would affect output by less than half than associated with a one-percentage point increase in capital ratios. The projected impacts arise mainly from banks passing on higher costs to borrowers resulting in a slowdown in investment. The GDP, however, returns to its baseline path in subsequent years.

1.11 The Institute of International Finance's (IIF) preliminary 'Interim Report on the Cumulative Impact on the Global Economy of Proposed Changes in the Banking Regulatory Framework' issued on June 2010 assessed that the impact of the new regulatory regime would be much higher. Full implementation of regulatory reform would subtract an annual average of about 0.6 percentage points from the path of real GDP growth over the five year period 2011-15, and an average of about 0.3 percentage points from the growth path over the full ten year period, 2011-2020. The Euro Area is hit the hardest; Japan the least, with the United States somewhere in the middle depending on the significance of the banking system relative to the economy, the pattern of debt intermediation flows and the extent to which systems needs to adjust to meet the new requirements. On the positive side, the model used in the IIF study allows for most of the quantifiable reforms that has been proposed. On the negative side, the model contains relatively little behavioural feedback and relies very heavily on the credit transmission channel.

1.12 A preliminary assessment of the impact of increased capital requirements on GDP was made by the Reserve Bank based on a small analytical static macro model with inputs from annual balance sheets and profit and loss accounts data of the banking sector and macroeconomic aggregates. The study looked at one time impact, unlike the convergence pattern that the BIS study simulated. The findings from the model will be used for various policy purposes. The Reserve Bank will calibrate the new capital standards in line with the enhanced Basel II norms while adopting the same to local conditions.

Systemically Important Financial Institutions

1.13 The BCBS is evolving an appropriate framework dealing with systemically important financial institutions (SIFIs) taking into account a number of tasks namely, (i) identification of SIFIs, (ii) differential systems for SIFIs by way of capital and liquidity surcharge and enhanced supervision, (iii) improving capacity to resolve SIFIs without recourse to tax payers money, (iv) reducing the probability and impact of SIFI failure and, (vii) improving the oversight of SIFIs. The BCBS and the FSB are developing a well integrated approach to SIFIs which could include combinations of capital surcharges, contingent capital and bail-in debt. In addition, work is continuing to strengthen resolution regimes. The FSB is also contemplating on measures to enhance the effectiveness of SIFI supervision.

Cross-Border Co-operation

1.14 Efforts are being directed at arriving on the framework for cross-border resolutions which pose considerable uncertainties for stakeholders due to lack of cooperation and coordination among different jurisdictions during times of crisis. The FSB released a set of principles for 'Cross-border Cooperation on Crisis Management'. The Report of the 'Cross-border Bank Resolution Group' by the BCBS issued in March 2010, which complements the work of the FSB provides the detailed approach to implementing the FSB's principles on cross-border cooperation and calls for (i) intervention by national authorities in a timely manner to ensure continuity of critical functions, (ii) development of plans by banks for promoting resilience under stress and facilitating quick resolution, (iii) strengthening of CCPs to mitigate settlement risks, (iv) convergence and coordination of resolution mechanisms, (v) planning for preserving and/or facilitating rapid resolution of systemically important banks and groups and, (vi) close cooperation among supervisors in home and foreign jurisdictions and resolution authorities for facilitating resolution of complex group structures.

Supervisory Colleges

1.15 The importance of supervisory colleges as a conduit to strengthen the effectiveness of supervisory practices for international banking groups was heightened by the recent global financial crisis. In light of this, the BCBS brought out a set of good practice principles on supervisory colleges in October 2010. These principles supplement the earlier guidance on cross-border cooperation and information sharing. These principles relate to objectives of supervisory colleges, structure of supervisory colleges, appropriate sharing of information by the college members with respect to principal risks and risk management practices of the banking group, integrity and confidentiality of information exchange, promoting collaborative work between members, interacting with institutions, complementing the crisis management structures and tailoring the supervision of large internationally active financial conglomerates to their systemic importance.

Financial Activities Tax

1.16 The Interim Report of the G-20 on Fair and Substantial Contribution by the Financial Sector of April 2010 for 'financial stability contribution' proposed a flat rate levy on all financial institutions and 'financial activities tax' levied on profits and remuneration. The taxes are designed to help pay for future financial clean-ups and reduce systemic risk by shrinking the size of the financial sector. The proposal was discussed at the G-20 meeting at Busan, Republic of Korea in June 2010, which called for implementation of levy taking each nations 'circumstance and options'. India's view was that there was need for better and well placed regulation rather than imposing levy on bank balance sheets.

Accounting Standards of Banks and Financial Institutions

1.17 Following the initiatives taken by the G-20 countries, nearly all FSB member jurisdictions have either adopted the International Accounting Standards Board (IASB) standards or are in the process of converging with or adopting these standards by 2012. The FSB has made considerable progress in achieving converged accounting standards in four areas namely (i) impairment of financial assets, (ii) de-recognition of repurchase agreements as off-balance sheet exposures, (iii) valuation under uncertainty in fair value measurement guidance and, (iv) netting of financial instruments. Standard setting bodies for accounting namely the Financial Accounting Standards Board (FASB) and the IASB are discussing and reconciling respective proposals on the formulation of a single set of high quality global accounting standard while retaining the project target completion date of June 2011.

Reform of Over-the-Counter (OTC) Market

1.18 The reform of the OTC derivatives market is being implemented in the wake of experience from the global financial crisis to reduce systemic risk inherent in the complexity of the interconnected financial system. According to the BIS, the outstanding derivatives contracts were valued at US$ 6,63,870 billion as at end-2009 of which just 3.4 per cent were traded on the exchanges while the rest were traded in private or OTC markets with terms agreed directly between the buyers and sellers. In May 2010, the Committee on Payment and Settlement System (CPSS) and International Organisation of Securities Commissions (IOSCO) issued standards for central counterparties (CCPs) so as to better address risks associated with OTC derivatives. A Working Group comprising of CPSS, IOSCO and European Commission is studying policy options for consistency of implementation of clearing and exchange or electronic trading requirements across jurisdictions. The US financial regulation Bill proposes to move the widely traded standardised OTC derivatives to clearing houses to reduce counterparty and systemic risks.

Reform of Credit Rating Agencies

1.19 Reducing the conflict of interest at the credit rating agencies (CRAs) and encouraging due diligence on the part of investors is one of the key agenda of financial sector reforms. Accordingly, the G-20 member countries have agreed to a regulatory oversight regime for CRAs consistent with IOSCO's CRA Code of Conduct. Proposed reform measures seek to prohibit rating agencies from structuring advise, replacing issuer pay-model by investor-pay model, introduction of pay-for-performance and wait-to-rate models, and reducing reliance on ratings for meeting prudential requirements. The BCBS is also addressing the issue of inappropriate incentives arising from the use of external ratings in the regulatory framework.

Executive Compensation Policy

1.20 The executive compensation policies and practices in banks should be consistent with the objective of promoting effective risk management and are fair to customers and prevent market abuse. Towards this end, the principles and standards designed by the FSB are aimed at ensuring that employees are paid in relation to the value actually and fully realised by the bank, and that compensation is consistent with maintaining the bank in strong condition with adequate capital and liquidity.

1.21 With a view to limiting excessive risk taking arising from the remuneration packages of employees, BCBS in October 2010 brought out a consultative paper detailing some initial supervisory considerations and factors that banks may consider while developing methodologies to align remuneration packages to risks.

Reform of Securitisation Market

1.22 The breakdown in pricing of securitised products in the aftermath of the crisis has virtually shut down the market. The IMF has called for re-encouraging securitisation on a safer basis, particularly, to support credit needs of households and small and medium-size enterprises. To improve transparency, the IOSCO published disclosure principles for asset backed securities in April 2010. The joint forum of BCBS and the IOSCO is studying whether incentives in the market for securitisation are aligned or not.

Deposit Insurance

1.23 The global financial crisis has underscored the need for a credible and transparent deposit insurance system for maintaining public confidence in the banking system. The Core Principles for Effective Deposit Insurance Systems, jointly developed by International Association of Deposit Insurers (IADI) and BCBS were released in June 2009. It constitutes a voluntary framework, based on best international practices for bringing about changes in existing system or setting up a new deposit insurance system. The core principles include requirements for operational independence, transparency and accountability for deposit insurer and call for having effective relationships with other safety-net participants while delineating the approach to be taken in relation to cross-border issues, membership and coverage, funding, public awareness, legal issues, failure resolution, reimbursing depositors and recoveries.

Supervisory/Regulatory Reforms – Regional/ National Initiatives

1.24 The European Union is putting in place the Alternative Fund Managers Directive

(AIFMD) for hedge funds, private equity funds and other alternative funds. At its core, the directive seeks to impose standards and regulatory oversight on a large swathe of shadow banking system that had largely gone unsupervised. The European Commission is also proposing European Market Infrastructure Legislation that will establish EU legislative frameworks for central counterparties (CCPs) and trade repositories.

1.25 The US Senate and House of Representatives passed the Bill re-titled as "Restoring American Financial Stability Act of 2010" and was signed by the President in July 2010 to become a law. The major objectives of the legislation are "to promote the financial stability of the United States by improving accountability and transparency in the financial system, to end 'too-big-to-fail', to protect the American taxpayer by ending bailouts, and to protect consumers/investors from abusive financial services practices".

1.26 The UK Financial Services Authority (FSA) is contemplating prescription of tighter capital rules than those proposed by the BCBS, particularly for systemically important banks. In a joint initiative with Financial Reporting Council (FRC), the FSA is proposing for regulatory scrutiny of the relationship between bank auditors and banks to ensure audit independence with regard to assigning valuations, particularly to complex financial instruments. The UK Stewardship Code developed by the Financial Reporting Council (FRC) is the first of its kind setting out good practices on the engagement of institutional investors with companies.

Sovereign Debt Crisis

1.27 The emergence of the sovereign debt in several Eurozone countries caused by large-scale fiscal stimulus plans, financial rescue packages and falling tax revenues brought to the fore the unviable government budget deficits and public debt in many advanced countries, which pose serious risks to global growth and financial stability. According to the IMF, the debt to GDP ratio for G-7 countries is expected to reach more than 113 percent in 2010, a level not seen since 1950. The fallout of the deteriorating fiscal conditions has been reflected in sharp increases in sovereign CDS spreads of Greece, Portugal and Spain and the magnitude of the changes in such spreads were coincidental with budget deficits. To overcome the sovereign debt problem, there is need for careful management of budget deficits, ensuring a smooth deleveraging process, implementation of prudent macro and prudential regulations to prevent overheating, adoption of regulatory reforms in banks and efforts to reduce cost of systemic failures.

3. Perspectives on Indian Banking

1.28 In 2009-10 there was a slowdown in the balance sheet growth of scheduled commercial banks (SCBs) with some slippages in their asset quality and profitability. Bank credit posted a lower growth of 16.6 per cent in 2009-10 on a year-on-year basis but showed signs of recovery from October 2009 with the beginning of economic turnaround. Gross non performing assets (NPAs) as a ratio to gross advances for SCBs, as a whole, increased from 2.25 per cent in 2008-09 to 2.39 per cent in 2009-10. Notwithstanding some weakening of asset quality, the Capital to Risk Weighted Assets Ratio (CRAR) of Indian banks in terms of Basel II norms at 14.5 per cent as at end March, 2010 was much higher than the regulatory prescription. However, the profitability of Indian banks as reflected by the Return on Assets (RoA) was lower at 1.05 per cent in 2009-10 than 1.13 per cent during the previous year.

1.29 Notwithstanding some knock-on effects of the global financial crisis, Indian banks withstood the shock and remained stable and sound in the post-crisis period. Indian banks now compare favorably with banks in the region on metrics such as growth, profitability and loan delinquency ratios. In general, banks have had a track record of innovation, growth and value creation. However, this process of banking development needs to be taken forward to serve the larger need of financial inclusion through expansion of banking services, given their low penetration as compared to other markets.

Regulatory Framework

1.30 The Reserve Bank has been taking timely initiatives to ensure that the regulatory framework for the banking industry is regularly updated in keeping with the evolution of the financial system, reduce chances of regulatory/ supervisory arbitrage and excessive risk taking. Besides higher capital adequacy ratio and requirement of statutory liquidity buffers in the form of Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR), banks are subject to regulatory norms pertaining to concentration risks, capital market exposure, inter-bank exposures, and external debt intermediation. Banks' exposure to derivatives have also been brought under the ambit of capital adequacy regime with prescriptions on use of credit conversion factors linked to the maturities of interest rate and exchange rate contracts. The Reserve Bank has already put in place a monitoring mechanism to capture the 'contagion risk' within financial conglomerates as also its cumulative exposure to specific outside entities, sectors and market segments from the point of view of various concentration risks facing the conglomerates.

Institutional Developments

1.31 In order to promote financial inclusion through larger number of banks, competition and good governance with diversified ownership, the Reserve Bank released a discussion paper on licensing of new private banks on 11 August, 2010. The discussion paper seeks to obtain feedback on the following aspects:

- Minimum capital requirements for new banks and promoters contribution
- Minimum and maximum limits on promoter shareholding and other shareholders
- Foreign shareholding in the new banks
- Whether industrial and business houses could be allowed to promote banks
- Should Non-Banking Financial Companies be allowed conversion into banks or to promote a bank
- Business model for the new banks.

1.32 Core investment companies primarily holding financial instruments are prone to market risk and hence need to be properly regulated to prevent systemic implications of their failure on the financial system. Accordingly, in August 2010 the Reserve Bank unveiled regulatory norms for core investment companies holding not less than 90 per cent of assets in the form of equity shares, preference shares, debt or loans in group companies. These holding companies and investment firms of large business houses with assets above ₹ 100 crore will be required to register with the Reserve Bank, maintain a minimum level capital and remain subject to appropriate leveraging norms.

1.33 The new Companies Bill, 2009 that seeks to replace the erstwhile Companies Bill, 1956 has, *inter alia*, proposed to include banks under the purview of class action suits. However, since the revised system of Ombudsman scheme has served well as a mechanism to provide quick and inexpensive redress of customers' grievances against banks, there may not be enough merit in extending the provision to banks under the new Bill.

Bank Recapitalisation

1.34 Capital forms the basic requirement for banks to expand balance sheets. Thus, banks will have to raise substantially higher levels of

Table I.3: Recapitalisation of Public Sector Banks

Figures in ₹crore Status	2010-11 Already completed by July 2010	2009-10 Completed	2008-09 Completed
1	2	3	4
UCO Bank	673	450	450
Vijaya Bank	700	-	500
United Bank of India	250	300	250
Central Bank@	250	450	700
IDBI Bank	3,119	-	-
Bank of Maharashtra	588	-	-
Union Bank	111	-	-
Total	5,691	1,200	1,900

@ Through participation in the proposal rights issue
Source: Press Information Bureau, Government of India

capital in order to provide the adequate resources needed by a growing economy. In the budget for 2010-11, the Government has provided for recapitalisation of ₹ 16,500 crore to help banks maintain a Tier I capital adequacy ratio in excess of 8 per cent. As part of this programme ₹ 5,691 crore was infused up to the end of July 2010 (Table I.3) The capital infusions have been in the form of direct equity and hybrid Tier I capital including perpetual non-cumulative preference shares.

Implications of Enhanced Basel II Capital Regime

1.35 In addition to the recapitalisation by the Union Government, in the medium to long run, banks will have to continue to shore up their capital base to support higher credit growth. At present, Indian banks are not likely to be significantly impacted by the proposed new capital rules. With CRAR at 14.5 per cent including 10.1 per cent of Tier I capital as on end-March, 2010, the enhanced capital norms are lower than this level. However, there may be some negative impact arising from shifting some deductions from Tier I and Tier II capital to common equity. Further, changes relating to the counterparty credit risk framework are likely to have capital adequacy implications for some Indian banks having large OTC bilateral derivatives positions.

1.36 Meanwhile, since the BCBS has taken in-principle position that no assets, including cash should be exempted for the measurement of leverage ratio, the SLR would not be excluded for the calculation of leverage. However, the proposed regulation would not constrain banks due to the existing lower leverage ratio and adequate Tier I capital and limited derivatives positions. On the other hand, few banks may be called upon to maintain additional capital and liquidity charges to cover systemic risk capital and liquidity. With national discretion provided on proposals relating to forward looking countercyclical buffers, the impact of this regulation may have to be considered from the standpoint of its effect on overall credit growth, although building such buffers would not be too difficult for banks in a cyclical upturn. In the Indian context it would be preferable to follow sectoral approaches to countercyclical policies which have served well so far. Meanwhile the risk management framework for the banking system as prescribed by the Reserve Bank continues to be strengthened with guidance received from standard setting bodies.

Long Term Financing

1.37 The constraints on the maturity of liabilities of the banking system largely consisting of retail deposits – biased towards the shorter end could inhibit banks to fulfill long term financing needs of sectors such as infrastructure as recent trends show that the bank lending to infrastructure sector is growing appreciably. The changing composition of bank credit in favour of long term financing can potentially aggravate asset liability mismatches in the banking system. It may not be prudent to further increase individual and group exposure norms for infrastructure financing, which already stand relaxed. Going forward, added impetus on take-out financing or other innovative credit enhancements mechanisms may have to be encouraged for bridging the gap between the demand and supply of long term funds.

1.38 Banks in India have also shown interest in sponsoring and managing private pools of capital such as venture capital funds and infrastructure funds. A discussion paper on prudential issues in banks' floating and managing such off balance sheet activities was issued by the Reserve Bank in January 2010 for comments. To promote infrastructure investment, in July 2010, the Reserve Bank permitted take-out financing arrangement through External Commercial Borrowings (ECB), under the approval route and subject to specified conditions, for the purpose of refinancing of Rupee currency loans availed of from the domestic banks by the sea port and airport, roads including bridges and power sectors for the development of new projects.

1.39 In August 2010, the Reserve Bank issued draft guidelines for CDS to seek feedback from stakeholders. The introduction of CDS would help banks to manage exposures while increasing credit penetration and lending to infrastructure and large firms without being constrained by the extant regulatory prescriptions in respect of single borrower gross exposure limits. Long term funding of corporates would entail development of flourishing corporate bond market. The Reserve Bank permitted repo in corporate bonds effective from March 1, 2010 for developing this market.

Loan Restructuring

1.40 Loan restructuring is resorted to manage NPAs in the short term, particularly, in case of credit worthy borrowers who are stressed by unexpected and adverse economic developments. The restructuring of borrowal accounts done by banks in 2009 may pose risk of losses over and above the initial diminution of the fair value of advances on account of reduction in the rate of interest and/or re-scheduling of the repayment of principal amounts. The improvement in domestic and global economic conditions, however, could help in limiting the extent of fresh slippages in the future. With a view to enhancing the soundness of individual banks as also the stability of the financial sector, the Reserve Bank advised the banks in December 2009 to ensure that their total provisioning coverage ratio, including floating provisions, should not be less than 70 per cent. Though the provisioning norm may provide a cushion against asset slippages, it may impact the profitability of banks.

1.41 Liquidity management is a fundamental component for safe and sound functioning of all financial institutions. Sound liquidity management involves prudent management of assets and liabilities (on- and off-balance sheet), supported by a process of liquidity planning taking into account changes in economic, regulatory or other operating conditions. Banks will have to put in place a robust liquidity management plan, especially through encouragement and retention of stable retail deposits.

1.42 The management of NPAs is one of the main business objectives of banks which requires appropriate appraisal, monitoring and management of issued loans. Gross NPA ratio has shown an increase in 2009-10. Moreover, there has been a deterioration of the asset quality as reflected by an increase in the proportion of doubtful and loss assets in the NPA profile of banks in 2009-10. The signs of financial stress thus remain an important concern for the Indian banking sector in the medium to long-term.

Interest Rates

1.43 The Base Rate system of loan pricing introduced with effect from July 1, 2010 is expected to enhance the transparency in the pricing of loans. As banks have been provided with greater flexibility in setting lending rates, they would also have to operate under a more competitive environment in the liberalised system. While lending rates have tended to be sticky, it is expected that the Base Rate system which is linked to cost of funds will show greater flexibility and strengthen both the interest rate and credit channels of monetary transmission. Interest rates on deposits have been rising since December 2009 taking cues from the rise in policy rates by the Reserve Bank. Going forward, it is important that banks focus on deposit mobilisation with commensurate interest rates that could boost retail deposits.

Securitisation

1.44 The RBI had issued guidelines on securitisation of standard assets in February 2006. These guidelines prohibit originators from booking profits upfront at the time of securitisation. Two other features relate to maintenance of capital at the required minimum of 9 per cent on any credit enhancements provided, and disallowing the release of credit enhancement during the life of the credit-enhanced transaction. Thus, banks in India do not have incentive to resort to unbridled securitisation as observed in "originate-to-distribute" and "acquire and arbitrage" models of securitisation in many other countries. In the light of the international experience of the financial crisis, particularly, the inability of regulation to prevent the excessive building up of risks through securitisation and off balance sheet leveraging, the Reserve Bank has issued draft guidelines on securitisation for banks and non-banking financial institutions in April 2010 and in June 2010, respectively, seeking comments on the same. Two important features included in the draft guidelines pertain to defining a minimum holding period before selling an asset to the Special Purpose Vehicle (SPV) and retention of a minimum portion of the loan prior to securitisation.

Accounting Standards

1.45 Well designed accounting covenants are necessary for maintaining financial stability. Accordingly, the G-20 Group on Enhancing Sound Regulation and Strengthening Transparency has recommended that the accounting standards setters and prudential supervisors should together identify solutions that are consistent with the complementary objectives of promoting financial stability and transparency. The Annual Policy Statement of 2010-11 announced that as part of the effort to ensure convergence of the Indian Accounting Standards (IAS) with the International Financial Reporting Standards (IFRS), all SCBs would be required to convert their opening balance sheet as at April 1, 2013 in compliance with the IFRS converged IAS. The presentation of financial statements in line with IFRS will be challenging for banks. The changeover from currently followed accounting principles viz., those prescribed by RBI to IFRS may have material impact on financial statements of bank particularly in areas such as provision of loan losses and impairment of investments which would require high level of judgment and extensive use of unobservable inputs and assumptions. This is turn would entail significant changes in financial reporting process. Specifically, unlike under the current RBI accounting rules where loans losses are provided based on provisioning rates in a mechanical fashion, the IFRS would require prior and fair assessment of expected impairment and upfront provisioning of loan losses.

1.46 However, with regard to Urban Co-operative Banks (UCBs) and Non-Bank Finance Companies (NBFCs), a staggered implementation schedule was considered appropriate depending on the size of net worth. Considering the amount of work involved in the convergence process, it is expected that banks and other entities initiate appropriate measures to upgrade their skills, management information system and information technology capabilities to manage the complexities and challenges of IFRS.

Financial Inclusion

1.47 Financial inclusion is being accorded top most priority by the Government and the Reserve Bank and is a central part of the policy agenda which needs to be carried forwarded in cost effective means particularly through use of effective technological solutions. Financial inclusion is important for the poor as it provides them opportunities to build savings, avail credit, make investments and equips them to meet emergencies. A combination of regulatory mandates, cost effective technology solutions and implicit and explicit incentives and moral suasion has been used to increase financial penetration of affordable banking services particularly in the rural and unorganised sectors.

1.48 Out of the 600,000 habitations in the country, only about 5 per cent have a commercial bank branch. Just about 40 per cent of the populations across the country have bank accounts, and this ratio is much lower in the north-east region of the country. People with debit cards comprise 13 per cent and those with credit cards comprise only 2 per cent. As discussed in Chapter IV, India ranks low when compared with the OECD countries and select Asian peer group in respect of financial penetration. The untapped potential with regard to financial inclusion needs to be harnessed using cost effective technology solutions and appropriate business models that make small value transactions viable.

1.49 During 2009-10, the Platinum Jubilee year of the Reserve Bank, the flagship project was the outreach programme aimed at financial inclusion and financial literacy. The Reserve Bank chose 160 remote unbanked villages to convert them into villages having 100 per cent financial inclusion with each household having at least one credit facility along with effective grievance redressal mechanism and awareness.

Financial Stability

1.50 Maintaining financial stability is one of the core goals of monetary policy in India. The Reserve Bank brought out its first Financial Stability Report in March 2010 which concluded that India was relatively less impacted by the global financial meltdown as robust regulatory and supervisory policies ensured the resilience of the financial sector. A financial stress indicator based on market indicators has been developed by the Reserve Bank for ongoing assessment financial stability.

1.51 Financial institutions in India have diversified into areas like insurance, securities and other non-banking financial services such as lending, leasing and hire purchase etc. The Reserve Bank has put in place a monitoring system with the intention of addressing concerns like excessive leverage or double gearing, regulatory arbitrage, moral hazard in relation to too-big-to-fail institutions and spread of contagion through failures inside a corporate group. A framework for enhanced supervision of Financial Conglomerates already exists but needs refinement as international consensus for a suitable policy framework for SIFIs evolves. In particular, while there is a need to have clarity on the definition of SIFI, the regulatory provisions will have to be suitably calibrated to prevent discretionary decisions compared to other regulated entities. SIFIs should also be required to complete 'living wills' and undertake advanced plans for contingent funding and de-risking. The increased presence of banks across the national boundaries calls for an effective cross-border supervision with appropriate rules for sharing information under the extant legal frameworks.

1.52 In the wake of global financial crisis, the issues of inter-connectedness and systemic risk concerns have come to fore. In this regard, the setting up of the Financial Stability and Development Council (FSDC), as announced in the Union Budget for 2010-11 is aimed at strengthening the institutional mechanism for financial stability along with financial inclusion and financial literacy. While coordination among the Government and financial regulators is essential, there has to be a clear demarcation of responsibilities of various regulatory authorities that can help in undertaking speedy and effective crisis prevention measures in the demarcated areas. Since the global crisis, world over, there has been a growing shift in favour of assigning greater responsibility to central banks for both systemic oversight and macro-prudential regulation. This greater responsibility is driven by capability of the central banks among the regulators to perform the intended tasks. However, in order to effectively discharge such responsibilities, institutional independence and autonomy of central banks is of crucial importance. In this context, the recent enactment of the Securities and Insurance Laws (Amendment and Validation) Bill 2010 raised some concerns. In operationalising the arrangement envisaged under the Bill, it is important to ensure that the autonomy of the regulators is not compromised either in fact or in perception.

Financial Sector Reforms

1.53 The major aim of financial sector reforms in India has been enhancing efficiency and profitability, while maintaining stability in the financial sector. In line with these objectives, the Reserve Bank has thus far promoted, among others, the participation of foreign banks, technological upgradation in the banking sector, recapitalisation of public sector banks, libralisation of the branch authorisation policy, adoption of innovative policy measures for financial inclusion, and application of countercyclical prudential measures. Financial sector reforms, going ahead, will focus on bank consolidation, containing the systemic risks arising out of interconnectedness of the banking sector with other components of the financial sector, and laying down the roadmap for furthering foreign banks' participation. With regard to the roadmap for foreign banks' participation, the review, which was due in 2009, was put on hold on account of the crisis. A discussion paper on the mode of presence of foreign banks in India is under preparation.

4. Conclusions

1.54 The regulatory and supervisory framework of the financial system across the world is undergoing a paradigm shift following the problems experienced during the global financial crisis. In this regard, multilateral and standard setting bodies like the G-20, IMF, BIS and FSB have been in the forefront to design an advanced regulatory framework to prevent the recurrence of such crisis. In particular, a mention may be made of the enhanced Basel II capital regime announced by the BCBS in September 2010. While this regime may have some adverse macroeconomic impacts in the short-term, it is expected to enhance the stability and safety of the financial system with consequent long-term benefits for stable growth. In India, the Reserve Bank has been initiating several measures to strengthen the banks and other financial institutions taking cues from the international developments. Important regulatory initiatives such as the introduction of the Base Rate system is expected to lead to transparent and effective pricing of loan products while the intent to allow opening of new banks will instill competition and accelerate financial inclusion. Technological initiatives will help in providing cost effective banking services in underbanked areas. Management of NPAs by banks remains an area of concern, particularly, due to the likelihood of deterioration in the quality of restructured advances. Going forward, liquidity management will become critical for banks, as the monetary policy stance responds to macroeconomic developments.