Developments in Commercial Banking

5. Capital to Risk-Weighted Assets Ratio

2.54 The role of Capital to Risk-Weighted Assets Ratio (CRAR) is well documented in the recent literature on banking and financial stability. At the end March 1999, all PSBs have already achieved 9 per cent CRAR, barring one. There were 4 banks with CRAR between 8 and 10 per cent as at end-March, 1999 (Tables II.22 and II.23). Further details are given in Appendix Tables II.8A, II.8b, II.8C.

6. Regional Rural Banks

2.55 The regional rural banks (RRBs), supplement the efforts of SCBs, co-operatives and rural development banks and cater to the specialized credit requirements of the rural sector. At present, there are 196 RRBs catering to the credit requirements of 451 districts. In recent years, RRBs showed (i) increase in profits, (ii) improvements in recovery performance of loans and (iii) decline in the holdings of their non-performing assets (NPAs). RRBs are also adapting themselves to the evolving regulatory standards.

Table II.22: Distribution of CRAR - Public Sector Banks: 1997-98 and 1998-99

(Number of banks)

	Banks	1997-98				1998-99			
		Below 4 per cent	Between 4-8 per cent	Between 8-10 per cent	Above 10 per cent	Below 4 per cent	Between 4-8 per cent	Between 8-10 per cent	Above 10 per cent
	1	2	3	4	5	6	7	8	9
1.	SBI	-	-	-	1	-	-	-	1
2.	SBI Associates	-	-	1	6	-	-	-	7
3.	Nationalised Banks	1	-	6	12	1	-	4	14
	Total	**1**	**-**	**7**	**19**	**1**	**-**	**4**	**22**

Table II.23: Distribution of CRAR - Indian Private Sector Banks and Foreign Banks in India: 1997-98 and 1998-99

(Number of banks)

	Bank Groups	1997-98				1998-99			
		Below 4 per cent	Between 4-8 per cent	Between 8-10 per cent	Above 10 per cent	Below 4 per cent	Between 4-8 per cent	Between 8-10 per cent	Above 10 per cent
	1	2	3	4	5	6	7	8	9
1.	Old Private Sector Banks	2	2	6	15	2	2	3	18
2.	New Private Sector Banks	-	-	2	7	-	-	2	7
3.	Foreign Banks	-	-	12	30	1	-	14	29

Mobilisation and Deployment of Funds

2.56 The total outstanding deposits (demand and time) of all RRBs showed a substantial increase of Rs.4,450 crore or 21.2 per cent from Rs.20,977 crore as on March 27, 1998 to Rs.25,428 crore as on March 26, 1999 (Table II.24). Their borrowings showed a more than two-fold increase from Rs.3.71 crore as on March 27, 1998 to Rs.7.90 crore as on March 26, 1999. On the asset side, bank credit showed an increase of Rs.1,330 crore or 13.7 per cent from Rs.9,687 crore as on March 27, 1998 to Rs.11,016 crore as on March 26, 1999.

2.57 The investments of RRBs continued to increase during 1998-99. They were up by 41.9 per cent, a shade higher than that of 41.8 per cent in the preceding year (Table II.24). A large part of their investment is channelised into other approved securities. The share of investment in other approved securities increased from 71.3 per cent as on March 27, 1998 to 76.2 per cent as on March 26, 1999. In contrast, the share of investment in government securities in total investment declined from 28.7 per cent in 1997-98 to 23.8 per cent in 1998-99.

Table II.24: Important Banking Indicators of RRBs: 1997 to 1999

(Rs. crore)

Item		March 28, 1997	March 27, 1998	March 26, 1999	Variations 1997-98	Variations 1998-99
1		2	3	4	5 (3-2)	6 (4-3)
1.	**Liabilities to the Banking System**	**125.31**	**136.70**	**151.11**	**11.39**	**14.41**
					(9.1)	**(10.5)**
2.	**Liabilities to Others**	**17,542.24**	**21,659.75**	**26,318.53**	**4,117.51**	**4,658.78**
					(23.5)	**(21.5)**
2.1	Aggregate Deposits (a+b)	16,971.34	20,977.37	25,427.83	4,006.03	4,450.46
					(23.6)	(21.2)
	(a) Demand Deposits	2,946.53	3,804.79	4,688.33	858.26	883.54
					(29.1)	(23.2)
	(b) Time Deposits	14,024.81	17,172.58	20,739.50	3,147.77	3,566.92
					(22.4)	(20.8)
2.2	Borrowings	0.59	3.71	7.90	3.12	4.19
					(528.8)	(112.9)
2.3	Other Demand & Time Liabilities*	570.31	678.67	882.80	108.36	204.13
					(19.0)	(30.1)
3.	**Assets with the Banking System**	**7,593.85**	**9,414.68**	**11,319.45**	**1,820.83**	**1,904.77**
					(24.0)	**(20.2)**
4.	**Bank Credit**	**8,544.02**	**9,686.69**	**11,016.47**	**1,142.67**	**1,329.78**
					(13.4)	**(13.7)**
5.	**Investments (a+b)**	**2,487.66**	**3,527.61**	**5,006.90**	**1,039.95**	**1,479.29**
					(41.8)	**(41.9)**
a.	Govt. Securities	722.91	1,011.09	1,190.54	288.18	179.45
					(39.9)	(17.7)
b.	Other Approved Securities	1,764.75	2,516.52	3,816.36	751.77	1,299.84
					(42.6)	(51.7)
6.	**Cash Balances**	**225.99**	**253.22**	**299.59**	**27.23**	**46.37**
					(12.0)	**(18.3)**

Memorandum Items :

a.	Cash Balance-Deposit Ratio	1.3	1.2	1.2
b.	Credit-Deposit Ratio	50.3	46.2	43.3
c.	Investment/Deposit Ratio	14.7	16.8	19.7
d.	Investment+Credit/Deposit Ratio	65.0	63.0	63.0

Notes: 1. * includes Participation Certificates issued to others.
2. Figures in brackets are percentage variations.

2.58 An analysis of the investment-deposit and credit-deposit ratio indicates that there was a perceptible shift in the assets portfolio of RRBs. The aggregate investment-deposit ratio of RRBs increased from 14.7 per cent as on March 28, 1997 to 16.8 per cent as on March 27, 1998 and then to 19.7 per cent as on March 26, 1999, while the credit-deposit ratio declined from 50.3 per cent to 46.2 per cent and further to 43.3 per cent over the same period. The investment and credit to deposit ratio stood at 63.0 per cent in 1998-99 as in the previous year.

Table II.25: Purpose-wise Disbursements of Loans and Advances of RRBs: 1997 and 1998

(Rs. crore)

	Purpose	As at end-March	
		1997	1998
	1	2	3
1.	Short term (crop loans)	1,203	1,413
2.	Term loan for agriculture and allied activities	588	640
3.	Investments		6
I	**Total Agriculture (1 to 3)**	**1,791**	**2,059**
		(45.6)	**(44.4)**
4.	Rural artisans, village and cottage industries	218	194
5.	Other Industries		162
6.	Retail trade and Self- employed, etc.	619	625
7.	Consumption loans	300	123
8.	Other purposes *	1,088	1,471
II	**Total Non-Agriculture (4 to 8)**	**2,225**	**2,575**
		(55.4)	**(55.6)**
	Total (I+II)	**4,016**	**4,634**
		(100.0)	**(100.0)**

Notes: 1. * include indirect advances.
2. Figures in brackets are percentages to the total.
Source: NABARD.

Purpose-wise Disbursements of Loans and Advances

2.59 Data on purpose-wise disbursements of loans and advances of RRBs are not as yet available for end-March 1999. As on March 31, 1998, the non-agricultural advances[5] constituted a larger share of 55.6 per cent, while the agricultural advances accounted for 44.4 per cent of the total advances (Table II.25). A significant proportion of agricultural loans is in the form of short-term crop loans. As at end-March 1998, the short-term crop loans at Rs.1,413 crore constituted a share of 68.6 per cent, while the term loans at Rs.640 crore accounted for a relatively smaller share of 31.1 per cent.

Financial Performance of RRBs

2.60 Of the 196 RRBs, the audited results on financial performance are available for 177 RRBs for the year 1998-99. An analysis of the financial performance of these RRBs shows that there have been significant improvements in both the number of profit-making banks as well as the profitability of these banks during 1998-99 as compared to 1997-98. The number of profit-making RRBs increased from 109 in 1997-98 to 132 in 1998-99. The operating profits of these banks showed more than a two-fold increase from Rs.114.47 crore in 1997-98 to Rs.304.66 crore in 1998-99 (Table II.26). The ratio of operating profits to total assets also showed more than a two-fold increase from 0.43 per cent in 1997-98 to 0.93 per cent in 1998-99, and this adjusted for the decline in the ratio of provisions and contingencies to total assets from 0.26 per cent to 0.23 per cent during the same period, led to a substantial improvement in the net profit ratio. The net profit ratio showed more than a four-fold increase from 0.16 per cent in 1997-98 to 0.70 per cent in 1998-99. The increase in profitability of RRBs can be attributed, *inter alia*, to both the decline in the ratio of intermediation cost to total assets and an increase in the 'spread'. The intermediation cost ratio (i.e. operating expenses to total assets) declined by 0.2 percentage points from 2.9 per cent in 1997-98 to 2.7 per cent in 1998-99. The decline in the intermediation cost can be attributed, *inter alia*, to the decline in the wage ratio from 2.5 per cent in 1997-98 to 2.4 per cent in 1998-99. The 'spread' of 177 RRBs increased by 0.4 percentage points from 2.8 per cent in 1997-98 to 3.2 per cent in 1998-99.

Table II.26: Financial Performance of Regional Rural Banks: 1997-98 and 1998-99

(Rs. crore)

	Item	1997-98			1998-99		
		Loss Making (68)	Profit Making (109)	177 RRBs	Loss Making (45)	Profit Making (132)	177 RRBs
	1	2	3	4	5	6	7
A.	**Income (i+ii)**	**651.48**	**1,856.22**	**2,507.70**	**525.33**	**2,630.03**	**3,155.36**
	(i) Interest Income	618.22	1,765.00	2,383.22	493.18	2,517.81	3,010.99
	(ii) Other Income	33.26	91.22	124.48	32.15	112.22	144.37
B.	**Expenditure (i+ii+iii)**	**877.16**	**1,587.19**	**2,464.35**	**695.71**	**2,230.93**	**2,926.64**
	(i) Interest Expended	542.42	1,079.20	1,621.62	433.47	1,520.22	1,953.69
	(ii) Provisions and Contingencies	30.85	40.27	71.12	24.33	51.61	75.94
	(iii) Operating Expenses	303.89	467.72	771.61	237.91	659.10	897.01
	of which: Wage Bill	268.49	403.03	671.52	209.49	572.71	782.20
C.	**Operating Profit/Loss**	**-194.83**	**309.30**	**114.47**	**-146.05**	**450.71**	**304.66**
D.	**Net Profit/Loss**	**-225.68**	**269.03**	**43.35**	**-170.38**	**399.10**	**228.72**
E.	**Total Assets**	**8,889.51**	**18,036.97**	**26,926.48**	**6,953.64**	**25,762.53**	**32,716.17**

F. Financial Ratios (per cent) $						
(i) Operating Profit/Loss	-2.19	1.71	0.43	-2.10	1.75	0.93
(ii) Net Profit/Loss	-2.54	1.49	0.16	-2.45	1.55	0.70
(iii) Income	7.33	10.29	9.31	7.55	10.21	9.64
(iv) Interest Income	6.95	9.79	8.85	7.09	9.77	9.20
(v) Other Income	0.37	0.51	0.46	0.46	0.44	0.44
(vi) Expenditure	9.87	8.80	9.15	10.00	8.66	8.95
(vii) Interest Expended	6.10	5.98	6.02	6.23	5.90	5.97
(viii) Operating Expenses	3.42	2.59	2.87	3.42	2.56	2.74
(ix) Wage Bill	3.02	2.23	2.49	3.01	2.22	2.39
(x) Provisions and Contingencies	0.35	0.22	0.26	0.35	0.20	0.23
(xi) Spread (Net Interest Income)	0.85	3.80	2.83	0.86	3.87	3.23

Notes: 1. Date related to audited balance sheets of 177 RRBs.
2. $ Ratios to Total Assets

Source: NABARD.

State-wise Recovery Performance of RRBs

2.61 During the year ending June 1998, RRBs showed improvements in recovery of loans. At the All-India level, the loan recovery to demand ratio of RRBs at 60.54 per cent during 1997-98 (July-June) was higher than that in the previous year (56.9 per cent). A state-wise analysis of recovery performance shows that Kerala registered the maximum recovery rate of 88.1 per cent during 1997-98 followed by Tamil Nadu with recovery rate of 79.37 per cent, Gujarat (72.33 per cent) and Punjab (72.11 per cent). Tripura showed the lowest recovery rate of 11.61 per cent during the year.

Non-performing Assets

2.62 The asset quality of RRBs has shown significant improvements in recent years. In the total loans, the share of standard assets has shown steady increase with the commensurate decline in the share of non-performing assets during 1996 to 1998. The share of standard assets in the total loans steadily increased from 56.9 per cent as at end-March 1996 to 63.2 per cent as at end-March 1997 and then to 67.2 per cent as at end-March 1998, while the share of non-performing assets concomitantly declined from 43.1 per cent to 36.8 per cent and then to 32.8 per cent over the same period (Table II.27).

2.63 A further analysis in terms of the composition of non-performing assets of RRBs shows that a significant proportion of NPAs is in the doubtful category followed in descending order, by the sub-standard and loss assets categories. In line with the decline in total NPAs, the doubtful and loss assets categories of NPAs also showed steady declines during 1996 to 1998. The sub-standard category of NPAs which declined from 9.3 per cent as at end-March 1996 to 8.2 per cent as at end-March 1997, increased marginally to 8.5 per cent as at end-March 1998 (Table II.27). The net NPAs as a percentage of net loans constituted 20.3 per cent in 1997-98 and 21.3 per cent in 1996-97.

2.64 The frequency distribution of gross NPAs as percentage to loans and advances of RRBs is given in Table II.28. It may be seen from the table that, in 1997-98, the number of RRBs having NPA to loans and advances ratio greater than 50 per cent has been lower than those in both 1996-97 and 1995-96. This indicates that in 1997-98 several RRBs lowered their NPAs as a fraction of their loans and advances. The median value of the NPA ratio has declined over the 3 years from 45.2 per cent in 1995-96 to 40.0 per cent in 1996-97 and 32.3 per cent in 1997-98. This implies that 50 per cent of the 196 RRBs in 1997-98 had NPAs less than 32.3 per cent of their total loans and advances. This shows that the improved performance of RRBs as a whole has been due to the improved performance by several banks rather than very good performance on the part of a few.

Table II.27: Classification of Loan Assets of all RRBs

(Per cent)

Category	As at end-March		
	1996	1997	1998
1	2	3	4
1. Standard Assets	**56.9**	**63.2**	**67.2**
2. Non-Performing Assets	**43.1**	**36.8**	**32.8**
2.1 Sub-standard	9.3	8.2	8.5
2.2 Doubtful	28.0	24.0	20.4
2.3 Loss	5.8	4.6	3.9

Table II.28: Frequency Distribution of Gross NPAs as Per Cent of Loans and Advances of RRBs

Range (Per cent)	Number of RRBs		
	1995-96	1996-97	1997-98
1	2	3	4
Below 10	4	10	12
10 - 20	21	26	33
20 - 30	23	35	46
30 - 40	35	27	30
40 - 50	29	42	37
50 - 60	28	25	21
60 - 70	34	21	13
70 - 80	16	7	3
80 - 90	5	3	1
90 - 100	1	0	0
Total	**196**	**196**	**196**
Median NPA Ratio	**45.2**	**40.0**	**32.3**

Regulatory Control and Supervision of RRBs

2.65 The following are the major regulatory control measures introduced during the year to strengthen the supervisory mechanism of RRBs.

i) RRBs have been exempted from the provisions of the proviso to sub-sections (1) and (1A) of Section 42 of the RBI Act, 1934, for a further period of two years upto December 31, 2000. This allows them to continue to maintain cash reserves at 3 per cent of their demand and time liabilities.

ii) Effective fortnight beginning January 7, 1995, RRBs are required to maintain a minimum of 85 per cent of their CRR balances on each of the first 13 days of the reporting fortnight. On the 14^{th} day, they will be allowed to lower the cash balances to adjust the average of daily balances. The main objective of this measure is to stabilize the cash balances of banks held with the Reserve Bank.

Recapitalisation of RRBs

2.66 The process of recapitalisation of RRBs which is being followed since 1994-95, was continued during the year 1998-99, though with reduced budgetary allocations. The budgetary allocations for recapitalisation were reduced from Rs.400 crore during 1997-98 to Rs.152.65 crore during 1998-99. However, the decline in the budgetary allocation was offset by the provision of additional equity support aggregating to Rs.305.30 crores in 1998-99. The Union Budget for 1999-2000 has made a provision of Rs.168 crores for the recapitalisation of RRBs (Table II.29).

Table II.29: Recapitalisation of Regional Rural Banks: 1994-95 to 1999-2000

Year	Amount (Rs. crore)
1	2
1994-95	300.00
1995-96	447.00
1996-97	400.00
1997-98	400.00
1998-99	152.65
1999-2000*	168.00

Note: * Budget estimate.

2.67 With a view to strengthening the capital base of RRBs and improving their financial performance, some RRBs have been identified as eligible, based on certain criteria[6], for fresh infusion of funds under Phase V of the recapitalisation process. The categories of RRBs considered eligible for recapitalisation include:

1. RRBs partially recapitalised during 1996-97 and 1997-98.

2. RRBs considered for the first time in 1998-99.

2.68 Based on the above criteria, 10 RRBs have been partially recapitalised in 1996-97 and 9 have been given further capital in 1997-98. 24 RRBs were provided additional equity for the first time. With the infusion of capital under Phase V, 175 of the total of 196 RRBs stand fully/partially recapitalised while 2 RRBs do not need recaptialisation support. This leaves only 19 RRBs outside the ambit of the recapitalisation program.

Other Policy Initiatives

2.69 The NABARD introduced several policy initiatives for improving the overall performance of the RRBs during the year 1998-99. These are as follows:

- In order to monitor the performance of RRBs, especially the weak ones, sponsor banks have been advised to undertake quarterly/half-yearly reviews of the banks coming under their jurisdiction. NABARD, RBI and GOI may selectively participate in the half-yearly review meetings.

- To hasten the process of turn around of RRBs and to further strengthen them, sponsor banks have been advised to explore the possibility of the merger of RRBs coming under them and operating in contiguous areas.

- In order to evolve an early warning system as part of the supervisory function of the NABARD, an off-site surveillance system has been introduced to supplement on-site inspection.

- The Government of India, in consultation with NABARD, has framed Appointment and Promotion Rules (1998) for the staff of RRBs.

- Kisan Credit Cards are being introduced in the RRBs to facilitate the provision of credit to farmers.

- RRBs have been encouraged to adopt self-help groups for channeling credit to the poor on a sustainable basis.

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5. Non-agricultural advances consist of advances to rural artisans, village and cottage industries, retail trade and self-employed, etc., and indirect advances.

6. Criteria adopted for selection of eligible RRBs include the following: (a) improvement in recovery performance; (b) deposit growth, (c) advances growth, (d) percentage of standard assets to the total loans and advances as on March 31, 1998, and (e) percentage of derecognised interest to total interest on loans and advances as on March 31, 1998.

7. Regional Spread of Banking

2.70 In the on-going phase of banking sector reforms, banks have been given freedom in regard to the opening up of branches subject to the approval of the Reserve Bank of India. An analysis of branch expansion of banks shows that the number of bank offices as at end-March 1999 has increased by 851 or 1.3 per cent from 64,267 as on last Friday of March 1998 to 65,118 as on March 31, 1999. During the same period, the number of centres, having bank offices, stood at 36,083. In as many as 31,036 centres (86 per cent of total) there were only single offices. There were 34 centres which had more than 100 offices each as at end-March 1999. At present, on an average, a bank office serves a population of 14,829.

2.71 The number of branches of commercial banks stood at 64,918 as on June 30, 1999 (excluding non-scheduled banks branches). The southern region registered the highest share of 27.2 per cent (Appendix Tables II.9 and II.10).

2.72 A disaggregated analysis of deposits and credit per bank shows that Delhi had the highest average deposit of Rs.5,548 lakh per office. This was followed by Chandigarh (Rs.3,113 lakh). At the all-India level, the deposits and credit per office worked out to Rs.1,078 lakh and Rs.598 lakh, respectively as on March 31, 1999. In regard to credit too, Delhi ranked first with an average outstanding credit of Rs.4,084 lakh per office, followed again by Chandigarh (Rs.2,610 lakh) as on March 31, 1999.

8. Scheduled Commercial Banks' Operations in Money Market Instruments

Call/Notice Money Market

2.73 The Reserve Bank of India has taken several initiatives during the year 1998-99 to further strengthen the call money market. To increase the width and depth of call money market, the Reserve Bank has allowed two additional mutual funds (MFs) as lenders in the call money market during the year. Besides, seventeen corporates were allowed to participate in the market and lend through primary dealers (PDs). The call rates remained in the range of 0.5 per cent to 12.5 per cent during 1998-99, with the exception of two occasions. The call market witnessed some volatility during the second half of August 1998 when policy changes were made by the Reserve Bank to stem the pressure in the foreign exchange market.

2.74 There has been sharp increase in the total turnover in the call money market during the year 1998-99. The daily average turnover increased by 3.3 per cent from Rs.23,613 crore during the fortnight ended March 27, 1998 to Rs.24,381 crore during the fortnight ended September 25, 1998, and then further by 39.8 per cent to Rs.33,009 crore during the fortnight ended March 26, 1999. An analysis of the participant-wise turnover indicates that there was a perceptible increase (75.7 per cent) in the turnover of SCBs from Rs.12,107 crore during the fortnight ended March 27, 1998 to Rs.19,773 crore during the fortnight ended March 26, 1999. Trends witnessed during 1998-99 continued during the current financial year as well. The daily average total turnover and the turnover of SCBs increased to Rs.34,211 crore and Rs.22,199 crore, respectively, during the fortnight ended August 13, 1999.

Certificates of Deposit

2.75 Certificates of Deposit (CDs) are issued by banks for meeting their short-term funds requirements. During 1998-99, banks were maintaining better liquidity in view of the low off-take/demand for credit and, therefore, the CDs market remained sluggish. Accordingly, the level of CDs outstandings showed a steep decline from Rs.14,296 crore as on March 27, 1998 to Rs.3,717 crore as on March 26, 1999. As a result, the interest rates declined from the range of 7.2 per cent to 26.0 per cent as on March 27, 1998 to the range of 8.0 per cent to 12.5 per cent as on March 26, 1999 (Appendix Table II.11). As on August 27, 1999, the outstanding amount of CDs issued by SCBs was Rs.3,293.32 crore.

Commercial Paper

2.76 The scheduled commercial banks' investments in commercial paper (CP) showed a significant increase during the year 1998-99. Reflecting the easy liquidity conditions and the declining interest rates in the money market, the effective discount rates on CP showed steady decline during the year, enabling the corporates to float CP and raise sufficient funds from the SCBs. During the year 1998-99, the outstanding investments of SCBs in CP increased from Rs.1,500 crore as on March 31, 1998 with an effective discount rate in the range of 13.6 per cent to 15.8 per cent to Rs.4,588 crore as on September 30, 1998 with an effective discount rate in the range of 7.7 per cent to 13.3 per cent. However, following the liquidity tightening measures introduced on August 20, 1998, the effective discount rate on CP increased subsequently.

2.77 During the period September 30, 1998 to February 28, 1999, there was no appreciable change in the outstanding investments of SCBs in CP. As on February 28, 1999, the outstanding investments by SCBs in CP amounted to Rs.5,367 crore with an effective discount rate in the range of 10.2 per cent to 13.0 per cent. In March 1999, the Reserve Bank reduced both CRR and fixed repos rate which eased the liquidity conditions in the money market. As a result, the amount of outstanding CP steadily increased and aggregated to Rs.7,658 crore as on September 30, 1999 with an effective discount rate in the range of 10.0 per cent to 13.0 per cent (Appendix Table II.12).

Bills Rediscounting Market

2.78 The bills rediscounting market has witnessed some improvements in terms of the increase in number of players. During the financial year 1998-99, two mutual funds viz., Kotak Mahindra and Infrastructure Leasing and Financial Services have been permitted to participate as lenders in the bills rediscounting market. For the current financial year upto September 30, 1999, three more mutual funds, *viz*., the Dundee Mutual Fund, the ING Saving Trust Mutual Fund and the Cholamandalam Cozenove Mutual Fund have been permitted to participate as lenders in the market.

2.79 The bills rediscounted by commercial banks showed nearly a three fold increase from Rs.286 crore as at end-March 1998 to Rs.792 crore as at end-January 1999. During the subsequent period, the market was in low key and as at end-March 1999 the outstanding bills rediscounted by banks with financial institutions stood at Rs.473 crore. Subsequently, with some improvement in the market, the outstanding amount of bills rediscounted, recouped to Rs.544 crore as at end-September 1999.

9. PLRs and Spread of PLRs of Scheduled Commercial Banks

Lending Rates

2.80 Since the introduction of reforms in banking sector, banks have been given freedom to determine their interest rates. The lending rates of banks are now in alignment with the market and, to a larger extent, the cross-subsidisation of interest rates has been withdrawn. With a view to strengthening the freedom of determining the lending rates by banks effective April 29, 1998, interest rates on credit limits upto Rs.2 lakh were not to exceed the Prime Lending Rate (PLR). Following the reduction in the Bank Rate from 10.0 per cent to 9.0 per cent in April 1998, a number of scheduled commercial banks revised their PLR downwards by 0.5-2.0 percentage points. Reflecting the easy liquidity conditions in the market, the PLR of banks was ruling in the range of 12.75 per cent to 14.5 per cent during April to July 1998. Subsequently, in August 1998, with a view to maintaining orderly conditions in the forex market, a number of monetary policy measures were initiated including the hike of 1 percentage point in CRR from 10.0 per cent to 11.0 per cent and 3 percentage points in fixed repos from 5.0 per cent to 8.0 per cent. With the exception of one bank, the SCBs maintained their PLR steady in the range of 12.75 per cent to 14.5 per cent despite the increase in interest rates of financial papers like CP, CDs and Government securities.

2.81 In view of the lower inflation rates, RBI announced reduction in the Bank Rate by one percentage point, Repo Rate by 2.0 percentage points and Cash Reserve Ratio (CRR) by 0.5 percentage point on March 1, 1999. This signaled the reduction of PLR by PSBs by 0.75 percentage point to 1.0 percentage point and accordingly the PLR of PSBs was in the range of 12.0 to 14.0 per cent. However, the foreign and majority of the private sector banks kept their PLR unchanged as these rates were in the range of 12 per cent-16.5 per cent during the same period and the 'spread' of majority of the banks was 4.0 per cent above their PLR. During the current financial year upto September 24, 1999, the PLR of PSBs has further come down by 0.5 percentage points to range between 12.0 per cent to 13.75 per cent (Table II.30). The PLR of private sector banks has been in the range of 10.5 per cent to 16.5 per cent, and that for foreign banks was in the range of 10.5 per cent to 18.5 per cent.

10. Scheduled Commercial Banks and Government Securities Market

2.82 The scheduled commercial banks, by subscribing to the primary issues of government securities, not only enable the government to raise resources for developmental activities but also invest their funds in risk free securities with assured returns. During the year 1998-99, the subscription of banks to the primary issues of dated securities amounted to Rs.19,746 crore. This constituted 23.58 per cent of the gross market borrowings of the Central Government and 17.7 per cent of the incremental aggregate deposits during 1998-99. As mentioned in the last year's Report, the State Bank of India received subscription for Resurgent Investment Bonds (RIB) to the extent of US $ 4.2 billion; of this, US $ 4.05 billion has been sold back to the Reserve Bank. This generated an additional liquidity of Rs.17,308 crore in the money market. Banks invested excess funds in T-Bills and dated securities of Government pending the utility of the RIB resources. Therefore, to provide liquidity for the banks investing in securities, the Reserve Bank extended a special liquidity support facility by way of refinance similar to the terms and conditions of General Refinance Facility (GRF). This facility was given upto March 31, 1999.

2.83 Besides the above mentioned initiatives, the Reserve Bank took several steps to develop the primary market for Government securities. Among others, the Reserve Bank has withdrawn the minimum period of three days for ready forward (repo) transactions effective October 31, 1998 to enable banks and other participants in the repos market to adjust their liquidity in a more flexible manner.

2.84 The Reserve Bank has instructed Schedule Commercial Banks on March 30, 1999 to create a new reserve account called the "Investment Fluctuation Reserve Account" in order to credit the excess provision towards depreciation on investments. This should be shown as a separate item in Schedule 2 - "Reserves and Surplus" under the head "Reserves and other Reserves" and this will also be eligible for Tier II capital. Earlier, the excess provision towards depreciation on investments was transferred to Capital Reserve Account by way of appropriation in the Profit and Loss Account. The existing amount of excess provision towards depreciation on investments held under Capital Reserve Account should be transferred to "Investment Fluctuation Reserve Account" as on March 31, 1999. The amount held in "Investment Fluctuation Reserve Account" could be utilised to meet, in future, the depreciation requirement on investment in securities.

2.85 The trends in the average yield on Government securities in the primary market since 1994-95 are presented in Table II.31. During 1998-99, the average yield on various Government securities issued in the primary market has increased for the 14 days, 91 days and 364 days treasury bills. However, the average yield for medium to long term dated securities remained steady during the year. The increased depth in secondary market for Government securities could be witnessed in the rise in the volume of outright transaction of Government dated securities, treasury bills and State Government Securities. During the year 1998-99, the turnover of all these instruments amounted to Rs.3,71,542 crore of which dated securities constituted 76.3 per cent. During the year 1999-2000 (upto September 24, 1999), the turnover in government securities in Mumbai aggregated Rs.3,94,382.8 crore. Of this, the share of dated securities showed a higher share of 89.0 per cent (Appendix Table II.13).

Table II.30: Distribution of Prime Lending Rate of Public Sector Banks

Month/ Year	PLR Range							
	12.0	12.5	12.75	13.0	13.25 - 13.75	14.0	14.5	Total No. of Banks
1	2	3	4	5	6	7	8	9
1998								
25-September	-	-	1	10	15	-	1	27
			(3.7)	(37.03)	(55.6)		(3.7)	
23-October	-	-	1	10	15	-	1	27
			(3.7)	(37.03)	(55.6)		(3.7)	
20-November	-	-	1	10	15	-	1	27
			(3.7)	(37.03)	(55.6)		(3.7)	

18-December	-	-	1	10	15	-	1	27
			(3.7)	(37.03)	(55.6)		(3.7)	
1999								
29-January	-	-	1	10	16	-	-	27
			(3.7)	(37.03)	(59.3)			
26-February	-	-	1	10	15	1	-	27
			(3.7)	(37.03)	(55.6)	(3.7)		
26-March	7	1	1	5	12	1	-	27
	(25.9)	(3.7)	(3.7)	(18.5)	(44.4)	(3.7)		
23-April	7	3	2	5	9	1	-	27
	(25.9)	(11.1)	(7.4)	(18.5)	(33.3)	(3.7)		
21-May	6	4	2	5	9	1	-	27
	(22.2)	(14.8)	(7.4)	(18.5)	(33.3)	(3.7)		
18-June	5	5	2	5	9	1	-	27
	(18.5)	(18.5)	(7.4)	(18.5)	(33.3)	(3.7)		
30-July	9	6	2	5	5	-	-	27
	(33.3)	(22.2)	(7.4)	(18.5)	(18.5)			
27-August	9	6	2	6	4	-	-	27
	(33.3)	(22.2)	(7.4)	(22.2)	(14.8)			
24-September	9	6	2	6	4	-	-	27
	(33.3)	(22.2)	(7.4)	(22.2)	(14.8)			

Note: Figures in brackets represents percentage distribution of banks.

Table II.31: Yields on Government Securities in the Primary Market: 1994-95 to 1999-2000

(Per cent)

Year	Maturities					
	Treasury Bills @			Dated Securities $		
	14 Days	91 Days	364 Days	2 Year	5 Year	10 Year
1	2	3	4	5	6	7
1994-95	-	9.16	10.15	-	12.00	12.35
					12.71	
1995-96	-	12.67	12.80	13.25	13.25	13.75
				13.50	13.85	14.00
1996-97	-	9.67	11.67	13.50	13.75	13.85
				13.62	13.55	13.65
1997-98	5.67	6.83	7.15	-	12.69	13.05
					11.15	12.15
1998-99	7.79	8.57	9.51	11.40	11.10-	12.00-
					11.78	12.25

1999-2000*	8.29	9.01	10.18	-	-	11.48-11.99

Note : @ Average implicit yield at cut-off prices.
$ Coupon Rates.
* April-October.

2.86 The yield on Government securities as at end-March 1998 was lower than that at end-March 1999, particularly at the shorter and medium end of the maturity spectrum. The yield curve remained steeper during 1998-99 as compared to 1999-2000 (upto September 1999). The lower short-term rates during 1998-99 reflected the policy objective of promoting economic growth by bringing down the level of CRR and the Bank Rate, after ensuring stability in the forex market during the year.

2.87 During the year 1999-2000, the yield difference between 5 year bond and 364 days T-bills declined from 1.57 per cent at end-March 1999 to 0.61 per cent at end-September 1999, by 96 basis points. In the case of 10 year bond, the yield difference declined by 73 basis points from 1.93 per cent as at end-March 1999 to 1.20 per cent as at end-September 1999. The decline in the yield spread has also coincided with a general downward shift in the yield curve in the medium and long-term segment. On the other hand, short rates have moved up in successive quarters since March 1999.

11. Rural Credit

2.88 The SCBs supplement the efforts of the National Bank for Agriculture and Rural Development (NABARD) and the co-operative banking sector in extending credit facilities to the rural sector of the economy. The rural credit extended by NABARD and the co-operative banking sector, is discussed in Chapter-III. As regards the SCBs credit to rural sector, the priority sector advances as well as the credit extended under various schemes, showed increases during the year 1998-99.

Bank Group-wise Distribution of Priority Sector Advances

Priority Sector Advances by Public Sector Banks

2.89 The priority sector advances of PSBs increased by Rs.15,881 crore or 17.4 per cent from Rs.91,319 crore as on the last Friday of March 1998 to Rs.1,07,200 crore as on the last Friday of March 1999. The priority sector advances of PSBs constituted 43.5 per cent of their Net Bank Credit (NBC) as on the last Friday of March 1999. In the priority sector advances as on the last Friday of March 1999, the largest proportion is shared by small-scale industries (39.8 per cent), followed by agriculture (37.4 per cent) and a group of other priority sectors (22.8 per cent). Agricultural advances of PSBs increased by Rs.5,773 crore or 16.8 per cent from Rs.34,305 crore as on last Friday of March 1998 to Rs.40,078 crore as on last Friday of March 1999. The agricultural advances, as on last Friday of March 1999 constituted 16.3 per cent of NBC (Appendix Table II.14).

Priority Sector Advances by Private Sector Banks

2.90 Private sector banks are also required to fulfill targets applicable to PSBs in respect of priority sector assistance and also for agriculture and allied activities. During the period ending the last reporting Friday of March 1999, the private sector banks deployed credit under the priority sector scheme amounting to Rs.14,155 crore, which constituted 41.4 per cent of NBC. Of this, the share of SSI constituted 18.9 per cent of NBC (Appendix Table II.15).

Priority Sector Advances by Foreign Banks

2.91 The Reserve Bank has stipulated that foreign banks operating in India are required to achieve a target of 32 per cent of their NBC in lending to the priority sector with two specific sub-targets of 10 per cent for SSI and 12 per cent for exports. During the period ending last Friday of March 1999, the foreign banks' assistance for export credit has shown an increase of Rs.728 crore or 14.7 per cent from Rs.4,950 crore as on the last Friday of March 1998 to Rs.5,678 crore as on the last Friday of March 1999. As a proportion to net bank credit, the export credit constituted as high as 25.0 per cent and this is more than twice the target of 12.0 per cent. The advances provided to SSI increased by Rs.376 crore (18.0 per cent) from Rs.2,084 crore as on the last Friday of March 1998 to Rs.2,460 crore as on the last Friday of March 1999 (Appendix Table II.16), accounting for 11.0 per cent in NBC.

Schemes for Rural Development

Integrated Rural Development Programme

2.92 Integrated Rural Development Programme (IRDP) is one of the important schemes formulated by the Government with the objective of alleviating poverty and providing income-generating assets to the beneficiaries in rural areas. During 1997-98, out of 16.97 lakh beneficiaries of IRDP, 46.13 per cent belong to SC/ST. During the year 1998-99, (i.e. upto February 1999), under the IRDP scheme, bank credit to the tune of Rs.1,641.98 crore was disbursed to 12.68 lakh beneficiaries (Table II.32).

2.93 An analysis of recovery performance of IRDP scheme indicates that the recovery of loans constituted 33.1 per cent of credit as at end-March 1999 as against 32.9 per cent in the corresponding period last year. IRDP and its allied schemes have been restructured into a new scheme *viz*., Swarnjayanti Gramin Swarojgar Yojana (SGSY) with effect from April 1, 1999.

Prime Minister's Rozgar Yojana for Educated Unemployed Youth

2.94 The Prime Minister's Rozgar Yojana for Educated Unemployed Youth (PMRY) is another important scheme promoted by the Government for which banks provide financial assistance to the beneficiaries. The PMRY scheme aims at improving the economic well-being of the unemployed youths throughout the country through various forms of financial/technical assistance. The progress under the scheme is as given in Table II.33.

Table II.32: Advances under IRDP

Year	Number of beneficiaries (lakh)	Total Credit (Rs. crore)
1	2	3
1992-93	20.69	1,037
1993-94	25.38	1,408
1994-95	22.15	1,451
1995-96	20.90	1,701
1996-97	18.89	1,953
1997-98	16.97	1,991
1998-99 (P)	12.68	1,642

Note: P - Provisional.

Lead Bank Scheme

2.95 The main focus of Lead Bank Scheme (LBS) is to enhance the proportion of bank finance to priority sector. The scheme controls and co-ordinates the activities of banks and other developmental agencies. The LBS has covered 567 districts as on March 31, 1999 as against 536 districts as on March 31, 1998. During the year 1998-99, 31 new districts have been formed as a result of reorganisation/bifurcation, and these districts were allotted to PSBs.

2.96 Under LBS, the sectoral targets set for the years 1997-98 and 1998-99 are given in Table II.34. As high as 98.4 per cent of the target was achieved during the year 1997-98. At the sectoral level, 99.4 per cent of the target was achieved each in the case of (i) agriculture and allied activities, and (ii) small scale industries. In the case of services sector, 94.2 per cent of the target was achieved.

Institutional Developments

Local Area Banks

2.97 With a view to providing institutional mechanism for promoting rural savings as well as for providing credit for viable economic activities in the local areas, the Reserve Bank announced a set of guidelines on August 24, 1996 for the setting up of Local Area Banks (LABs) in the private sector. As on June 30, 1999, eight LABs have been given approval in principle: one each in Maharashtra, Punjab, Andhra Pradesh, Tamil Nadu, Rajasthan and Gujarat and two in Karnataka. So far, the Reserve Bank received 215 applications for the setting up of LABs and of these, 194 applications have been disposed off. These banks are essentially expected to bridge the gap in credit availability and to enhance the institutional credit framework in the rural and semi-urban areas.

Table II.33: Financial Assistance under PMRY

(Amount in Rs. crore)

Year	Target	Sanctions	Disbursements

	(Number of youths)	Number of youths	Amount	Number of youths	Amount
1	2	3	4	5	6
1993-94	42,040	30,029	188.55	23,035	137.02
1994-95	2,39,215	1,85,803	1,054.99	1,58,863	872.67
1995-96	3,21,360	2,87,218	1,678.88	2,41,843	1,378.07
1996-97	3,07,163	2,71,768	1,653.06	2,28,487	1,352.10
1997-98	3,45,000	2,63,361	1,589.31	2,08,976	1,218.96
1998-99(P)	3,54,350	2,62,091	1,562.90	1,46,525	835.72

Note: P - Provisional.

12. Prudential Regulatory Measures

Loan Review Mechanism

2.98 During 1998-99, in October 1998, the Reserve Bank advised commercial banks to adopt a Loan Review Mechanism for larger advances soon after their sanction, and monitor any weakness that may develop in such accounts for initiating timely corrective action.

Reduction in the time frame for substandard assets

2.99 To move further toward the international standards regarding provisioning norms, the Reserve Bank has decided that an asset should be classified as doubtful, if it has remained in the sub-standard category for 18 months instead of 24 months by March 31, 2001. In this context, banks have been permitted to meet the additional provisioning requirements in two phases i.e. as on March 31, 2001 and March 31, 2002.

Balance Sheet of Banks - Disclosure of Information

2.100 During the year 1998-99, the Reserve Bank issued guidelines for improving transparency in the financial statements of banks. From the accounting year ending March 2000, banks have been advised to disclose the following additional information in the ‘Notes to Accounts':

- Maturity pattern of loans and advances.
- Maturity pattern of investment in securities.
- Foreign currency assets and liabilities.
- Movements in NPAs.
- Maturity pattern of deposits.
- Maturity pattern of borrowings.
- Lending to sensitive sectors[7].

Regulatory Reviews

2.101 During 1998-99, a review of the various instructions issued to banks on procedural and financial aspects was undertaken with a view to not only giving a sharper focus to regulatory practices and ensuring stricter compliance but also providing more autonomy to banks. Accordingly, banks were given autonomy in the following areas: (i) acquisition of premises on lease/rental basis; (ii) issue of rupee denominated subordinated loans as Tier II capital subject to certain conditions; (iii) acquisition and disposal of immovable property for banks' own business; and (iv) full autonomy to private and public sector banks for opening of branches subject to fulfillment of certain conditions.

Table II.34: Annual Credit Plan of Financial Institutions under Lead Bank Scheme

(Amount in Rs. crore)

	Sector	1997-98			1998-99
		Target	Achievement	Per cent to Achievement	Target
	1	2	3	4	5
a)	Agriculture & Allied activities	28,143.91	27,984.76	99.4	34,590.09
b)	Small Scale Industries	9,810.51	9,748.38	99.4	12,096.74
c)	Services	8,681.75	8,176.81	94.2	10,976.23
	Total	**46,636.17**	**45,909.95**	**98.4**	**57,663.06**

Bridge Loan

2.102 During 1998-99, norms relating to bridge loans were further made flexible by the Reserve Bank. In addition to the expected equity flows/ issues, banks have been advised that they could extend bridge loans against expected proceeds on non-convertible debentures, external commercial borrowings, global depository receipts and/ or funds in the nature of foreign direct investments provided the bank concerned is satisfied that the borrowing company has already made firm arrangements for raising the aforesaid resources/ funds.

Venture capital

2.103 In order to encourage the flow of funds for venture capital, it has been decided in April 1999 that the overall ceiling of 5 per cent of incremental deposits of the previous year, will stand automatically enhanced to the extent of the bank's investment in venture capital (including units of dedicated venture capital funds meant for ‘Information Technology'). This would be subject to the condition that the venture capital funds/companies are registered with the SEBI.

Investments in Shares and Debentures

2.104 The Reserve Bank brought out a consolidated circular on August 28, 1998 incorporating certain changes in the existing guidelines relating to advances against shares/ debentures/bonds. It also covers guidelines to banks to grant working capital facilities to stock brokers registered with the SEBI and who have complied with capital adequacy norms prescribed by SEBI/stock exchanges to meet the cash flow gap between the delivery and payment for DVP transactions undertaken on behalf of the institutional clients *viz*. FIs, FIIs, mutual funds and banks. The circular further indicates that the margins may be determined by the banks themselves, and banks on their part may also institute adequate safeguards and monitoring mechanism.

Investment portfolio of banks -Classification of investments under "permanent" and "current" category

2.105 In March 1999, banks were advised that the excess of provision towards depreciation on investments should be appropriated to "Investment Fluctuation Reserve account" instead of "Capital Reserve" account and shown as a separate item in Schedule 2-"Reserve and Surpluses" under the head "Revenue and Other Reserves". This amount will be eligible for inclusion in Tier II capital. In April 1999, banks have been advised that by March 31, 2000, they should classify a minimum of 75 per cent of their investments in approved securities as "current" investments.

Settlement Advisory Committee

2.106 In the Union Budget for 1999-2000, it was indicated that to settle chronic cases specially those relating to the small scale sector in a timely and speedy manner, PSBs would be encouraged to set up settlement advisory committees. Accordingly, the Reserve Bank has communicated guidelines to all PSBs for the constitution of Settlement Advisory Committees (SACs) for compromise settlement of non-performing assets of the small scale sector. The guidelines would cover all non-performing assets (NPAs) which are chronic and at least three years old as on March 31, 1999 and will be operative only up to September 30, 2000. The guidelines will apply to borrowal accounts that have become non-performing in the small scale industrial sector and small businesses, including trading and personal segment and agricultural sector. It can also cover the cases pending before the courts/Debt Recovery Tribunals (DRTs). However, consent decree to reflect the compromise settlement will have to be obtained in such cases. The Reserve Bank has advised all the public sector banks that their boards may lay down norms for compromise settlements and frame suitable guidelines for SAC on the basis of the guidelines set out by the Reserve Bank. Once the settlement amount is calculated as per the Reserve Bank guidelines, it should normally be paid at one time. The bank's board should review the decisions taken by the SAC and also ensure that the process of settlement is completed within six months.

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7. The sensitive sectors have been defined as sectors which are sensitive to arrest price fluctuations such as real estate, capital market and such other sectors as defined by the Reserve Bank of India from time to time.

13. Customer Service

2.107 The Reserve Bank and the Government of India have been issuing guidelines to banks to offer better customer service with higher scale of customer satisfaction. During the year, the following measures were undertaken by the Bank in the matter of Customer Service:

(i) Operation of bank accounts by old/sick/ incapacitated customers: The Reserve Bank has issued guidelines for operation of accounts by old/sick/incapacitated customers. Accordingly, if a person cannot be physically present in the bank to withdraw the amount, he/she may authorise a person on his/her behalf to withdraw the money.

(ii) Citizens' Charter of banks: To bring greater transparency in customer service, the PSBs have published "Citizens' Charters" providing information regarding various banking activities offered to customers and also regarding the availability of grievances redressal mechanism for dealing with customers' complaints.

(iii) Nomination facility in Deposit Accounts: Banks have been advised to indicate on the face of the pass book/term deposit receipt about registration of nomination in the account. This would minimise the hardships caused to family members of the deceased depositors in settlement of claims.

14. Para Banking Activities

Subsidiary for Satellite Dealership

2.108 During the year, the Bank of Madura Ltd. has been permitted to set up a subsidiary in the name of "Madura Securities Ltd." for undertaking satellite dealership in the Government securities market.

Housing Finance by Banks

2.109 During 1998-99, the Corporation Bank has been granted final approval to set up a wholly owned housing finance subsidiary with a paid-up capital of Rs.10 crore subject to usual terms and conditions.

15. Supervisory Issues

Financial Supervision

2.110 The term of the Board for Financial Supervision (BFS) which is the supervisory authority for financial supervision has been extended upto March 27, 2000 or till the Central Board of the Reserve Bank is reconstituted, whichever is earlier. The Board held thirteen meetings during the period July 1998 to June 1999. The main supervisory issues addressed by the Board are as follows:

(i) Off-site surveillance system for banks, All India Financial Institutions and NBFCs.

(ii) On-site inspection of banks, AIFIs and NBFCs.

(iii) Asset quality, capital adequacy measures and prudential norms of banks.

(iv) Strengthening internal control, management information system, fraud monitoring procedures, etc. within the supervised institutions as an extension of the task of supervision.

(v) Registration and prudential norms of NBFCs.

2.111 During the period July 1998 to June 1999, the BFS discussed various memoranda placed by the Department of Banking Supervision of the Reserve Bank on the performance of banks, financial institutions and subsidiaries of banks covering the period ended on March 31, 1997 and 1998 and in some cases period ended September 1998. The Board gave directions on several regulatory and supervisory issues that came up during the course of deliberations. As a part of supervision, for evaluating the financial performance and conditions of commercial banks and financial institutions, financial regulators employ a combination of on-site and off-site modes of surveillance mechanisms. In the on-site examination, the supervisors evaluate the health of banks in terms of rating system, preferably on a yearly basis, besides the banks' adherence to regulatory requirements in day-to-day operations. However, with the growing nature of financial integration, globalisation and use of technology at large scale, more complexities have developed in banking transactions alongwith associated risks. Hence, regulators have to supplement the surveillance with off-site monitoring so as to capture 'early warning signals' of financial system and to deter financial crisis of the nature of East Asia or Latin America. Off-site surveillance is catching up in many developing countries by strengthening their management information systems (MISs) and use of technology in banking transactions.

2.112 The off-site monitoring success is linked to the effective use of select parameters. Among them, the analysis of financial statements and reports submitted by banks preferably at short-term intervals, periodic meetings with the management of banks and assessment by independent rating agencies form a major part. Apart from these, an in-depth analysis of secondary market movements of listed bank scrips would provide an insight into the level of confidence about the financial performance of banks by the investing public. These alongwith on-site inspection reports, would enable the regulators to formulate judgments of banks' performance and suggest corrective policies, as and when required.

2.113 In India, the supervisory process of on-site monitoring is complemented by off-site monitoring, with the setting up of off-site surveillance (OSMOS) system in 1995 under the umbrella of Board for Financial Supervision (BFS). The OSMOS receives mandated quarterly/ half-yearly/annual returns from commercial banks and these returns help to prepare 'early warning signals.' Besides, the Board reviews the monitoring done by the DBOD in regard to frauds and house-keeping in banks such as reconciliation of entries in inter-branch accounts, inter-bank accounts including Nostro Accounts and the balancing of books of accounts. The Board has reviewed the progress in the Information Technology and steps taken to address Y2K (Year 2000) problem in banks. Under the directions of the Board, the following working groups have been set up in the Reserve Bank:

(i) to frame guidelines on write off/compromise settlements.

(ii) to prepare a checklist for inspecting officers of the Reserve Bank to evaluate the internal audit system in banks inspected by them.

(iii) to conduct an in-depth study of frauds of Rs.1 crore and above reported by commercial banks during the last three years.

(iv) to suggest solutions for speedy reconciliation of outstanding entries under NOSTROAccounts.

(v) to suggest appropriate measures to regulate Non-SLR Investments and bringing in more transparency, accountability and risk perception.

2.114 Efforts towards further building up of supervisory skills in the Reserve Bank to meet the new demands of supervision in relating to changing practices, have been geared up. The need and applicability of tailor-made training programmes, dovetailed to suit supervisory requirements, are being assessed with the help of the Department for International Development, U.K. covering all vital aspects of banks' functioning including treasury operations, asset-liability management and risk assessment.

Asset-Liability Management System in Banks

2.115 In a fairly deregulated and liberalised environment, the banks have to determine their own interest rates on deposits and advance in both domestic and foreign currencies on a dynamic basis. The interest rates on banks' investments in government and other securities are market related. Intense competition for business involving both assets and liabilities, together with increasing volatility in the domestic interest rates as well as foreign exchange rates, has brought pressure on the management of banks to maintain a good balance among spreads, profitability and long-term viability. Imprudent liquidity management can put banks' earnings and reputation to a greater risk.

2.116 Banks need to address these risks in a structured manner by upgrading their risk management system and adopting more comprehensive Asset-Liability Management (ALM) practices than done hitherto (Box II.4). The Core Principles enunciated by the Basle Concordant have highlighted the ALM as the fundamental base on which successful banking is built. Taking into account the importance of the management of asset-liability and the prescription thereof in accordance with the Basle Core Principles, the Reserve Bank had issued draft guidelines in September 1998 for putting in place a comprehensive Asset-Liability Management (ALM) System in banks. Subsequently, the draft guidelines were reviewed by the Reserve Bank in the light of the issues raised/suggestions made by the banks. The final guidelines, revised on the basis of the feedback received, were implemented effective April 1, 1999. Banks have been advised to set up an internal Asset-Liability Committee headed by the Chief Executive Officer/Chairman and Managing Director or Executive Director. The Management Committee or any specific Committee of the Board is required to oversee the implementation of the ALM system and review its functioning periodically.

Audit Sub-Committee

2.117 During 1998-99, the Audit SubCommittee met thrice, and reviewed the need for making provision for net debits in respect of long outstanding entries in inter-branch accounts, assignment of risk weight to items like Indira Vikas Patra, Kisan Vikas Patra, PSU bonds, debentures, etc., while computing CRAR and examining the disclosure and transparency in final accounts of banks.

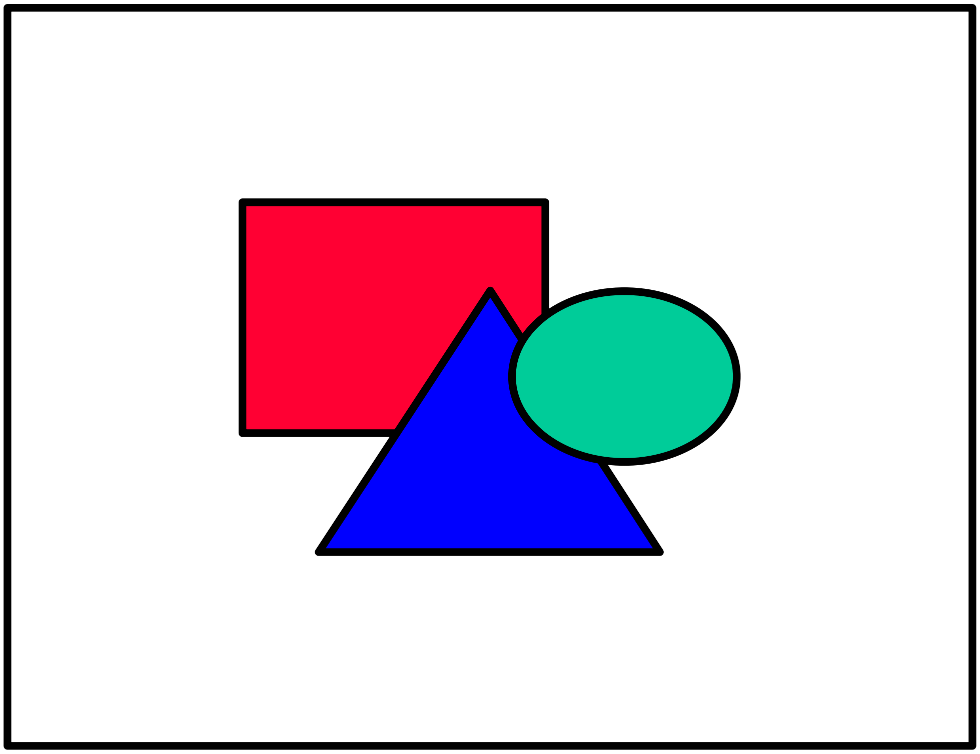
2.118 The recommendations of the Committee also included procedural changes in the appointment of statutory auditors of PSBs and financial institutions so as to plan (i) timely auditing, (ii) guidelines to statutory auditors of registered non-banking companies, (iii) specific requirement of reporting to the Reserve Bank, regarding any violation/non-compliance of provisions of the RBI Act, and (iv) NBFC directions on acceptance of public deposits and adherence to prudential norms.

Box II.4: Asset-Liability Management

In liberalised financial markets, banks' assets and liabilities variations are considerably influenced by interest rate and exchange rate volatility. The competitive environment in the banking system due to removal of various barriers in their operations has added pressure to the importance of financial management. Unlike in the repressed financial market, banks have to manage not only credit risk but a variety of other financial risks including interest rate, exchange rate, liquidity, settlement, and transfer risks to maximise profit and minimise risks. The complexity of financial risks requires that a strong and dedicated risk management system is put in place covering: (1) assets, liabilities and off-balance sheet risks, (2) information and scientific risk management techniques and (3) dedicated asset-liability managers or committee (ALCO). Asset-Liability management as a mean of risk management technique is an important function in a bank (Chart). It primarily focuses on how various functions of the bank are adequately co-ordinated, essentially covering planning, directing, and controlling of the levels, changes and mixes of the various balance sheet accounts.

In Asset-Liability Management (ALM), bank is strategically concerned with management of market risk consisting of (a) interest rate risk, (b) foreign exchange risk, (c) equity price risk and (d) commodity price risk. Also ALM function covers liquidity management and capital planning. ALM has been a concern for bank management as a result of market volatility, financial innovations, regulatory initiatives and increasing awareness of top management in the banking system. Broadly, the ALM objectives are to control the volatility of net interest income and net economic value of a bank. The supplementary objectives cover control of volatility in all target accounts, control of liquidity risk, and ensure an acceptable balance between profitability and growth rate. In order to achieve these results, the asset- liability managers or ALCO must be guided by policies that specifically address the bank's overall asset-liability management goals and risk limits, and by information that relates directly to its asset-liability positions.

The banking industry, to compete in a free market conditions, has to give utmost priority for managing and minimising risks inherent in banking operations. Across the world, it was observed that failure[1] of risk management and control systems were significant factors for bank failures. The success of asset-liability management depends on the effective existence of (1) Information and Policies, and (2) Risk Management System.



1. Information and Policies

The primary objective of ALM is to ensure that there are asset-liability managers and an asset-liability committee (ALCO) that manages the bank's balance sheet in such a manner so as to minimise the volatility in its earnings, liquidity, and equity to changes in market conditions. The attainment of this objective may be manifested in such results as stable net interest margins, optimal earnings, adequate liquidity, and effective control of financial risks. To reach these objectives, the information base in a bank has to be strong and sound. ALCO must be aware of policies which would address asset-liability management goals and risk limits, and by information that relates directly to its asset-liability position[2]. Although framing policies/goals are important in ALM, it is equally important that prompt and effective implementation of the same are taking place in the system. For the purpose of effective functioning of ALCO, two major policies should be addressed by the bank management: (1) ALCO authority, purpose, membership, and (2) performance targets (e.g. net interest margins, ROA, etc.) to be achieved.

In managing financial risks, the management of interest rate risk dominates the ALM function of a bank. Therefore, the important determinant of a bank's exposure to interest rate risk is the extent to which its assets and liabilities are mismatched. Here, mismatch refers to the timing cashflows of assets and liabilities. Mismatches in the management of assets and liabilities can be avoided, provided the banks improve timeliness, accuracy, and completeness of the basic risk management information. Even the problems identified in loan portfolio should be communicated so as to avoid any major funds problems to asset-liability managers.

2. Risk Management System

In view of the increasing market risks in banking operations, banks should be able to accurately measure and adequately control market risk. Banks should have in place a well-structured risk management system. A risk management process that includes measuring risks, controlling risks and monitoring risks will help banks to attain these goals.

a) Measuring Risk

Due to difficulty in measuring interest rate risks and also the controversies present in the understanding of the concept, measurement of interest rate risks assumes greater importance in the ALM function. A bank's overall risk can be defined as the probability of failure to achieve an expected value and can be measured by the standard deviation of this value. In addition, the expected value must serve as a comprehensive indicator of the bank's performance under changing market conditions. It has been observed that banks' risk exposure depends upon volatility of interest rates and asset prices in the financial market, the banks' maturity/sensitivity gaps, the duration and interest rate elasticity of its assets and liabilities and the ability of the management to measure and control the exposure. In the management of banks' assets and liabilities, interest risk management lays the foundation for a good ALM.

b) Risk analysis and management

Interest rate risk can be analysed in the following four methods :

1. Gap analysis.

2. Duration analysis.

3. Value at Risk (VaR).

4. Simulation.

Gap analysis is the most important basic technique used in analysing interest rate risk. It measures the difference between a bank's assets and liabilities and off-balance sheet positions which will be repriced or will mature within a predetermined period. (Gap is the difference between rate-sensitive assets minus rate sensitive liabilities). The duration analysis estimates the average amount of time required before the discounted value or the present value of all cash flows (e.g. principal and interest) can be recovered by an asset holder including that of bank's depositor. The concept can be used for all assets, liabilities and off-balance sheet items. Another concept which is also used is Value at Risk (VaR) model. VaR estimates the maximum potential loss in a position over a given holding period for a given confidence level. Another interest rate risk analysis method is simulation model which attempts to determine whether the model adequately captures the banks' current and projected cash flows, taking into account the different interest rate and market price scenarios. Simulation model is simply an interactive process and not an optimization model.

As banks are prone to more market risk in a liberalised and more competitive environment, ALM model is very much useful for the senior management of a bank to take several important decisions. ALM function will be effective from April 1, 2000. The issues are to be considered for better management ALM function are as follows:

Policy issues

Strengthening of information technology in commercial banks would be an important prerequisite to implement effectively ALM system in banks. The data base of banks has to cover all operations of branches for a detailed analysis of assets and liabilities and for forecasting a comprehensive projection of liquidity conditions under various scenarios. The software packages used must be well tested and have extensive computing power to analyse the massive amount of Asset/Liability data under alternative interest rate scenarios.

It is well understood that every financial transaction or commitment has implications for a bank's liquidity. As banks are very much concerned with converting illiquid assets into liquid assets, a proper liquidity management with associated liquidity policies would help the management in formulating business strategy. A schedule of liquidity reviews and less frequent, but more in depth reviews should be provided for. These reviews provide the opportunity to re-examine and refine a bank's liquidity policies and practices in the light of a bank's liquidity experience and developments in its business. For banks with an international presence, the treatment of assets and liabilities in multiple currencies adds a layer of complexity for two reasons. First, banks are often less well known to liability holders in foreign currency markets. In the event of market concerns, especially if they relate to a bank's domestic operating environment, these liability holders may not be able to distinguish rumour from fact. Second, in the event of a disturbance, a bank may not always be able to mobilise domestic liquidity to meet foreign currency funding requirements. Hence, better liquidity management becomes an important concern when banks indulge in multi currency transaction.

ALCO is a most powerful body in the ALM framework. Hence, for taking business decision the boards of banks rely on ALCO reports. The membership of ALCO in a bank should be broad-based rather than confined to representation from treasury and investment areas.

Although, a bank may formulate robust policies and strategies for ALM, unless the staff members are adequately trained and skilled manpower is available, the success of ALM would be limited.

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1. Experiences in developed financial markets have indicated two major difficulties inherent in the asset-liability management process. These are the failure to: (1) adopt meaningful policies; and (2) implement the policies once they are adopted.

2. According to Scott (1992), the information required for ALM are (1) historical, current and projected data on the bank's assets-liability portfolios, including any projected additions, maturities, and repricing; (2) interest rates and yields as its current and projected portfolios; (3) market limitations on the banks' ability to adjust its product prices; and (4) changes in the bank's balance sheet caused by customers' decisions to prepay their loans, withdraw their deposits before maturity, and transfer their business to other banks.

Debt Recovery Tribunals

2.119 The establishment of Debt Recovery Tribunals (DRTs) under the Recovery of Debts, due to Banks and Financial Institutions Act, 1993 was one of the most important steps taken by the Government for expeditious adjudication and recovery of debts due to banks and financial institutions. The Report of the Second Narasimham Committee, while identifying the shortcomings of DRTs, had recommended that these DRTs should be vested with the powers of attachment before judgement, for appointment of receivers and for preservation of property.

2.120 Recognizing the importance of DRTs, the Reserve Bank constituted a Working Group in March 1998 (Chairman: Shri N.V. Deshpande) to review the functioning of the DRTs, and suggest measures to improve their efficacy for recovery of debts. The Working Group, in its report submitted in August 1998, made a number of recommendations addressing both the structural aspects relating to the functioning of the DRTs as well as legal lacunae observed in the Act. The Government of India has broadly accepted the recommendations made by the Group and a bill, *viz*., the Recovery of Debts due to Banks and Financial Institutions (Amendment) Bill 1999 was introduced in the Parliament seeking amendments to certain provisions of the Act.

2.121 Simultaneously, in line with the Budget announcements in 1998-99, an Expert Group was constituted by the Government under the Chairmanship of Shri T. R. Andhyarujina, former Solicitor General of India, to suggest appropriate amendments in the legal framework affecting the banking sector. The Expert Group would examine the legal lacunae observed in the functioning of DRTs and suggest amendments in various external legislations affecting the banking sector such as, the Transfer of Property Act, foreclosure laws, Stamp Act, Indian Contract Act, DRT Act, etc.

Frauds in Banks

2.122 The Reserve Bank monitors frauds in banks and cautions banks with a view to enabling them to put in place appropriate safeguards. The Advisory Board on bank frauds set up in March 1997 under the Chairmanship of a former Deputy Governor of the Reserve Bank (Shri S.S. Tarapore), is examining the issue on a continuous basis. Under the revised dispensation, the Board functions under the aegis of the Central Bureau of Investigation (CBI), but the Reserve Bank provides full secretarial and other support to the Board. The Board gives advice on the cases referred to it by CBI (earlier RBI), officials of public sector banks of the rank of a general manager and above regarding their role and responsibility in such cases.

2.123 In order to enhance managerial effectiveness both at micro as well as macro levels, the Central Vigilance Commission (CVC) notified, with effect from January 1, 1999, the Special Chapter on Vigilance Management in Public Sector Banks for inclusion in the Vigilance Manual. The Special Chapter was finalised in consultation with the Reserve Bank, the Indian Banks' Association, the Central Bureau of Investigation and the Ministry of Finance. The CVC has reiterated that the Special Chapter has been prepared keeping in mind the special needs of bank managers and the problems faced by them in their day-to-day functioning.

2.124 The major changes brought about by the above Chapter include empowerment of the office of the CVC and its superintendence over the functioning of the Delhi Special Police Establishment, in so far as it relates to investigation and progress thereof of offences alleged to have been committed under the prevention of Corruption Act, 1988. The Commission has been given the powers of a civil court and its jurisdiction is co-terminus with the executive powers of the Union. The Advisory Board on Bank Frauds (ABBF), which was earlier set up by the Reserve Bank, has since been redesigned as the Central Advisory Board on Bank Frauds (CABBF) and would now form part of the organisational infrastructure of the Central Bureau of Investigation (CBI).

Y2K Compliance of Commercial Banks

2.125 In order to address the Y2K problem in banks, the Reserve bank has devoted a great deal of attention to Year 2000 compliance issues. Accordingly, a high Level Working Group headed by a Deputy Governor was constituted during 1998-99 to monitor compliance efforts and give strategic direction to the departments of the Reserve Bank exercising supervisory jurisdiction over various segments of the financial system.

2.126 The Department of Banking Supervision has articulated a highly focused supervisory strategy to ensure that Y2K issues are appropriately addressed within each bank and financial institution consisting of:

- Establishment of targets and benchmarks for the industry.
- Issue of supervisory guidance on Y2K issues.
- Off-site monitoring of compliance efforts.
- Unaudited certification of compliance by banks.
- Verification of compliance efforts through on-site supervisory examinations.
- Proactive supervisory pressures and enforcement action.
- Ensuring that contingency planning by banks is in place.

2.127 The approach adopted by the Reserve Bank has created awareness about the Y2K problems and activised the top managements of both banks and financial institutions to devise appropriate strategies so as to proactively address the issues in the context of their domestic and cross-border operations (Box II.5).

2.128 Banks and financial institutions have reported completion of the entire exercise including renovating/replacing systems and its validation through testing/implementing tested system. They have worked out contingency plans and their validation and testing are presently going on.

Box II.5: Y2K Preparedness of Banks

In recent years, the Indian financial sector has witnessed spurt in activities in the field of information technology. The usage of computer system, net working, satellite communication, etc. in banking operations have revolutionised the banking services. Viewed from this background, the computer-based communication systems in banks will have to face challenges of likely malfunctioning of systems at the turn of the century i.e. Year 2000. The year 2000 problem is receiving pro-active attention of the financial community. Further, the interconnectedness of financial institutions and their various external dependencies add complexity to the risk management considerations associated with Year 2000. The serious impact of Y2K problem in various activities of banking organisations may be listed out below:

- Calculation of Interest.
- Current data may be erased or archived as old data.
- Bank may not have access to legacy databases with implications for both operations and management information system (MIS).
- Functionality and data integrity may be impaired.
- Affects automatic computation of forward rates, delivery, pick-up, payment and receipt schedules. Exposes banks to Product Delivery Risk.
- ATMs and Shared Payment Networks may not function.
- Computer activated time locks and burglar alarms with embedded chips may not function.
- Credit risk implications due to customers, correspondents and counter parties not being compliant.
- Questions of credibility and credit rating also arise.
- Crises of confidence due to information asymmetry and liquidity risk if customers are not taken into confidence.
- Y2K problem is resource intensive and has implications for the bank's bottom line.
- Y2K problem for banks may end up in legal risk.

While deciding the exposure limit of a customer, banks should factor in Y2K risk assessment of their customers and counter parties in their credit appraisals. However, it has to be recognised that the scope and impact of the year 2000 problem for banks depends largely on the level of automation and networking.

The degree of usage of information and technology and the consequent sophistication of such automation present a mixed picture. The 104 scheduled commercial banks in India have a network of approximately 64000 branches. Of these, around 2800 branches are fully computerised. There are another 16345 and 15550 branches with stand alone PCs and Ledger Positing Machines, respectively. Basically, these are mainly used for front office purposes and to a limited extent for back office automations. There are also 435 bank offices with mini computers. Mainframes are mainly limited to clearing and settlement, management information system (MIS), Credit Card transactions processing and inter-branch reconciliation. Another 17 controlling offices of banks are equipped with mainframes. In order to meet Y2K requirements, banks are upgrading their level of technology with the latest versions of compliant hardware and software with better features and processing speeds.

Recognising the problems of Year 2000, the Reserve Bank has taken the initiatives and sharply focussed its attention to ensure that the banks appropriately address the problem. A High Level Working Group headed by Deputy Governor of the Reserve Bank has been constituted to monitor the compliance efforts and give strategic directions and proactively ensure that all institutions address the Y2K problem. Supervisory initiatives have been taken since 1997 with the issue of circulars to all commercial banks advising them to put in place appropriate time bound strategies to assess, convert and validate all systems and applications so as to achieve fully compliant systems. The focus involves creation of awareness about the Y2K problem and to activate the top management of banks to have an appropriate strategy in place to address the problems in the context of their domestic and cross-border operation.

100 per cent Y2K readiness has been reported by all the commercial banks as at end August 1999. Other segments of the financial sector, viz, Regional Rural Banks, Primary Dealers and financial institutions-both at the central and state levels have made efforts at achieving full Y2K compliance and have so far progressed remarkably well in this task. The feedback regarding the participation by the banks in the mandatory test recommended by Society for Worldwide Interbank Financial Telecommunication (SWIFT) has revealed that all the 60 banks, which are members of SWIFT have successfully completed testing. Up-to-date information on Y2K related issues available from Bank for International Settlements (BIS), Federal Reserve and other countries including Bank of England is shared by the Reserve Bank with all banks. It, however, needs to be kept in mind that achieving full compliance is often dependent on certain exogenous factors like lags in promised delivery schedules by vendors and the need to customise and transport Y2K compliant versions of packages across a number of geographically dispersed branches, which often leads to time overruns.

Banks have to ensure that the remedial measures are complete and all of them undertake continuous testing programmes. Secondly, contingency planning has to be put in place so as to counter Technology Systems Risk. Contingency plans have to ensure that all economic activities would continue to function in an efficient manner during the transition to the twenty-first Century. This would help the banking business to survive in the event of failure of computer systems and their back-ups. Therefore, contingency plans should take care of two major risks: (a) operational risks arising out of failures in internal systems and problems with facilities provided in the organisation and (b) credit and liquidity risks of banks. Thirdly, banks should address their external dependencies particularly in relation to their exposure to customers, correspondents and counter parties. Fourthly, the impact of embedded systems needs to be assessed and mitigated. This is basically due to the fact that embedded systems have high degree of impact when failure occurs. Fifthly, banks will have to critically examine the resources that they would have to put up in place in the event of Year 2000 failure. Sixthly, banks have to ensure that they do not face reputational risks. Banks should adopt clear cut approaches to create credibility and instill confidence of the public in their operations. They have also to ensure that there are transparent practices and measures adopted in tackling Year 2000 problems. These issues are to be addressed with the full involvement and commitment of the Top Management and the Board of Directors. Banks are encouraged to get third party certification and audit of their Y2K readiness.

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2.129 A separate Y2K Project Cell was formed in the Department of Banking Supervision to spearhead the Reserve Bank's supervisory initiative on Y2K and monitor the compliance efforts in the financial sector (including non-banking subsidiaries of commercial banks, financial institutions, primary urban co-operative banks, etc.). The Cell also seeks feedback in respect of the compliance efforts of institutions whose position falls within the scope of surveillance of other bodies/ institutions (SFCs/ SIDCs, Housing Finance Companies, Regional Rural Banks, State and District Co-operative Banks, etc.).

2.130 The compliance efforts of banks and financial institutions are monitored through a monthly reporting system. On-site verification of compliance efforts in respect of commercial banks and financial institutions is carried out through the regional offices of the Department of Banking Supervision. The banks and other institutions in the financial sector supervised by the Reserve Bank have been advised to keep their Board of Directors suitably apprised of their progress at least bi-monthly.