Chapter I

Banking Developments and Perspectives

One of the major areas of the macro-economy that has been the subject of focused attention in recent years is the financial sector soundness and efficiency. Within the broad ambit of the financial sector, a well-functioning banking sector is regarded as the bedrock of a stable financial system. The renewed focus on the banking sector has been driven by two major considerations. First, the growing universalisation and internationalisation of banking operations, driven by a combination of factors, such as, the continuing deregulation, heightened competition and technological advancements, have altered the face of banks from one of mere intermediator to one of provider of quick, efficient and consumer-centric services. In the process, the potential for risks has also increased. Secondly, the widespread banking problems that have plagued large areas of the globe have raised a gamut of questions relating to the linkages between banking reforms and reforms of other segments of the financial sector, the extent of exposures to sectors which are characterised by asymmetric information problems, and the 'contagion' effect. It has, therefore, become necessary to promote robust financial practices and policies, especially in respect of banks, in order to sustain financial stability. This is all the more true in developing economies where assets of the banking system constitute a substantial proportion of financial sector assets. In this context, a number of policy measures have been taken in recent years to improve the health and efficiency of Indian commercial banks. This chapter provides an overall view of the policy initiatives undertaken since 1999-2000, the financial performance of scheduled commercial banks during 1999-2000 and a perspective towards developing a more stable, efficient, resilient and vibrant banking system.

1. Policy Environment

Monetary and Credit Policies

1.2 The annual Monetary and Credit Policy Statements as well as Mid-term Reviews have, in recent years, elaborated on a number of medium to long-term structural reform measures for providing stability to the financial system, besides undertaking short-term monetary policy initiatives, when felt necessary, to stimulate the economy. The major short-term monetary and credit policy measures announced during 1999-2000 and 2000-01 (up to October) are given in Appendix Table I.1. The table shows that interest rates generally softened in 1999-2000 as cash reserve requirements were reduced and access to liquidity support mechanisms was eased. In 2000-2001 (up to October), after a brief continuation of the trends noticed in the previous year, the interest rates and cash reserve requirements were moved up, and liquidity support was modulated to suit the market conditions. The main objectives of structural measures have been five-fold, *viz.,* (a) to increase operational effectiveness of monetary policy by broadening and deepening various segments of the market; (b) to redefine the regulatory role of the Reserve Bank in order to make it more efficient and purposive; (c) to strengthen the prudential and supervisory norms; (d) to improve the credit delivery system; and (e) to develop the technological and institutional infrastructure of the financial sector.

1.3 The important policy measures

pertaining to various segments of the money market during 1999-2000 and 2000-01 (up to October 2000) are given in Appendix Table I.2. The table shows that liberalisation of money market has been given a major thrust essentially to improve the functioning of the market. The major monetary and credit Policy measures announced in the Mid-term Review of October 10, 2000 are indicated in Box I.1.

Box I.1: Major Policy Measures Announced in the Mid-term Review of Monetary and Credit Policy for the year 2000-2001

(i) In the context of improving the efficacy of the Liquidity Adjustment Facility (LAF) and to make the money market more efficient and to enable the development of a short-term rupee yield curve, as recommended by the Narasimham Committee II, it is necessary to move towards the objective of pure inter-bank call money market. However, considering the fact that the repo market is yet to be broad-based in terms of instruments and participants and yet to acquire enough depth, it was decided to extend the permission granted to select corporates, which have been given specific permission to route call money transactions through Primary Dealers (PDs) which is available up to December 2000, for a further period of six months, i.e., up to June 2001. In addition to select corporates which have been permitted to route call money transactions through PDs, there are several non-bank institutions such as Financial Institutions and Mutual Funds which are currently permitted to lend directly in the call/notice money market. In order to make necessary transitional provisions in respect of these institutions also, before the call money market is confined only to banks and PDs, it was decided to constitute a Group to suggest a smooth phasing out by a planned reduction in their access to call/notice money market. The Group would also include representatives of non-bank institutions.

(ii) The guidelines for issue of Commercial Paper (CP) were finalised, after taking into account the views from the market participants on the draft guidelines and the Report of an Internal Group circulated in July 2000. The new guidelines are expected to provide considerable flexibility to participants and add depth and vibrancy to the CP market while at the same time ensuring prudential safeguards and transparency.

(iii) In order to provide flexibility and depth to the secondary market, the restriction on transferability period for CDs issued by both banks and financial institutions, which was earlier fixed at 15/30 days from the date of issue, is withdrawn.

(iv) In order to improve the functional efficiency of the market, the rating for the term deposits accepted by select all-India financial institutions, which are governed by the Reserve Bank guidelines, has been made mandatory, with effect from November 1, 2000.

(v) As a part of tightening the prudential norms, banks were advised in October 1998 to make a general provision on standard assets of a minimum of 25 basis points from the year ended March 31, 2000. The guidelines were partially modified on April 24, 2000 stipulating that the provision should be made on a global portfolio basis and not on domestic advances. The general provision on standard assets woud be included in Tier II Capital, in line with international best practices followed in this regard.

(vi) The Reserve Bank issued final guidelines on categorisation and valuation of banks' investment portfolio. As per the new guidelines, banks are required to classify the entire investment portfolio (including SLR securities and non-SLR securities) under three categories, viz., 'Held to Maturity', 'Available for Sale' and 'Held for Trading'. Out of these, the investment portfolio 'Held to Maturity' will not exceed 25 per cent of the total investments, subject to certain criteria.

(vii) In order to bring more transparency to the balance sheets of public sector banks and as a further step towards consolidated supervision and to provide additional disclosures, it has been decided that public sector banks should also annex the balance sheets of their subsidiaries to

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their balance sheet beginning from the year ending March 31, 2001.

(viii) Owing to factors such as the improvements in the payment and settlement systems, recovery climate, and upgradation of technology in the banking sector, the concept of "past due" (grace period of 30 days) would be dispensed with, effective March 31, 2001.

(ix) In order to facilitate quick export-related payments and to reduce transaction costs, it was decided to restore fully the earlier entitlements in respect of Exchange Earners Foreign Currency (EEFC) accounts of Export oriented units, units in Export Processing Zone, Software Technology Park or Electronic Hardware technology Park, as prevalent prior to August 14, 2000, i.e., 70 per cent (from 35 per cent). Similarly, entitlement regarding inward remittances in respect of others was restored to 50 per cent (from 25 per cent). It was also decided that EEFC accounts (including existing accounts) would henceforth be held in the form of chequeable, current deposit accounts and no credit facility would be provided by banks against EEFC balances.

Liquidity Adjustment Facility

1.4 In line with the recommendations of the Committee on Banking Sector Reforms (Chairman: Shri M. Narasimham), popularly known as the Narasimham Committee II, the Reserve Bank decided to introduce a Liquidity Adjustment Facility (LAF) to set a corridor for money market interest rates. LAF has replaced the Interim Liquidity Adjustment Facility (ILAF) which was introduced in April 1999, pending upgradation in technology and legal/procedural changes to facilitate electronic transfer and settlement. The ILAF operated through a combination of repo, export credit refinance, collateralised lending facilities and open market operations (OMO) and provided a mechanism for injection as well as absorption of liquidity to/from banks and primary dealers (PDs) in order to overcome the liquidity mismatches in supply and demand.

1.5 In the light of the experience gained during 1999-2000, the introduction of LAF by the Reserve Bank in June 2000 represented the first stage of transition to a full-fledged LAF. In this stage, the additional collateralised lending facility (ACLF) for banks and level II liquidity support to PDs were replaced by reverse repo auctions, while the fixed rate repo was replaced by variable rate repos, effective June 5, 2000. In the next stage, collateralised lending facility (CLF) for banks and level I liquidity support to PDs would also be replaced by variable rate repo/reverse repo auctions. Some minimum liquidity support to PDs would be continued but at an interest rate that would be linked to a variable rate in the daily repo auctions as obtained from time to time. With full computerisation of Public Debt Office (PDO) and introduction of real time gross settlement (RTGS) system expected to be in place by the end of 2000-01, in the subsequent stage, repo operations through electronic transfers would be introduced. In the final stage, it would be possible to operate LAF at different timings of the same day. The quantum of adjustment as also the rates would be flexible, responding immediately to the needs of the system. The funds would meet primarily the day-to-day liquidity mismatches in the system and not the normal financing requirements of eligible institutions. Both the time-table and the scope of proposed changes would, however, be subject to review in the light of actual experience.

1.6 Effective June 5, 2000, the first stage of LAF was operationalised. Initially, repos/ reverse repo auctions, conducted on a daily basis (Monday through Friday) and with one day maturity (except on Fridays/days preceding

holidays) were introduced. Subsequently, in August 2000, multiple repo/reverse repo auctions with 3-7 day maturity periods were introduced. Interest rates in respect of both repos and reverse repos are the cut-off yields emerging from auctions conducted on a uniform price basis.

Special Fund Facility for Security Settlement

1.7 Pursuant to the announcement in the Monetary and Credit Policy for 2000-01, the Reserve Bank introduced a special fund facility, effective October 3, 2000, for settlement of transactions in Central/State Governments dated securities as well as Treasury Bills. The scheme would provide collateralised intra-day (not overnight) funds to banks and PDs to facilitate settlement of securities transactions in case of gridlock. Gridlock occurs in the delivery *versus* payment system on account of shortage of funds on a gross basis in the current account of SGL account holder(s). Banks and PDs who are eligible for CLF and Liquidity Support Facility (LSF), respectively, from the Reserve Bank, are entitled to this facility. Credit would be available at the Bank Rate on a collateralised basis and would be extended against undrawn CLF/LSF. In addition, a flat fee of Rs.25 per transaction would be charged from each of the beneficiary participants. All transferable Central Government dated securities and Treasury Bills (except 14-day Treasury Bills) would be eligible collateral for this facility. The drawal would be restricted to 95 per cent of the face value of outstanding securities in reverse repo constituent SGL account of a participant after providing for successful bids in reverse repo auctions.

Government Securities Market

1.8 The Reserve Bank continued with the process of further deepening and widening of the Government securities market. The number of PDs increased to 15 as at end-March 2000 from 13 as at end-March 1999. The system of underwriting by PDs in respect of Treasury Bill auctions was changed effective April 20, 1999. Presently, each PD is required to bid up to a fixed percentage of the notified amount and all PDs together have to bid for more than 100 per cent of the issue. Consequently, PDs are not required to take devolvement and the commission payment to PDs for participation in the Treasury Bill auctions was withdrawn, effective June 5, 2000. As regards dated securities, it was decided to accept underwriting from PDs, up to 100 per cent of the auction issue (as against 50 per cent earlier), effective April 27, 2000. PDs were earlier permitted in 1999-2000 to underwrite auction issues of State Government securities. The liquidity support to PDs was based on their bidding commitments and secondary market operations during 1999-2000. From the year 2000-01, bidding commitments and primary and secondary market performance are taken into account for fixing liquidity support under Level I which is subject to a cap of three times their net owned funds. PDs were advised to evolve reasonable leverage ratios with the consent of their boards of directors. Detailed guidelines on internal control systems relating to securities transactions were issued on December 31, 1999 on a uniform basis. Fresh guidelines for capital adequacy standards for PDs are being evolved to address market risks.

1.9 The Reserve Bank has been announcing an advance release calendar on issue of Treasury Bills on a half-yearly basis since April 1999 to remove market uncertainties. Further, 182-day Treasury Bills were reintroduced on fortnightly basis, effective May 26, 1999 providing market players with an additional instrument. The Reserve Bank also initiated the process of consolidation of

outstanding loans since May 1999 to ensure sufficient volumes and liquidity in any particular issue which would also facilitate the emergence of benchmarks and development of Separate Trading of Registered Interest and Principal Securities (STRIPS). Further, as announced in the Monetary and Credit Policy for 2000-01, entities allotted securities in primary auctions have been allowed to sell them on the date of allotment itself, the transfer and settlement being effected in the next working day. Technological upgradation of Government securities market by setting up an Electronic Screen-based Negotiated Dealing System and computerisation of the Public Debt Office will facilitate electronic bidding in auctions and dealing in Government securities and money market instruments including their derivatives. This would also facilitate smooth settlement through connectivity.

1.10 The amendment to Securities Contracts (Regulation) Act, 1956, effective March 1, 2000, has vested the Reserve Bank with regulatory powers to regulate dealings in government securities, money market securities, gold related securities as well as securities derived from these securities and ready forward contracts in bonds, debentures, debenture stock, securitised and other debt securities. The Reserve Bank permitted all entities having SGL and current account with Mumbai office, to enter into repos in Treasury Bills and Central and State Government dated securities. So far, 64 non-bank entities are eligible.

Commercial Banking System

1.11 In the wake of the recent financial crises, there has been a renewed focus world wide on containing risks. In this context, there have been proposals for introduction of new capital adequacy norms and development of international standards and codes with the objective of achieving/maintaining stability. In India too, efforts have been made to move towards international best practices in banking supervision. The policy measures during 1999-2000 and 2000-01 (up to October) concerning banking activities focus on various issues such as regulation and supervision, enhanced competition, prudential norms, etc (Appendix Table I.3).

Strengthening the Banking System

Capital Adequacy

1.12 As a part of the follow-up of the recommendations of the Narasimham Committee II, it was decided in October 1998 to raise the stipulated minimum capital to risk-weighted assets ratio (CRAR) of scheduled commercial banks by one percentage point to 9 per cent from the year ended March 2000. Banks were advised in October 1999 to assign a risk-weight of 2.5 per cent to cover market risk in respect of investments in securities outside the SLR by the year ending March 31, 2001 (over and above the existing 100 per cent credit risk-weight). A market risk-weight of 2.5 per cent had been prescribed for Government and other approved securities from March 31, 2000. Further, banks were advised in April 2000 to assign a risk-weight of 100 per cent only on those State Government guaranteed securities issued by defaulting entities and not on all the securities issued or guaranteed by the concerned State Government. With regard to provisioning for standard assets, it was clarified that the general provision of 0.25 per cent on standard assets should be made on global portfolio basis and not on domestic advances alone. It was announced in October 2000 that the general provision on standard assets would be included in Tier II capital, together with other 'general provisions/loss reserves', up to a maximum of 1.25 per cent of the total risk weighted assets.

Public Issue of Shares

1.13 During 1999-2000, six old private sector banks – Ganesh Bank of Kurundwad Ltd.

(Rs.0.54 crore), Ratnakar Bank Ltd. (Rs.5.89 crore), Nainital Bank Ltd. (Rs.2.50 crore), Bharat Overseas Bank Ltd. (Rs.10.50 crore), Bank of Rajasthan Ltd. (Rs.67.24 crore) and Sangli Bank Ltd. (Rs.15.77 crore) were granted permission to issue shares on rights basis for augmenting their capital. While five banks have collected the full amounts of the issue, Sangli Bank Ltd. has collected Rs.3.15 crore.

Ownership Pattern of Nationalised Banks

1.14 Recognising that the nationalised banks need to augment their capital base to cope up with the changing operational environment, the Government has permitted banks to access capital market, both at home and abroad. However, as the amount of capital which can be raised by the nationalised banks from the capital market has been constrained by the minimum shareholding of 51 per cent by the Central Government, the Union Budget for 2000-2001 has envisaged a reduction in the minimum Government shareholding in nationalised banks to 33 per cent. It was also stated in the Budget that in the process of reduction of Government shareholding limit, the public sector character of these banks would remain unchanged and that the fresh issue of shares would need to be widely held by the public. The Government also proposed to bring about necessary changes in the legislative provisions to accord flexibility and autonomy to the Boards of the banks.

Recapitalisation and Write-offs of Losses against Capital of Nationalised Banks

1.15 The Government had contributed an aggregate amount of Rs.20,446.12 crore towards recapitalisation of nationalised banks by end-March 1999. The Government did not provide any amount on this account in 1999-2000. During 1999-2000, the Government provided a sum of Rs.297.07 crore towards writing down of the investments (capital base) of Vijaya Bank for adjustment of its losses. With this, the losses of nationalised banks written off against capital amounted to Rs.6,334.44 crore.

Recovery Management

1.16 The relatively high level of non-performing assets (NPAs) of public sector banks (PSBs) has been a matter of concern. Its reduction is closely linked to recoveries. However, the recovery management has been impeded by the fact that laws have not been robust enough to provide comfort to banks' efforts in reducing the level of NPAs. Various measures have been taken recently to address this issue which include: announcement in the Union Budget 2000-01 for setting up of seven more debt recovery tribunals (DRTs), strengthening the infrastructure of DRTs and amendment to the Recovery of Debts Due to Banks and Financial Institutions Act. The Act, *inter alia*, has sought to empower the DRT to straightaway issue certificate for recovery on the basis of decree or order of Civil courts.

1.17 The Reserve Bank had issued guidelines to PSBs for the constitution of Settlement Advisory Committees (SACs) for compromise settlement of chronic NPAs of small scale sector in May 1999. A review of the performance of SACs revealed that progress of recovery of NPAs through this mechanism was not satisfactory. Consequently, the Reserve Bank issued revised guidelines in July 2000 covering all sectors, including the small scale sector, to provide a simplified, non-discretionary and non-discriminatory mechanism for recovery of NPAs with outstanding balance of up to Rs.5 crore as at

end-March 1997. The scheme would be operative up to end-March 2001.

Restructuring of Weak Public Sector Banks

1.18 The Working Group on Restructuring Weak PSBs (Chairman: Shri M.S. Verma), had concluded that a comprehensive restructuring strategy dealing with operational, organisational, financial and systemic aspects, would be the most appropriate for the three identified weak banks. Subsequently, the Union Budget for 2000-2001 announced that weak bank-specific Financial Restructuring Authority (FRA) would be constituted, not an authority to deal with all weak banks put together as recommended by the Working Group. Under the proposed framework, the statutes governing PSBs would be amended to provide for supersession of the Board of Directors on the basis of recommendations of the Reserve Bank and constitution of a FRA for such a bank, comprising experts and professionals. The amendments would also enable the FRA to exercise special powers, including all powers of the Board of the bank. The Government would consider recapitalisation of the weak banks to achieve the prescribed capital adequacy norms, provided a viable restructuring programme acceptable to the Government as the owner and the Reserve Bank as a regulator is made available by the concerned banks. The restructuring plans submitted by the three identified weak banks are being finalised by the Government/Reserve Bank.

Asset-Liability Management

1.19 Given the increasing internationalisation of banking operations, commercial banking operations are subject to significant mismatch between assets and liabilities with implications for several types of risks, such as, the interest rate risk, liquidity risk and foreign exchange risk which are likely to arise and need to be addressed. It may be recalled that draft guidelines on asset-liability management (ALM) were issued in September 1998 and on the basis of the feedback received from banks on the draft guidelines, the final guidelines were issued in February 1999 for implementation by banks from April 1, 1999.

1.20 Asset-Liability Management Committees (ALCOs) have been set up in all banks and are headed by Chairman and Managing Director/ Executive Director to manage various risks from risk-return perspective. Besides, Management Committee or a specific Committee of the Board has been formed in each bank to oversee implementation of the ALM system and review its functions periodically.

1.21 The guidelines introduced two returns, *viz*., Statement of Structural Liquidity and Statement of Interest Rate Sensitivity covering liquidity risk management and interest rate risk management in respect of banks' dealings in rupee. As regards foreign currency risk, banks were advised to follow the instructions issued by the Exchange Control Department in December 1997 that introduced two returns, *viz*., Statement of Maturity and Position (MAP) and Statement of Interest Rate Sensitivity (SIR).

1.22 In July 1999, the Reserve Bank advised banks to submit four returns with effect from the quarter ended June 1999. The two returns on foreign currencies, *viz*., MAP and SIR have been aligned in periodicity and time–buckets with the Rupee statements on Structural Liquidity and Interest Rate Sensitivity for the purpose of supervisory returns. Banks have been provided with structured formats for compiling these returns. Banks have started submitting the returns since the quarter ended June 1999.

1.23 Keeping in view the prevailing

Management Information System (MIS) in banks and in the absence of high level of computerisation, banks were advised to ensure coverage of at least 60 per cent of their assets and liabilities from April 1, 1999 and 100 per cent by April 1, 2000. In view of genuine difficulties expressed by a few banks, it was decided to grant extension to some of the banks, subject to their covering at least 80 per cent of business by April 1, 2000 and 100 per cent by April 1, 2001.

1.24 The Reserve Bank embarked on a project to upgrade the off-site data base supervisory statistics with enhanced capabilities of processing of reports on risk exposures based on submission of returns on ALM, introduced for banks and all-India term lending and refinancing institutions.

1.25 Considering the existing MIS and technical expertise, banks have been advised to adopt the Traditional Gap analysis as a suitable method for measuring interest rate risk. It is, however, the intention of the Reserve Bank to move over to the modern techniques like Duration Gap analysis, Simulation and Value at Risk over time when banks acquire sufficient expertise and improvement in acquiring and handling of MIS. Banks are, therefore, required to stipulate a time frame for switching over to the new techniques. The switchover is for prescribing explicit capital charge for interest rate risk in the trading book.

Risk Management

1.26 The increased complexity in banking operations, and the need to prevent financial crises of the type witnessed in East Asia, have necessitated continuous efforts towards strengthening the soundness of financial entities, and in particular, upgradation of risk management practices and procedures. As part of this, guidelines on Risk Management Systems were issued in October 1999, providing essential details to enable the banks to put in place a comprehensive risk management system to take care of credit risk, market risk and operational risk. The guidelines show that risk management is a necessary condition for maintaining, preserving and enhancing financial stability in the context of the financial and structural reforms that are being undertaken. An important means for positioning appropriate risk management techniques is the MIS. Development and strengthening of MIS would require in the first place a strong data base, and other information sets, and secondly, application of data mining techniques and behavioural and technical relationships among different variables.

Exposure Norms

1.27 Effective April 1, 2000, the exposure ceiling in respect of an individual borrower was reduced from 25 per cent to 20 per cent of the bank's capital funds. Where the existing level of exposure as on October 31, 1999, was more than 20 per cent, banks were expected to reduce the exposure to 20 per cent of capital funds over a two-year period (i.e., by end-October 2001). The Rupee sub-ordinated debt raised by banks as Tier-II capital would not be included in the capital funds for the purpose of determining the exposure ceiling to individual group borrowers.

1.28 A review of current practices regarding credit exposure limits *vis-à-vis* international best practices shows that there are certain issues which require further consideration. The first relates to the concept of 'capital funds'; second relates to the scope of the measurement of credit exposure, in particular, the coverage of non-fund and other off-balance sheet exposures; and the third relates to the level of exposure limit itself. Taking into account the

complexities involved, it has been decided to prepare a detailed Discussion Paper on the subject which would *inter alia* address issues relating to current practices in India *vis-à-vis* international best practices and the possible alternative approaches with pros and cons and other relevant aspects. The Discussion Paper which is expected to be finalised by December 2000, would be circulated among banks. Based on the comments and suggestions on the issues, and followed by an interaction with banks, the Reserve Bank would take a final view on the approach that should be adopted with a view to making it effective from end-March 2002.

Consolidated Supervision of Banks and their Subsidiaries

1.29 The Reserve Bank initiated steps to move towards consolidated supervision whereby banks would voluntarily build in the risk-weighted components of their subsidiaries into their own balance sheet on notional basis by applying risk-weights to subsidiaries' assets identical to those applied to banks' own assets. Banks would also be required to earmark additional capital in their books in a phased manner beginning from the year ending March 2001 to obviate the possible impairment to their net worth during the period of switching over to a unified balance sheet for the group as a whole. The principal bank in the group would be responsible for monitoring the group operations from prudential perspective and provide data/information to the Reserve Bank including filing of returns regarding subsidiaries. The returns in respect of each of the subsidiaries would cover capital adequacy, large credit exposures, asset quality, ownership and control, profitability and contingent liabilities and credit exposure to each of the subsidiaries. Further, PSBs would also be required to annex the balance sheets of their subsidiaries to their balance sheet beginning from the year ending March 2001, to bring more transparency to the balance sheets of PSBs and as a further step towards consolidated supervision and to provide additional disclosures.

Supervisory Initiatives relating to Foreign Branches of Indian Banks

1.30 A Working Group was set up in the Reserve Bank to go into the entire gamut of the management of overseas operations of Indian banks. Officials from major banks having overseas operations, apart from officials from the Reserve Bank were represented in the Working Group. Some of the important recommendations of the Group are:

- Introduction of a new supervisory reporting system called the DSB-O returns to replace the existing RALOO (Returns on Assets and Liabilities of Overseas Offices) statements. The existing system is to be rationalised with focus on market risks which were not adequately captured in the present set up.

- Introduction of comprehensive policies in respect of credit and investment management at the overseas branches taking into account the host country regulation/legislation. The objective is to improve the asset quality by taking advantage of the emerging opportunities in the overseas markets.

- Formulation of appropriate risk management policies taking into account the scale and complexity of operations, risk philosophy and risk taking capacity of banks. Such policies should aim at identification of risks, their quantification, monitoring and control.

- Banks to put in place strong management information system which would provide comprehensive/valuable feed back to the top management on a timely basis to

enable the top management to initiate appropriate action.

- Periodicity of inspection of foreign branches to be decided by banks taking into account the instructions of the host country regulator in this regard, if any, and status of the branch. In addition, banks to introduce a system of quick assessment/ review of the larger foreign branches at more frequent intervals.

- As regards supervision by the Reserve Bank, apart from the DSB-O returns, the quarterly DO letters from the Head Offices, copies of the head office inspection reports of the foreign branches and inspection reports of the host country regulator to be used as supplementary off-site tools. The Reserve Bank is required to undertake on-site supervision of foreign branches, the frequency of which depends on its perception of supervisory concerns.

- Banks to initiate action on reviewing their personnel policies consisting of placement policy, succession policy, and retention policy for smooth functioning of overseas branches.

1.31 In view of these recommendations, the Reserve Bank set up a new cell named 'Foreign Branches Cell' in the Department of Banking Supervision to oversee the implementation of these recommendations and also to provide sharper focus on the supervision of overseas operations. The Reserve Bank has introduced DSB-O quarterly reporting system consisting of seven returns in place of RALOO statements from the quarter ended June 2000. Further, the banks were advised to review their policies relating to credit, investment, risk management, etc. in the light of the Group's recommendations and furnish to the Reserve Bank the progress reports in this regard on a quarterly basis, which are being monitored in the Cell.

1.32 The Cell has started analysing the portfolio appraisal reports of the overseas operations. The supervisory action being undertaken includes discussion with the top management on the identified supervisory concerns and follow-up action on the assurances given by the bank. Other activities of the Cell include analysis of returns from overseas offices and undertaking country analysis on a periodical basis.

1.33 The most recent initiative undertaken by the Cell is the preparation of market intelligence reports on overseas markets. Such reports are being prepared and circulated in the department on a fortnightly basis. These reports are expected to act as an important input for initiating supervisory action.

Technological Developments

Information Technology

1.34 During 1999-2000, the Reserve Bank focussed on two major areas in the field of computers and information technology (IT). One of the issues of concern related to smooth year 2000 transition which entailed a thorough examination of the hardware, software, operating system and networking systems in vogue in the entire financial sector and in particular, in the banking sector so as to ensure that there would be business continuity. The efforts made by the Reserve Bank to encourage and to foster implementation of necessary action in this regard by commercial banks helped to further improve IT infrastructure with latest equipments and solutions and integrated networks. The second area of focus was on overall technological upgradation in banks, essentially to facilitate smooth and efficient

payment and settlement, improved customer service and the resultant increase in profitability.

1.35 It was in this direction that the Committee on Technology Upgradation in the Banking Sector set up by the Reserve Bank made wide-ranging recommendations based on which the Reserve Bank drew up an Action Plan for implementation of the recommendations. Besides, three sub-groups have also been constituted to (i) review periodically security policies, message formats, software, etc.; (ii) examine legal issues of electronic banking; and (iii) monitor progress of computerisation of branches of banks handling Government transactions.

1.36 Furthermore, an institutional mechanism in the form of National Payments Council has been constituted in May 1999, with Deputy Governor Shri S.P. Talwar as the Chairman, to focus and recommend broad policy parameters that provide basis for designing and developing an integrated payment and settlement system. The council has a broad representation from commercial banks and other financial sectors (Box I.2).

1.37 The ultimate goal is to design and develop a settlement system which will be based on multiplicity of deferred/discrete net settlement systems and RTGS, and facilitate efficient funds management, house-keeping and customer service. Both domestic and cross-border payment transactions as well as equity and other securities settlements would be part of such a system. The infrastructure that will help to make it a reality will be large, and will include networking of computerised bank branches, with their controlling offices, central treasury cells and head offices with the proviso for introducing standardisation of operating systems and networking platforms within the bank and a bank-level standardised gateway to Indian Financial Network (INFINET). A consultant has been appointed to assist the

Box I.2: National Payments Council - Policy Decisions

The National Payments Council was constituted in May 1999 with the objective of providing perspectives and recommendations on broad policy issues to help design, develop and maintain an integrated, robust payment and settlement system for the country. Several important policy decisions were taken by the National Payments Council in its meetings held between July 1999 and June 2000. These are detailed as under:

(i) Introduction of Real Time Gross Settlement (RTGS) System.

(ii) Adoption of the 'Y' topology for the RTGS involving a service provider between the originator and beneficiary of the transaction and its settlement in the books of the Reserve Bank (Chart I.1).

(iii) Constitution of five permanent Task Forces on a) Monetary Policy and related issues, b) Payment and Settlement Systems Oversight, c) Legal Issues, d) Technology Related Issues, and e) Systems and Procedures - related issues.

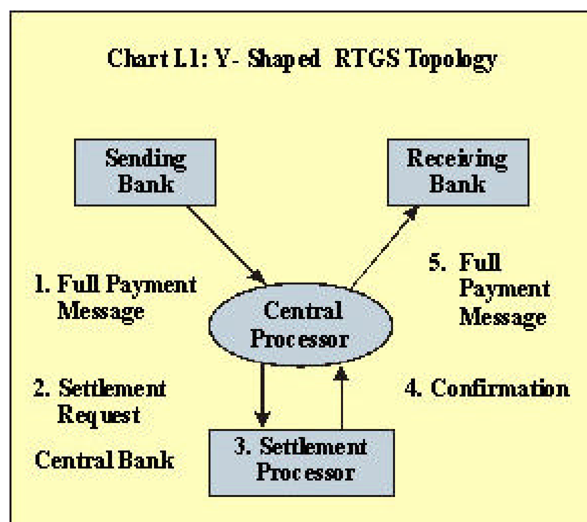
(iv) Provision of Collateralised credit and/or Repo based intra-day liquidity by the Reserve Bank with terms and conditions providing due recognition to risk management.

(v) Recommendation of standards for smart cards for financial transactions and thereafter operationalisation of these standards in the context of the guidelines given for the introduction of debit/smart cards.

(vi) Adoption of Generic Architecture Model for payment systems which provides for a 'tree' structure (for older banks) and a 'star' topology (for newer banks) for inter branch networking of individual banks with the proviso for a bank-level standardised gateway to the Indian Financial Network (INFINET).

(vii) Strategies for computerisation and networking of bank branches, to ensure that most of the major centres are covered by the INFINET.

implementation of the RTGS.



Smart Card based Payment System

1.38 Progress is being made towards developing standards for newer payments instruments such as SMART cards. A pilot project on SMART Card technology in India titled 'SMART Rupees System (SMARS)' was undertaken by the Indian Institute of Technology, Mumbai to examine the viability and use of SMART cards as retail payment instruments within the country. It came out with a set of recommendations on SMART cards standards. With a view to examining these recommendations and for determining the standards for the Indian banking industry, the Reserve Bank set up a 'Working Group to study the recommendations for SMART card based Payment System Standards' in September 1999. The Working Group submitted its Report to the Reserve Bank in January 2000 and the recommendations were accepted by the Reserve Bank. These have been forwarded to the Bureau of Indian Standards for adoption as National Standards.

Rationalisation of Procedures

Regulations Review Authority

1.39 The Reserve Bank had set up a Regulations Review Authority (RRA) (with Deputy Governor Dr. Y.V. Reddy as RRA) on April 1, 1999 for one year for reviewing the Reserve Bank's rules, regulations, reporting systems, etc., in the light of suggestions received from general public, market participants and users of services of the Reserve Bank. However, as the scope of the work for RRA has been found to be large, the term of RRA has been extended by one more year from April 1, 2000. During 1999-2000 and the first half of 2000-01, the Authority received 235 applications, which contained more than 400 suggestions, pertaining to various functional areas of the Reserve Bank. Implementation of the accepted suggestions has paved way for streamlining several existing procedures in the Reserve Bank, particularly in its departments which deal with the public. The suggestions also compelled a review of the Reserve Bank's reporting systems and contributed to rationalisation of a number of statistical returns and reports. The RRA initiated the work relating to compilation of subject-wise master circulars by merging circulars issued over the years on select subjects. One circular on Exposure Norms has already been issued and others are at various stages of finalisation. Further, it is proposed to issue an updated Master Circular on select subjects at the beginning of each year.

1.40 With a view to having a consistent policy with regard to investor protection, MMMFs were brought under the regulatory purview of Securities and Exchange Board of India (SEBI) which regulate mutual funds in general. Mutual Funds have been permitted to issue units to foreign institutional investors (FIIs).

1.41 The Reserve Bank has permitted banks to fix service charges which would generally be based on the cost of providing services. Banks have also been urged to pay interest at the rate applicable for appropriate tenor of fixed deposit for the period of delay beyond 10/14 days in collection of outstation instruments and pay penal interest at the rate of 2 per cent above the fixed deposit rate applicable for any abnormal delay that might be caused by bank branches in collection of outstation instruments.

1.42 The Reserve Bank also did away with sample test checking of newly printed MICR instruments at MICR cheque processing centres before putting them into use and withdrew the requirement of obtaining succession certificate from the legal heirs, irrespective of the amount involved in the account of a deceased customer.

1.43 A few important developments during the first half of the current year (April-September, 2000) as a result of implementation of the suggestions were : (a) putting in place in the Reserve Bank, a comprehensive information transmittal system in electronic form for the benefit of seekers of information from the Bank, (b) revision in the Bank's instructions relating to nomination facility for the benefit of investors in Relief Bonds, (c) increase in the limit of same day credit of local/outstation instruments sent for collection by banks from Rs.5,000 to Rs.7,500 per instrument, (d) streamlining the procedure for prompt payment of interest to scheduled commercial banks on the eligible CRR balances, and (e) relaxation in the prescribed eligibility criteria for opening and maintaining Non-Resident External Rupee Accounts by the central co-operative banks.

Transparency and Disclosure

1.44 In February 1999, the Reserve Bank issued guidelines for improving transparency in the financial statements of banks. Accordingly, banks were required to disclose the following information as 'Notes on Accounts' to their balance sheets from the year ended March 31, 2000: (i) maturity pattern of loans and advances, investments in securities, deposits and borrowings, (ii) foreign currency assets and liabilities, (iii) movements in NPAs, and (iv) lending to sensitive sectors as defined by the Reserve Bank from time to time. It was decided that the sensitive sectors in respect of which information was to be disclosed for the year 1999-2000 would include (i) capital market, (ii) real estate and (iii) commodities. Considering, however, the difficulties expressed by certain banks in disclosing the maturity pattern of Indian Rupee assets and liabilities, in the 'Notes on Accounts' as they have not covered 100 per cent of their business under ALM system, banks were allowed to disclose, if need be, this information in the Director's Report. Banks were, however, advised in May 2000 to disclose the above information in the 'Notes on Accounts' to their balance sheets from the year ending March 31, 2001. Such disclosures and transparency practices would help improve the process of expectation formation by market players and eventually lead to effective decision-making by banks.

Institutional Reforms for Capacity Building

Credit Information Bureau

1.45 There has been a widely felt need to establish a Credit Information Bureau (CIB) designed to obtain and share data on borrowers in a systematic manner for sound credit decisions, thereby helping to facilitate

Box I.3: Working Group to Explore the Possibilities of Setting up a Credit Information Bureau in India – Major Recommendations

The Working Group constituted by the Reserve Bank to explore the possibilities of setting up a Credit Information Bureau in India submitted its Report in November 1999. The major recommendations of the Working Group are indicated below.

The existing legal framework does not permit disclosure of information except in cases where there is explicit consent of the constituent or where suits have been filed. Amendments to existing Acts relating to banking sector or enactment of a master legislation would be necessary to form a full-fledged Credit Information Bureau.

Pending legislative changes, to begin with, a Credit Information Bureau can be set up to pool the limited information as is possible under the existing legal framework and share such information among its members.

The proposed Credit Information Bureau could be set up as a separate company jointly owned by banks and FIs under the regulatory purview of the Reserve Bank. Co-option of a foreign technology partner/collaborator would also provide the necessary expertise.

The Bureau should inherit the best international practices with regard to collection of information, processing of data and sharing of information and it should build up effective systems to ensure the security of data maintained by it and restrict access to its data base to institutions accredited by it and evolve an appropriate code of access.

avoidance of adverse selection. This would also facilitate reduction in NPAs. In June 1999, a Working Group was constituted to explore the possibilities of setting up a CIB in India. The Group, in its Report submitted to the Reserve Bank, recommended the setting up of a CIB in India (Box I.3).

1.46 Based on the recommendations of the Working Group and realising the importance of developing better institutional mechanisms for sharing of credit-related information, the Union Budget 2000-01 announced the establishment of a Credit Information Bureau. Subsequently, in the Monetary and Credit Policy of April 2000, the Reserve Bank advised banks and financial institutions to make the necessary in-house arrangement for transmittal of the appropriate information to the Bureau. The State Bank of India (SBI) has entered into a Memorandum of Understanding (MOU) with the Housing Development Finance Corporation (HDFC), with Dun and Bradstreet Information Services Ltd. and Trans Union International Inc. as foreign partners, to set up a CIB within the confines of the existing legislation. The work of preparing a master legislation to establish a full-fledged Bureau is underway.

Deposit Insurance Reform

1.47 Reforming the deposit insurance system is a crucial component of the present phase of financial sector reforms in India. Accordingly, a Working Group was constituted by the Reserve Bank on Reforms in Deposit Insurance in India (Chairman: Shri Jagdish Capoor). The Group submitted its Report in October 1999. The major recommendations of the Group include: (i) fixing the capital of Deposit Insurance and Credit Guarantee Corporation (DICGC) at Rs.500 crore, to be contributed fully by the Reserve Bank; (ii) withdrawing the function of credit guarantee on loans from DICGC; and (iii) risk-based pricing of the deposit-insurance premium in lieu of the present flat rate system. The task of preparation of the new draft law has been taken up in supersession of the existing law.

Diversification in Banking Operations

Insurance

1.48 The Insurance Regulatory and Development Authority (IRDA) Act, 1999 was passed by the Parliament. The Act is a major milestone in liberalisation as it opens the way for private sector entry into the insurance business. It also provides statutory backing to the IRDA. Under this Act, foreign equity will be restricted to 26 per cent of the total paid-up capital.

1.49 With a view to assessing the scope, desirability and eligibility of institutions to take up insurance business, draft guidelines were initially framed for banks entering into insurance business with risk participation as also for permitting banks to undertake fee-based business as insurance agents. On the basis of feedback received from banks and financial insitutions (FIs), the Reserve Bank issued final guidelines for banks' entry into insurance business along with the announcements in the Monetary and Credit Policy for the year 2000-2001. The guidelines are as under:

1. Any scheduled commercial bank would be permitted to undertake insurance business as an agent of insurance companies on fee basis, without any risk participation. The subsidiaries of banks would also be allowed to undertake distribution of insurance product on agency basis.

2. Banks which satisfy the eligibility criteria would be permitted to set up a joint venture company for undertaking insurance business with risk participation, subject to safeguards. The maximum equity contribution such a bank can hold in the joint venture company will normally be 50 per cent of the paid-up capital of the insurance company. On a selective basis, the Reserve Bank may permit a higher equity contribution by a promoter bank initially, pending divestment of equity within the prescribed period. The eligibility criteria for joint venture participant as on March 31, 2000 will be as under: (i) the net worth of the bank should not be less than Rs.500 crore; (ii) the CRAR of the bank should not be less than 10 per cent; (iii) the level of NPAs should be reasonable; (iv) the bank should have net profit for the last three continuous years; and (v) the track record of the performance of the subsidiaries, if any, of the concerned bank should be satisfactory.

3. In cases where a foreign partner contributes 26 per cent of the equity with the approval of IRDA/Foreign Investment Promotion Board, more than one public sector bank or private sector bank may be allowed to participate in the equity of the insurance joint venture.

4. A subsidiary of a bank or of another bank will not normally be allowed to join the insurance company on risk participation basis. Subsidiaries would include bank subsidiaries undertaking merchant banking, securities transactions, mutual fund, leasing finance, housing finance, etc.

5. Banks which are not eligible as joint venture participant, as above, can make investments up to 10 per cent of the net worth of the bank or Rs.50 crore, whichever is lower, in the insurance company for providing infrastructure

and services support. Such participation shall be treated as an investment and should be without any contingent liability for the bank.

1.50 Prior approval of the Reserve Bank is required for banks to enter into insurance business. The Reserve Bank would give permission to banks on a case-by-case basis, keeping in view all relevant factors including the position in regard to the level of NPAs of the applicant bank so as to ensure that NPAs do not pose any future threat to the bank in its present or in the proposed line of activity, *viz.*, insurance business. With a view to ensuring insulation of banking business from any risks which may arise from insurance business, there should be 'arms length' relationship between the bank and the insurance outfit. With the issuance of Notification by the Government, specifying "Insurance" as a permissible form of business that could be undertaken by banks under Section 6(1)(o) of the Banking Regulation Act, 1949, applications were invited from banks with supporting documents for their entry into insurance business. While 12 banks had expressed their intention to enter into insurance business either by way of joint venture, strategic investments or agency arrangements, applications to enter into insurance business on risk participation basis, supported by required documents have been received from three banks. Of these, "in principle" approval has been given to two banks, *viz.*, SBI and Vysya Bank Ltd.

Subsidiary for Assaying and Hallmarking of Gold

1.51 The Reserve Bank granted 'in principle' approval to the SBI for setting up the subsidiary SBI Gold and Precious Metals Private Ltd. (SBIGPMPL) with an authorised and paid up capital of Rs.15 crore for undertaking assaying and hall marking of gold. The SBI's share in equity would be 51 per cent in the joint venture. The other equity participants in the venture are Allahabad Bank (8.5 per cent), Corporation Bank (8.5 per cent) and Canara Bank (6 per cent). Credit Suisse Financial Products, London (as the foreign partner) would be holding 26 per cent equity in the joint venture.

Banks' Investments

Investment in Shares and Debentures

1.52 Effective April 24, 1999, the overall ceiling of investment by banks in ordinary shares, convertible debentures of corporates and units of mutual funds (other than debt funds), which was at 5 per cent of their incremental deposits of the previous year, was enhanced to the extent of banks' investments in venture capital. Such investments in venture capital were also included under the purview of priority sector lending.

Valuation of Banks' Investments

1.53 The Reserve Bank had advised the banks in April 1992 to bifurcate their investments in approved securities into 'permanent' and 'current' categories, and to keep not less than 30 per cent of their investments in the current category from the accounting year 1992-93. The ratio of current investments was gradually increased to a minimum of 70 per cent of the approved securities for 1998-99 and further to a minimum of 75 per cent for 1999-2000.

1.54 Under the Mid-term Review of Monetary and Credit Policy of October 10, 2000, the Reserve Bank finalised the guidelines on categorisation and valuation of banks' investment portfolio. The guidelines would be effective from the half-year ended September 2000. First, the banks are required to classify the entire investment portfolio (including SLR securities and non-SLR securities) under three categories, *viz.*, 'Held to Maturity', 'Available

for Sale' and 'Held for Trading'. The investments in the 'Held to Maturity' category should not exceed 25 per cent of the total investments. The banks have been given the freedom to decide on the extent of holdings under 'Available for Sale' and 'Held for Trading' categories. Secondly, investments classified under 'Held to Maturity' category need not be 'marked to market' and will be carried at acquisition cost, unless it is more than the face value, in which case the premium should be amortised over the period of remaining maturity. The individual scrips in the 'Available for Sale' category will be marked to market at the year-end or at more frequent intervals. The individual scrips in the 'Held for Trading' category will be marked to market at monthly or at more frequent intervals. Thirdly, the Reserve Bank will not announce the Yield to Maturity (YTM) rates for unquoted Government securities, as hitherto, for the purpose of valuation of investments by banks. The banks are required to value the unquoted SLR securities on the basis of the YTM rates to be put out by the Primary Dealers Association of India (PDAI) jointly with the Fixed Income Money Market and Derivatives Association (FIMMDA) at periodical intervals. The valuation of the other unquoted non-SLR securities, wherever linked to the YTM rates, will be with reference to the YTM rates as put out by the PDAI/ FIMMDA.

Banks' Investments in Capital Market

1.55 In pursuance of the Monetary and Credit Policy for 2000-01, a Standing Technical Committee of the Reserve Bank and SEBI on Bank Financing of Equities was constituted to develop operative guidelines for a transparent and stable system of banks' financing of equities and investments in shares. The Committee submitted its report to the Reserve Bank on August 30, 2000. The guidelines reflected the Committee's approach to optimise the capital market returns without exposing them to undue risks arising from market volatility. The Reserve Bank circulated the draft guidelines in September 2000. The final guidelines were announced in October 2000, after taking into account the views expressed by the banks and other market participants. As per the final guidelines, the terms and conditions for financing of initial public offerings (IPOs) should be the same as those applicable to advances against shares to individuals. As recommended by the Committee, within the overall exposure to sensitive sectors, the bank's total exposure to the capital market by way of investments in ordinary shares, convertible debentures and units of mutual funds (other than debt funds) should not exceed '5 per cent of total outstanding advances as on March 31 of the previous year' as against the earlier ceiling of '5 per cent of incremental deposits of the previous year'. The Board of Directors of banks shall formulate their policy on total exposure to capital market, keeping in view its overall risk profile. In respect of those banks where the present outstanding investments in equities are relatively small and well below the 5 per cent overall ceiling, as a prudential measure, the Board should also lay down an annual ceiling for fresh investments in equities so that any increase in fresh investments in equities takes place in a phased, gradual and cautious manner, within the absolute ceiling fixed by the Board for each year. The RBI-SEBI Technical Committee will review the actual working of the new guidelines in consultation with select banks.

Rural Credit, Housing Finance and Credit to Small Scale Industries

Rural Credit

1.56 In order to strengthen the capital base of the rural institutions, a sum of

Rs.152.65 crore was expended by the Central Government during 1998-99 to strengthen the capital base of Regional Rural Banks (RRBs). Besides, a budgeted sum of Rs.168 crore was released for restructuring the capital base of select RRBs during 1999-2000. The Reserve Bank has been providing to National Bank for Agriculture and Rural Development (NABARD), a General Line of Credit (GLC) to enable it to meet the short-term credit requirements of co-operative banks and RRBs. For the year 1999-2000 (July–June), the Reserve Bank renewed a credit limit of Rs.5,700 crore, sanctioned in the previous year, to NABARD consisting of Rs.4,850 crore under GLC I (for seasonal agricultural operations) and Rs.850 crore under GLC II (for various other approved short-term purposes). In view of the increase in sanction of credit limit by NABARD to co-operatives and RRBs in general, and for meeting the additional requirements of funds on account of cyclone /floods in Orissa in particular, an additional limit of Rs.400 crore under GLC I was sanctioned in December 1999, on request by NABARD.

1.57 Provision of micro-credit by banks has emerged as an important instrument for alleviating poverty, particularly in rural areas, as this raises the productive capacity of the beneficiaries. Banks were accordingly advised in February 2000 to make micro-credit an integral part of their corporate credit plan. Micro-credit is reckoned as part of banks' priority sector lending since February 2000. Further, with a view to providing an additional avenue for bank's lending to agriculture and increasing the outreach of banks in rural areas, lending by banks to non-banking financial companies (NBFCs) for on-lending to agriculture is reckoned for the purpose of priority sector lending as indirect finance to agriculture since April 2000. In a significant move, micro-credit/ rural credit has been included in the list of eligible NBFC activity for being considered for FDI/OCB/NRI investment. This would cover extension of credit facilities at the micro level to small producers and small enterprises in the rural and urban areas.

1.58 The total ground level credit for agriculture and allied activities disbursed by co-operative banks and commercial banks (including RRBs) increased by 13.2 per cent to Rs.41,764 crore during 1999-2000 from Rs.36,897 crore during 1998-99. The NABARD has been playing a significant role in providing and facilitating adequate credit support to agriculture and other rural activities. The amount of funds sanctioned and disbursed by NABARD under Rural Infrastructure Development Fund (RIDF) amounted to Rs.14,923 crore and Rs.6,680 crore, respectively, as at end-August 2000. Kisan Credit Cards (KCC) numbering 57.41 lakh were issued by PSBs, RRBs and co-operative banks; the amount sanctioned under this scheme amounted to Rs.9,632 crore as at end-March 2000. All PSBs have been advised to set monthly targets within the yearly target fixed for the bank and draw action plan for achieving the overall target. The role played by NABARD and co-operative banks in augmenting the flow of credit to the rural sector is detailed in Chapter III, while that of commercial banks (including RRBs) is detailed in Chapter II of this Report.

Housing Finance

1.59 Commercial banks were advised to compute their minimum share of housing finance allocation for 1999-2000 and 2000-01 at 3 per cent of their incremental deposits of the previous year or the amount of housing finance allocation fixed for the previous year, whichever was higher. Prior to October 1999, indirect housing loans sanctioned by banks to intermediary housing agencies against the direct loan sanctioned/proposed to be

sanctioned by the latter were reckoned as part of their housing finance allocation, provided the loan per borrower by such intermediary agencies did not exceed Rs.5 lakh and Rs.10 lakh in rural/semi-urban and urban/ metropolitan areas, respectively. In order to enhance the flow of credit to housing sector, effective October 29, 1999, banks were advised that housing finance sanctioned by them to housing finance intermediary agencies would henceforth be reckoned for the purpose of achievement of their housing finance allocations, irrespective of the per borrower size of the loans extended by these agencies.

Credit to Small Scale Industries

1.60 Total credit provided by PSBs to small-scale industries (SSIs) as at end-March 2000 constituted 15.6 percent of net bank credit and 35.8 per cent of total priority sector advances of these banks. Out of the advances to SSI sector, the advances to tiny sector (i.e. to units where investment in plant and machinery does not exceed Rs.25 lakh) constituted 54.0 per cent of advances to SSI sector. Those banks which have not achieved the priority sector-lending target of 40 per cent even after effecting their contribution to the RIDF, have, however, been included in the consortium for providing finance to the Khadi and Village Industries Commission (KVIC). Such credit is reckoned as their indirect lending to SSIs under the priority sector. These loans are provided at 1.5 percentage points below the average prime lending rates (PLRs) of five major banks in the consortium. As at the end of June 2000, an amount of Rs.518.18 crore was outstanding out of an amount of Rs.704.00 crore disbursed by the consortium under the scheme.

1.61 Banks were advised in January 1998 to ensure that their corporate borrowers financed at least 25 per cent of their credit purchases by accepting bills drawn on corporates by their suppliers, particularly those belonging to the SSI sector. This was aimed at development of a bills culture. Effective October 29, 1999, banks were given freedom to charge interest rates on discounting of bills without reference to PLR, thereby enabling banks to offer competitive rates of interest. This measure would motivate corporates to make use of the bill route for receiving/paying their credit sales/credit purchases. In view of the above and considering the operational problems faced by banks in implementing the bills discipline, the mandatory minimum 25 per cent for acceptance of bills was withdrawn, effective November 2, 1999.

1.62 As a part of follow up of the Union Budget 2000-01 proposals, the Reserve Bank increased the limit for collateral requirement on loans from Rs.1 lakh to Rs.5 lakh in respect of the tiny sector. To promote credit flow to small borrowers, the composite loan limit (for providing working capital and term loans through a single window) was increased from Rs.5 lakh to Rs.10 lakh. PSBs were requested to accelerate their programme of SSI branches to ensure that every district and SSI clusters within districts are well served by at least one specialised SSI bank branch. The Government decided that SSI branches would need to obtain ISO certification to improve the quality of their banking services. A new central credit guarantee scheme for SSI is proposed to be implemented through Small Industries Development Bank of India (SIDBI), which would cover loans up to Rs.10 lakh for the banking sector. The guaranteed loans would be securitised and tradable in the secondary debt market. Further, PSBs have been advised to complete the process of opening/ operationalising SSI branches by December 2000.

2. Financial Performance of Scheduled Commercial Banks during 1999-2000

1.63 This Section presents highlights of the financial performance of scheduled commercial banks during the year 1999-2000 on the basis of the balance sheets of these banks. The analysis is in terms of both the aggregate and group-wise position of scheduled commercial banks.

Profitability

1.64 The operating profits of scheduled commercial banks increased by Rs.4,613 crore in 1999-2000 (33.4 per cent) to Rs.18,423 crore as against a decline of Rs.830 crore (5.7 per cent) in 1998-99. Net profits increased by Rs.2,816 crore (62.7 per cent) to Rs.7,306 crore during 1999-2000 as against a decline of Rs.2,012 crore (30.9 per cent) during 1998-99. As a share of total assets, operating and net profits increased by 21 and 19 basis points to 1.66 per cent and 0.66 per cent, respectively, during 1999-2000 as against a decline of 39 and 35 basis points, respectively, during 1998-99. The improvement in financial performance reflected (i) higher rate of growth in interest income than interest expenditure during 1999-2000, ii) a lower rate of growth in operating expenses during 1999-2000 as compared with that in the preceding year, and iii) a higher rate of growth in other income than that in 1998-99.

1.65 Operating and net profits across all bank groups exhibited a substantial increase during 1999-2000 as against a decline across all bank groups (barring nationalised banks in operating profits) during 1998-99. In particular, new and old private sector banks registered operating profit growth of 81.8 and 80.4 per cent respectively, during 1999-2000, as against a decline of 7.5 and 26.8 per cent, respectively, in the preceding year. The rise in operating profits of foreign banks too turned out to be high at around 51.5 per cent as against a decline of 30.3 per cent during 1998-99.

1.66 PSBs exhibited an operating profit growth of 23.7 per cent during 1999-2000 as compared with a marginal increase of 2.8 per cent during 1998-99. Even more spectacular was the increase in net profits (57.2 per cent) as against a decline of 35.3 per cent in 1998-99. The improved financial performance of PSBs, despite a sharper increase in interest expenditure (15.8 per cent) than that in interest income (14.5 per cent), was attributable to the spurt in other income and deceleration in operating expenses. Booking of capital gains by PSBs in their treasury operations in the context of the downward movement of interest rates, *inter alia,* boosted their other income.

1.67 As a proportion of total assets, provisions and contingencies of scheduled commercial banks increased by 2 basis points to 1.00 per cent during 1999-2000. The aggregate figure, however, hides the vast differences in bank-group-wise position in respect of provisions. On the one hand, provisions by both foreign and new private sector banks increased sharply by 44 basis points and 40 basis points, respectively, to 2.07 per cent and 1.15 per cent, respectively, during 1999-2000 while provision of old private sector banks increased by 27 basis points to 1.00 per cent. On the other hand, provisions by PSBs declined by 6 basis points to 0.89 per cent, mainly due to the sharp decline in the provisions of 17 basis points by the SBI Group. Provisions by nationalised banks increased marginally by one basis point.

Spread

1.68 The movements in the interest income and interest expenditure were influenced by liquidity conditions and the varying response

of major bank groups to the monetary policy signals of the Reserve Bank. The spread of PSBs declined by 10 basis points to 2.70 per cent during 1999-2000, due to a 9 basis points fall in interest income. The spread of SBI and nationalised banks group declined by 9 and 10 basis points, respectively. The spread of foreign banks improved sharply by 38 basis points owing to a sharper fall in interest expenditure compared with that of interest income. While the spread of old private sector banks improved by 18 basis points, that of new private banks declined by 11 basis points. The interest rate spread varied markedly across major bank groups – from 1.87 per cent for new private sector banks to 3.85 per cent for foreign banks. For the SCBs, the spread continued to exhibit a declining trend and was at 2.72 per cent during 1999-2000 as against 2.78 per cent during 1998-99.

Intermediation Cost

1.69 An indicator of competitiveness in banking is the intermediation cost (i.e. operating expenses as a proportion of total assets). There was a sizeable decline in the intermediation cost of SCBs to 2.49 per cent during 1999-2000 from 2.67 per cent in 1998-99, with wage bill declining from 1.75 per cent to 1.66 per cent. Among the bank groups, the highest order of decline in intermediation cost during 1999-2000 was recorded by the foreign banks (38 basis points). New private sector banks recorded the lowest intermediation cost (1.42 per cent). PSBs recorded a decline of 14 basis points in intermediation cost to 2.52 per cent during 1999-2000.

Size of Balance Sheet

1.70 The share of capital in total liabilities declined to 1.66 per cent as at end-March 2000 from 1.92 per cent as at end-March 1999. With regard to assets, scheduled commercial banks were able to increase their total assets by 16.8 per cent. The share of loans and advances and investments in the total assets increased to 39.9 per cent and 37.3 per cent, respectively, as at end-March 2000.

Off-Balance Sheet Activities

1.71 Reflecting the growing importance of non-fund based activities of the banking sector, the off-balance sheet exposures (contingent liabilities) of all SCBs recorded an increase of 27.6 per cent to Rs. 5,84,441 crore in 1999-2000, led by a sharp increase of 31.4 per cent in forward exchange contracts. The off-balance sheet exposures as a proportion to the total liabilities of all SCBs increased by 4.4 percentage points from 48.2 per cent in 1998-99 to 52.6 per cent in 1999-2000.

Non-Performing Assets

1.72 During 1999-2000, there was a marked improvement in the proportion of net NPAs to net advances with the number of PSBs with net NPAs up to 10 per cent increasing from 18 to 22. Similarly, the number of old private sector banks and foreign banks with net NPAs of less than 10 per cent went up from 17 to 18 and from 27 to 31, respectively. New private banks continued to have net NPAs below 10 per cent during 1999-2000.

Capital to Risk-Weighted Assets Ratio

1.73 As against the stipulated minimum CRAR of 9 per cent of scheduled commercial banks, all but one PSB attained the norm during 1999-2000. This achievement needs to be viewed against the fact that no public sector bank was recapitalised during 1999-2000. Of the 24 old private sector banks, 21 banks met the 9 per cent norm. All the 8 new private sector banks and 42 foreign banks had CRAR in excess of 9 per cent. It may be recalled that the Narasimham Committee II had emphasised the raising of CRAR to 10 per cent by end-March 2002. 22 PSBs, 19 old private sector

banks, 7 new private sector banks and 37 foreign banks had CRAR in excess of 10 per cent as at end-March 2000.

3. Perspectives

1.74 As the present phase of reforms gathers momentum and competitive pressures become strong, more focussed attention would need to be paid to inter-related sets of issues regarding (a) strengthening the foundation of the banking system; (b) streamlining banking procedures including upgrading of technologies and networking; and (c) effecting structural changes in the system.

1.75 It needs to be recognised that given the size of the financial system, broadly defined, the question of banking soundness cannot be analysed in isolation from the broader system. This is because financial disturbances, wherever they originate, can have serious consequences for the rest of the economy. In view of the universalisation of banking operations, the walls between banks and non-bank entities are getting gradually blurred. However, banks in their present structural form continue to have strategic importance, notwithstanding the importance of other major entities of the financial system, *viz*., development financial institutions (DFIs) and NBFCs.

Strengthening the Commercial Banking System

Capital Adequacy Measures

1.76 Capital constitutes the basic cushion as a rescue for contingencies. The Basle Committee on Banking Supervision (BCBS) had released a Consultative Paper on New Capital Adequacy Framework in June 1999 to further strengthen the soundness of the financial system and better align regulatory capital with the underlying risks faced by banks. Recognising the implications of the new framework on emerging market economies like India, the Reserve Bank constituted an internal Working Group to examine the impact, applicability, scope, problems and the time span of its implementation in India. The Reserve Bank has finalised its views on the basis of the recommendations of the Group, and subsequently forwarded its comments to the Basle Committee. The main thrust of the comments is to ensure sufficient flexibility in the framework to fully reflect the macro-economic environment, structural rigidities and concerns of emerging markets. The Reserve Bank felt that where banks are of simple structure and have subsidiaries, the framework could be adopted on stand-alone basis with the full deduction of equity contribution made to subsidiaries from the total capital. Besides, national supervisors should have discretion to prescribe a material limit up to which cross-holdings could be permitted. Moreover, the Reserve Bank felt that assigning greater role to external rating agencies in regulatory process would not be desirable. Instead, domestic credit rating agencies, which are more adequately informed, would be more effective, subject to adequate safeguards. Further, the Reserve Bank viewed that risk weights of banks ought to be de-linked from that of the sovereign. Instead, preferential risk weights in the range of 20-50 per cent, on a graded scale may have to be assigned on the basis of risk assessments by domestic rating agencies. Furthermore, the proposal for assigning favourable risk weight to short-term claims would jeopardise the stability of the international financial architecture. Again, the proposal to link the banking supervisor implementing/endorsing the *Core Principles for Effective Banking Supervision* was not considered desirable. Finally, while the Committee's views on increased disclosures and enhanced transparency are reasonable, national supervisors should consider the ability

of the market to logically interpret the information.

1.77 The new capital adequacy norms proposed by the BCBS in June 1999, if implemented, are likely to be stricter than those prevailing at present. The new norms with its explicit emphasis on ratings, internal and external, are likely to have implications for the required levels of capital (Box I.4). These issues gain in importance in view of Government ownership of banks and the ability of the PSBs to raise capital either

Box I.4: Ratings of Banks

The Basle Committee on Banking Supervision (BCBS) has proposed a revised Capital Adequacy Framework in 1999, which uses a three-pillar approach consisting of (a) a minimum capital requirements pillar, (b) a supervisory review pillar to ensure that the bank's capital is aligned to its actual risk profile, and (c) a market discipline pillar to enhance the role of the other market participants in ensuring that appropriate capital is held by prescribing greater disclosure. The revised framework is presently being discussed by supervisory authorities all over the world.

The revised framework places an explicit emphasis on ratings. Risk differentiation between counterparties, be they sovereign governments, banks, corporates, public sector enterprises or securities firms is sought to be done either on the basis of external or internal ratings. In broad summary, the weights based on external risk assessment proposed for claims on sovereign governments, banks and corporates are presented in Table 1.

The Reserve Bank, however, favoured greater reliance on internal ratings-based approach for banks, which could be structured under an acceptable framework so that a standardised approach to internal rating could be adopted. The internal ratings-based approach could incorporate supplementary customer information, which is typically not available to credit assessment institutions. It could also extend to a greater number of counter-parties, such as, unrated borrowers in the small/retail sector. This would encourage banks to refine their risk assessment and monitoring process, which would facilitate better management of their loan books. The regulators should, however, evolve suitable process and criteria for approving the rating framework so as to ensure the integrity of different banks' systems and that the parameters are consistent across various institutions. While encouraging banks to use their own internal rating systems for distinguishing better the credit quality, the issues that need to be addressed relate to: (i) mapping of bank grades into a series of

Table 1: Proposed Risk Weights based on External Risk Assessment

Assessment	Claim on			
	Sovereign Governments	Banks		Corporates
		Option 1	Option 2	
1	2	3	4	5
AAA to AA-	0	20	20	20
A+ to A-	20	50	50*	100
BBB+ to BBB-	50	100	50*	100
BB+ to B-	100	100	100*	100
Below B-	150	150	150	150
Unrated	100	100	50*	100

* Claims on banks of short-term maturity, e.g., less than 6 months would receive a weighting that is one category more favourable than the usual risk weight on the bank's claim.

Option 1 : Based on risk weight of sovereign where bank is incorporated.
Option 2 : Based on assessment of the individual bank.

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regulatory risk-weight baskets; (ii) development of capital charge on the basis of rating grades; (iii) ensuring consistency between the standardised approach and an internal ratings-based approach; and (iv) minimum standards and sound practical guidelines for key elements of rating process and supervisory process. Besides, a common standards review mechanism would need to be put in place.

Secondly, with regard to the new framework, the Reserve Bank has preferred that assessments be made by the domestic rating agencies for assigning preferential risk weights for banking book assets (excluding claims on sovereign), subject to adequate safeguards. In its view, domestic rating agencies that have up-to-date and ongoing access to information on domestic macro-economic conditions, legal and regulatory framework, etc. would be better placed to rate domestic entities *vis-à-vis* external rating agencies. This would also facilitate the national supervisory authorities to have greater access to the quality of assessment sources and methodologies used by various rating agencies and also facilitate evolving country-specific parameters for rating of various counter-parties. In general, the skepticism about the role of external rating agencies arises because different external rating agencies resort to different parameters for risk evaluation, which are often not transparent. Apart from the lack of uniformity in selection of parameters, the mix and weightage of objective and subjective factors also vary across agencies, which, in the Reserve Bank's view, may lead to incorrect assessments. Due to enormous subjective element involved in the rating process and the lack of transparency in risk assessment, and other reasons, the role proposed to be assigned to the external rating agencies is a matter of supervisory concern. This is particularly so in emerging market economies which are assigned sovereign credit ratings which put an upper limit on corporate credit ratings, irrespective of their individual creditworthiness and past debt service record.

Yet another type of rating that can be expected to play a significant role is supervisory rating. The second pillar of the new framework expects supervisors to specify bank-specific capital add-ons based on the risk profile of individual banks, thereby effectively raising the Basle minima for riskier banks. Although supervisors would use different methods to diagnose the risk profile of their banks, it can be expected that some would use the component or composite ratings of supervisory rating models (such as CAMELS) which can provide useful indicators of risk profile. Whatever be the manner of determining risk profile, what is evident is that several banks in the Indian context could be expected to have higher than system capital charge required of them, which would eventually raise the capital requirements for the system as a whole.

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internally or from the market. It appears that even after allowing for additional infusion of capital through internal generation and access to subordinated debt, the gap between the additional capital requirement and the leeway available to raise capital from the market is likely to remain quite sizeable. In this situation, an issue that would require critical attention and would need to be resolved is whether this gap should be filled by contribution from the owners/shareholders or whether legislative ceiling for capital to be subscribed by the public should be raised. Provision of banks' capital by the Reserve Bank would tantamount to monetisation with inflationary implications, while contribution to additional capital by the Government will adversely impact the fiscal situation. Therefore, there seems on balance, to be a

strong case for raising the legislative ceiling for market participation in equity capital of PSBs. In this context, the pronouncement in the Union Budget 2000-01 that the Government would reduce its holdings in PSBs to 33 per cent while ensuring that banks retain their public sector character, assumes importance.

Asset-Liability Management

1.78 The increasing internationalisation of banking operations engenders the possibility of a significant mismatch between assets and liabilities, which have adverse implications for liquidity and solvency of the banking sector. In this context, pro-active ALM assumes importance. Broadly, the objectives of ALM are to contain the volatility of net interest income and net economic value of a bank. The supplementary objectives would be to reduce variability in all target accounts including control of liquidity risk, and to ensure balance between profitability and asset growth. To realise these objectives, asset-liability managers must be guided by policies that specifically address the bank's overall ALM goals and risk limits, and also by information that relates directly to its asset-liability positions. Such risk management strategies would help to reduce the adverse effects of macro-economic shocks on the soundness of the financial system.

Risk Management

1.79 Given the diversity and varying size of balance sheet items among banks as well as across the bank-groups, the design of risk management framework would need to be geared to meet bank-specific requirements, covering the size and complexity of their business, risk philosophy, market perception and the existing level of their capital. In other words, banks would need to evolve their own systems compatible with the type and size of operations as well as risk perception. While doing so, banks would need to critically evaluate their risk management systems in the light of the guidelines issued by the Reserve Bank and evolve an appropriate system to overcome the existing deficiencies and institute the requisite improvements.

1.80 The need for putting in place ALM and risk management systems in banks has underscored the imperative of building internal capacities to make appropriate analysis of the evolving domestic and international business and economic circumstances. These include both market conditions and the issues arising out of financial market integration. In this context, the role of bank economists assumes crucial importance. Bank managements will have to reorient and restructure their statistical and economics wings in a way that economists in Indian banks have an important role to play as much as in most international banks.

Risk Based Supervision

1.81 Considering the complexities of banking business and emerging product innovations with complex risk profiles, there is a growing acceptance that a Risk Based Supervision (RBS) approach would be more efficient than the traditional transaction based approach. RBS entails monitoring of banks by allocating supervisory resources and focusing supervisory attention according to the risk profile of each institution. The instruments of RBS are off-site monitoring and on-site inspection supplemented by market intelligence mechanism. However, off-site surveillance has gained primacy internationally in recent times, given the ease and promptness of monitoring (Box I.5). Therefore, the Reserve Bank has decided to gradually move towards a risk based approach to inspection. Apart from strengthening the risk modelling capabilities based on off-site data and associated research for 'predictive

Box I.5: Off-site Monitoring and Surveillance Systems in Select Countries

The growing complexity of financial institutions coupled with the need for frequent and continuous monitoring has made off-site monitoring an important instrument of supervision. Countries all over the world have embraced off-site surveillance mechanisms in varying degrees. The Monetary and Credit Policy of April 2000 has observed that the Reserve Bank would draw on other countries' experiences in moving towards RBS and it would be instructive, in this context, to examine the off-site monitoring procedures adopted in different countries.

United Kingdom: In the UK, integrated supervision over the financial system is carried out by the Financial Services Authority (FSA). The FSA system of bank supervision is predominantly off-site with most of the on-site work being done by accountancy firms called 'reporting accountants' specialising in bank audit. The off-site database of FSA includes statistical returns submitted by banks to the Bank of England and information available within FSA files about the banks. Banks are required to submit returns covering aspects of capital adequacy, balance sheet, profit and loss account, liquidity and large exposures, large deposits, foreign exchange exposures and country exposures. Risk assessment of banks is carried out on the basis of CAMELB factors (capital, assets, market risk, earnings, liabilities and business) covering business risk and COM factors (internal controls, organisation and management). The supervisory process is divided into three phases, *viz*., risk assessment phase, tools of supervision and risk evaluation phase. The concerns identified by off-site analysis are supplemented by one or all of the tools of supervision, i.e., accountants reports, traded markets team visit, risk review team visit, liaison with overseas regulators, prudential and ad-hoc meetings with the banks. The risk-based supervisory process is dynamic, in that the analyst receives new information throughout the process. This may cause the analyst to adapt or revise supervisory actions and initiatives throughout the supervisory period.

France: Supervision over the banking system is carried out by the French Banking Commission known as Commission Bancaire. The off-site monitoring system involves prudential regulation of banks on five parameters, *viz*., minimum capital and reserves, liquidity, large exposures ratio, solvency ratio and capital adequacy ratio. Quarterly monitoring of bank's compliance with the prescribed guidelines is done and any violations are taken up with the bank. The returns received from banks include prudential ratios, balance sheet and off-balance sheet exposures, and profit and loss accounts. While prudential ratios and balance sheet are received on quarterly basis (some of the institutions submit them on monthly basis), profit and loss account and prudential ratios like capital adequacy and solvency ratios are required to be submitted on half-yearly basis. In addition to the above off-site returns received from the supervised institutions, the Commission also receives two reports relating to internal controls containing details of internal control policies every year. The off-site information is supplemented by on-site inspection reports. Actions under off-site surveillance are preventive measures like advising bank management, resorting to on-site inspection and other measures and disciplinary sanctions.

Singapore: Bank supervision in Singapore is the responsibility of the Monetary Authority of Singapore (MAS). The authority's off-site monitoring system complements and provides the basis for continuous supervision of banks. Under the off-site system, the MAS has prescribed a set of returns of varying periodicity (monthly, quarterly and annual). The returns cover the capital adequacy, asset quality, statutory liquidity, connected lendings, call money borrowings, negotiable certificates of deposit, balance sheet, large borrowers, profit and loss account, foreign exchange business transacted and loan syndication. The returns are analysed by a team of off-site analysts, each analyst being responsible for a portfolio of banks. The results of the off-site analysis are conveyed to the on-site examination division. Specific concerns arising out of the off-site analysis are also investigated through targeted appraisals carried out by on-site examination teams.

Hong Kong: The Hong Kong Monetary Authority (HKMA) is entrusted with the responsibility of promoting general stability and effective working of the banking system under the Banking Ordinance. A member of off-site team is assigned to supervise a portfolio of banks as a Case Officer and to do all related off-site supervisory work. The HKMA's approach is that of continuous supervision through a combination of on-site inspection, off-site reviews and prudential meetings. HKMA collects monthly/quarterly prudential off-site returns covering assets and liabilities, profit and loss, capital adequacy, liquidity, large exposures, loan classification, maturity profile

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of assets and liabilities, foreign exchange position, interest rate risk, country risk, market risks and a certificate of compliance with various requirements under the law. These returns are called either on an individual basis, or combined or in the case of capital adequacy, liquidity and large exposures, on a consolidated basis. The accuracy of submitted returns and the quality of systems are regularly scrutinised by external auditors, besides by the HKMA's on-site supervisors. There is a CAMEL rating system in place to trigger discriminatory supervision. Off-site examiners use the data to make regular (at least annual) off-site reviews, which result in a CAMEL type rating and they also set the triggers for each bank or bank group. Where there are causes for concern, the reviews are more frequent. The off-site examiners also run regular reports mirroring bank performance on the bank data.

United States: In the US, the Board of Governors of Federal Reserve (FED) is responsible for supervising national banks. The Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of Currency (OCC) are responsible for supervision of other types of banks. The supervision is basically conducted by a very strong on-site examination. This is supplemented by the off-site surveillance process called the Financial Institutions Monitoring Systems (FIMS), which is used to track the financial condition of individual banks and banking organizations between on-site examinations. Based on the call reports, which cover the entire gamut of banking operations including Capital Adequacy, Asset Quality, Earnings and Large exposures, received from the bank, the FED prepares a Uniform Bank Performance Report (UBPR) bank-wise or bank-holding company (BHC)-wise. UBPR covers five quarter' data. This report is generated at quarterly intervals and forwarded to banks/ BHCs. The report covers all the important supervisory indicators. Comparisons with the peer group are also provided. Peer group is arrived at on the basis of asset size of the existing banks and newly established banks are grouped separately.

India: In India, as part of the new supervisory strategy piloted by the Board for Financial Supervision (BFS), the Reserve Bank set up an Off-Site Monitoring and Surveillance system (OSMOS) in 1995 in order to supplement the existing system of on-site inspections and to provide a means of closer and continuous monitoring of bank performance. Under OSMOS, banks are required to submit quarterly and half-yearly returns on several aspects of financial performance, including asset quality, capital adequacy, large exposures, connected lending, ownership patterns, etc. As a move towards further strengthening the off-site monitoring process, a second tranche of four returns covering liquidity and interest rate risk in local and foreign currencies has recently been introduced. A return covering critical information about the operations of Indian subsidiaries of banks has been introduced, effective quarter ended September 2000 as a move towards consolidated supervision of banking groups**.** Standard reports and detailed individual and systemic analyses are carried out and shared with the Bank Monitoring Divisions of respective banks to initiate timely supervisory intervention.

Off-site surveillance in different economies has evolved over a period of time, depending on the country's financial system and their level of development. As the supervisory framework acquires greater sophistication, it is expected that the off-site surveillance will acquire greater prominence for developing policy positions that are both relevant and beneficial.

supervision', the overall compliance burden under the RBS framework is likely to be largely rationalised.

1.82 To develop an overall plan for moving towards RBS, international consultants were appointed. They completed Phase 1 of the project by conducting a review and evaluation of the current supervisory and regulatory framework, policies, guidelines, instructions, tools, techniques, systems, available IT infrastructure and various internal and external linkages. The thrust of the Phase 1 recommendations is on enhancements to the regulation and supervision framework leading to increased effectiveness of overall supervision through greater focus on risk as well as a realignment of the inspection process to fall in line with a more risk-based approach. Their recommendations cover vital areas, such

as, data management, supervisory process, inspections, feedback to banks, external audit, etc. During Phase 2 of the project, the Consultants are expected to work out the practical and operational aspects of the above recommendations and suggest a new RBS framework including the sequencing of different stages and a time frame for implementation.

International Financial Standards and Codes

1.83 Against the background of financial and currency crises in some parts of South-East Asia, Mexico, Brazil and Russia, the systemic stability issues have come under a sharp focus. Best market practices, transparency and data dissemination have been increasingly viewed as important areas where standards, codes, and core principles need to be evolved and internationally accepted for adoption. India has recognized that fostering the implementation of standards is a means through which financial stability could be secured and maintained. In the context of the ongoing financial reforms and in the light of the country's economic circumstances and institutional and legal infrastructure, a Standing Committee on International Financial Standards and Codes (Chairman: Dr.Y.V.Reddy) was set up in December 1999 with the objective of laying down a road-map for aligning India's standards and practices with international best practices. The Standing Committee identified ten core areas and set up Advisory Groups for each of the areas, *viz*., international accounting and auditing, monetary and financial policies, banking supervision, fiscal transparency, securities regulation, insurance regulation, data dissemination, payment and settlement system, corporate governance and bankruptcy laws. The Groups are undertaking a review of standards, with reference to the Indian circumstances and the feasibility of implementation of international standards within a time frame, given the legal and institutional practices in India. The Advisory Group on Transparency in Monetary and Financial Policies (Chairman: Shri M.Narasimham) has submitted its report to the Chairman of Standing Committee on September 13, 2000. The Group has examined in detail issues related to the clarity of roles and responsibilities including transparency in monetary policy formulation and implementation. Further, the Advisory Groups on Banking Supervision (Chairman: Shri M.S.Verma), Insurance Regulation (Chairman: Shri R.Ramakrishnan) and Payment and Settlement System (Chairman: Shri M.G.Bhide) submitted the first part of their Reports in September 2000. The Report on "Banking Supervision" has taken an exhaustive account and given recommendations pertaining to four major areas in banking regulation, *viz.*, corporate governance in banks, transparency practices in Indian banking, supervision of cross-border banking and internal rating practices adopted by banks. The Report on "Insurance Regulation" mainly deals with the various provisions relating to licensing of insurance companies in the light of standards set by the International Association of Insurance Supervisors (IAIS) and the Twenty Insurance Guidelines issued by OECD. The Report on "Payment and Settlement System" has dealt with issues pertaining to the inter-bank payment and settlement system covering Core Principle and Central Bank responsibilities. The reports have been placed on the Bank's web-site for wider public information and debate.

Prompt Corrective Action

1.84 Worldwide, there is an increasing movement towards building a safe and sound banking system, backed by a strong supervisory regime. This is in accordance with one of the *Core Principles for Effective Banking Supervision*, which mandates that banking supervisors must have at their disposal adequate supervisory measures, backed by legal provisions, to bring about timely corrective action. Such a phenomenon has

prompted the supervisory authorities to consider the possibility of introducing a system of Prompt Corrective Action (PCA) in India. The response has been dictated by two major considerations. The first is the responsibility of bank supervisors to identify problem banks at an early stage. The other is to monitor the behaviour of troubled banks in an attempt to prevent failure or to limit losses or contagion.

1.85 In view of the above considerations, a system of PCA with various trigger points and mandatory and discretionary responses by the supervisors is envisaged for the banking system in India. In addition to CRAR, two additional indicators, *viz*., 'Net NPA' and 'Return on Assets', reflecting asset quality and profitability, respectively, have been included under the broader PCA regime. Trigger points have been proposed under each of the three parameters, taking into account the practicality of implementation of certain measures in the Indian context. For CRAR, three trigger points have been proposed - CRAR of greater than or equal to 6 per cent, but less than 9 per cent; greater than or equal to 3 per cent but less than 6 per cent; and less than 3 per cent. For Net NPAs, two trigger points have been proposed - greater than 10 per cent but less than 15 per cent; and 15 per cent and above. For ROA, the trigger point has been set at less than 0.25 per cent. A discussion paper on PCA has been put on the Reserve Bank's web-site for wider circulation, inviting suggestions and comments from banks and others.

Non-Performing Assets

1.86 The level of NPAs of the banking system in India has shown an improvement in recent years, but it still remains high. A significant part of the problem arises on account of the carry-over of old NPAs in certain sun set industries. The problem is often complicated by the fact that there are a few banks which are fundamentally weak and where the potential for return to profitability, without substantial restructuring, is doubtful. The resolution of the NPA problem requires greater accountability on the part of corporates, greater disclosures in the case of defaults, and an efficient credit information system. Action has been initiated in all these areas, and it is expected that, with the help of stricter accounting and prudential standards and appropriate legal support, NPAs will be effectively contained.

1.87 The problem of NPAs is closely tied to the issue of legal reforms. Recognizing that the legal framework pertaining to the banking system might act as an impediment to its efficient functioning, initiatives have been taken to align the legal setup with the requirements of the banking system. The legal framework is a key ingredient for limiting moral hazard. Given the high transactions costs of finality of settlement, including legal costs, there is an urgent need for developing workable laws on contract, collateral and bankruptcy proceedings and to implement and streamline court procedures for seeking effective and rapid remedies under these laws. The issue would assume greater importance as economic liberalization gathers momentum. Otherwise, the continual state of innovation and evolution of new financial products in the liberalization process would outpace the existing legislation and raise the need for implementing fine and sharper points of law. It is, therefore, essential that the requisite legal framework is quickly put in place.

1.88 In India, the issues pertaining to legal framework have been examined by the Expert Group under the Chairmanship of Shri T.R.Andhyarujina, former Solicitor General of India. The Group, in its Report submitted in February 2000 to the Government recommended, among other things, the creation of a new law granting statutory power of

possession and sale of security directly to banks and FIs and adoption of the draft Securitisation Bill. It has also suggested the provision of additional avenues of recovery of dues to banks and FIs by empowering them to take possession of securities and sell them for recovery of loans. The Report is under consideration of the Government.

Corporate Governance

1.89 Experience of various countries with regard to bank failures has clearly identified inadequate/inefficient management as one of the principal factors. Banking supervisors therefore seek, as one of their key tasks, to enhance the quality of corporate governance in bank management. The corporate governance structure of the bank needs to be transparent and consistent, striking a balance between promoting safe and sound banking, on the one hand, and the flexibility required for effective competition, on the other. The Basle Committee has also mentioned in one of its *Core Principles* that supervisors should encourage and pursue market discipline by encouraging good corporate governance (through an appropriate structure and set of responsibilities for a bank's Board of Directors and senior management), and enhancing market transparency and surveillance.

1.90 The Advisory Group on Banking Supervision (Chairman: Shri M.S.Verma) observed that while ownership of banks is not an important issue in establishing corporate governance practices, the extent of compliance of the standards of corporate governance varies from bank to bank. The salient recommendations of the Group are given below.

(i) All banks should attain an acceptable minimum level of corporate governance. Subsequently, banks may make a sustained progress towards achieving the best international standards within a reasonable timeframe.

(ii) The unions and the management should achieve a consensus on converting the present performance-unrelated uniform remuneration structure fixed for all PSBs and at all levels of management into performance-related remuneration structure.

(iii) A comprehensive risk management system should be put in place in all banks within two to three years. Since banks are in different stages of implementation of risk management systems, small banks, in particular, would require encouragement and technical support to undertake risk management practices.

(iv) The statutory provision (Section 20 of the B.R. Act, 1949) prohibiting connected lending to directors and their connected parties needs to be extended to include large shareholders.

(v) Banks need to develop mechanisms for ensuring percolation of corporate strategic objectives and set values throughout the organisation.

(vi) Since Boards of very few banks are known to enforce clear lines of responsibility and accountability for themselves, there is an urgent need to follow the best practices in the banks in respect of constitution and functioning of the Boards. While nominating individuals on banks' Boards, the practice of pre-induction

briefing or post-induction orientation can be put in place forthwith to develop a proper appreciation of their role in the banks' corporate governance. A ceiling needs to be imposed on the number of Boards and the number of Committees a Director can work at a time, since members of Board of Directors are required to give their valuable time to the governance of banks.

(vii) With a view to conducting corporate governance in a transparent manner, public disclosure in respect of details of qualifications of the Directors needs to be revealed in the balance sheet. Banks also need to be encouraged to disclose the senior management structure, basic organisational structure, information about incentive structure, and nature and extent of transactions with affiliated and related parties.

(viii) The legal processes also need to be strengthened to facilitate corrective action like removal of the incompetent management.

1.91 The Group, however, noted that the guidelines and norms for good corporate governance in banks and overall responsible corporate governance are still in formative stages and healthy conventions do not exist. Laws which can be seen as supporting or facilitating corporate governance are also yet to be framed. It will, therefore, take time to enact tenets of good governance in a piece of legislation.

1.92 Compliance with regulatory prescriptions is a minimal requirement of good corporate governance and what is required are internal pressures, peer pressures and market pressures to reach standards far higher than those prescribed by regulatory agencies (Box I.6).

Box I.6: Corporate Governance in the Banking Sector

Under corporate governance, banks articulate corporate values, codes of conduct and standards of appropriate behaviour etc, and have systems and controls to ensure compliance with them. The Board sets the strategic objectives and corporate values of banks and specify transparent lines of responsibility and accountability, which are communicated throughout the organisation. The Board and the top management meet at specified intervals for timely exchange of information on the bank's financial condition and management practices.

It is, therefore, possible to identify different sets of players in the corporate governance system. There is a dynamic balance among them that determines the prevailing corporate governance system depending on the stage of institutional development and the historical development. Two aspects of financial systems in other countries emerge as particularly important in determining the operation of corporate governance, *viz*., ownership of the corporate sector and the structure of corporate Boards. In UK, more than 60 per cent of issued equity is held by financial and non-financial corporations. In US, on the other hand, shareholdings have until recently been held mainly by individuals. In Japan, the groupings can be classified into former *zaibatsus*, new bank-centred groups and manufacture-centred groups. In Germany, most groupings are industry-based but there are also bank and insurance-based groupings. In Sweden, groupings are predominantly family-controlled. With regard to structure of corporate Boards, several authors have observed that carefully designed Board structures prevent hostile takeovers from taking place.

Since banks are important players in financial system in India, special focus on the corporate governance in the banking sector becomes critical. Secondly, the Reserve Bank, as regulator, has responsibility on the nature of corporate governance in the banking sector. Thirdly, to the extent that banks have systemic implications, corporate governance in the banks is of critical importance. Fourth, given the dominance of public ownership in the banking system in India, corporate practices in the banking sector would also set the standards for corporate governance in private

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sector. Finally, with a view to reducing the possible fiscal burden of recapitalising the PSBs, attention towards corporate governance in the banking sector assumes added importance since PSBs must be in a position to assure the market that their system of corporate governance is such that they can be trusted with shareholders' money.

It is important in this context to examine the regulatory issues under Government ownership that interact with the corporate governance practices in India. The first issue is that of enhancing corporate governance in banks. However, the usefulness of the common supervisory mechanism would require strengthening internal controls and facilitate monitoring by focusing on a few identifiable parameters.

Secondly, the approach of the Reserve Bank to regulation has some features that would enhance the need for and usefulness of good corporate governance in the banking sector. The transparency aspect has been emphasised by expanding the coverage of information, timeliness of such information and the analytical content in various publications. Further, interaction with market participants has been intensified both at informal level and formal fora, like advisory committees.

Thirdly, there is an issue of institutional structure for regulation. The basis of the institutional approach is to cover institutions, irrespective of business, which is convenient from the prudential angle. This contrasts with the functional approach to regulation which seeks to control business activity, irrespective of institutions. In reality, there is an overlap and over time, such overlap between institutions and business are bound to become increasingly complex. In view of the above, it is deemed essential to review and identify a model that is suitable in the Indian conditions and is consistent with future needs.

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Streamlining the Banking Procedures

Importance of Audit Procedures

1.93 The system of audit plays an important role in ensuring a proper functioning of the banking system. The need for external audit in maintaining the soundness of the banking system is being increasingly felt, particularly after the recent experience of many East Asian countries. In India, auditors nominated by the Reserve Bank have been playing a crucial role in ensuring the overall soundness of the banking system. However, the system of audit needs to be made more extensive, accountable and brought in line with the internationally accepted standards.

Transparency and Disclosure

1.94 One of the characteristic features of a perfectly competitive market model is the free flow of information or the transparency of business operations. Transparency not only helps the creditors to make optimal decisions regarding their investment portfolio, but also imposes market discipline on banks to perform well in a competitive manner (Box I.7).

Internal Controls

1.95 Cumbersome loan and documentation procedures in banks impinge on the efficient functioning of the banking sector. It is,

therefore, vital that internal controls, which consist of a wide spectrum of internal inspection and audit, observance of manuals and procedures, submission of control returns by branches/controlling offices to higher level offices, visits by controlling officials to the field level offices, simplification of documentation procedures and efficient inter-office communication channels, are substantially strengthened. The Reserve Bank

Box I.7: Transparency Practices in Commercial Banks

Transparency of banking operations plays an important role in ensuring effective market discipline, a potentially crucial mechanism for keeping banks prudent. This particularly helps investors and depositors to ascertain the true health of financial entities and assist policy makers to initiate timely and adequate remedial action when required. Transparency, in the context of the banking operations, may be defined as public disclosure of reliable and timely information that enables the users of that information to make an accurate assessment of a bank's financial condition and performance, business activities, risk profile and risk management practices.

In a liberalised economic framework, market discipline constitutes a critical pillar of supervision of commercial banks, together with minimum capital requirements and supervisory review of capital adequacy. Under certain circumstances, market mechanisms complement supervisory efforts by rewarding banks that adopt prudent business strategies and penalising those that do not. Public disclosure encourages safe and sound banking practices and acts as a deterrent to imprudent risk taking while providing incentive for effective risk management. Market discipline, however, can be effective only if market participants have access to timely and reliable information which enables them to assess correctly a bank's activities and the risks inherent in those activities.

Systematic transparency in the working of the banking sector enhances the stability of a financial system. A regular flow of information keeps market agents aware of the situation and prevents sudden unpredictable reactions. Public disclosure also helps limit the contagion of a run on a bank by allowing the market to distinguish between banks that are genuinely vulnerable from those that are not. If disclosure norms are universally implemented, whereby banks provide comprehensive, accurate, and timely information on their financial conditions, performance, risk exposure, etc., a sound and well managed bank stands to benefit, e.g. in accessing the capital market and in developing immunity to contagion. However, while piecemeal implementation does not ward off the threat of the 'contagion effect', systemic stability would be impaired if adverse information about weak banks becomes public knowledge all of a sudden. Hence, complete transparency would need to be gradually put in place. Further, operational risks associated with certain activities cannot be unambiguously quantified, so that disclosures in this respect may not always give a clear picture to the market. Riskiness of a bank's portfolio must also be viewed in the context of its risk appetite and its risk management skills. These again tend to be somewhat subjective in nature so that an exact quantification is not possible. In such cases disclosure alone would not lead to transparency.

The Transparency Sub-group of the Basle Committee on Banking Supervision (BCBS) identified six qualitative characteristics of the information disclosed by banks that are critical for ensuring that such disclosure leads to transparency regarding the operation of banks. These characteristics include comprehensiveness, relevance, timeliness, reliability, comparability and materiality. Comprehensiveness of information relates to the scope or span of activities covered by such information. The supervisor should seek information about the different activities undertaken by banks by themselves or through subsidiaries and the risks associated with these activities. Relevance is the characteristic that distinguishes facts, qualitative or quantitative, from information and in order to be relevant, information must be timely. Reliability of information depends on its factual accuracy and freedom from bias in presentation. As regards comparability, information disclosed must be comparable on two fronts. First, it must be comparable for the reporting entities, to enable the market mechanism to distinguish between 'good' and 'bad' banks. Second, it must be comparable across time for the supervisor to be able to gauge the trends in the performance of banks. The onus for ensuring comparability, therefore, rests to a large extent with the supervisor. Finally, information

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is material if its omission or misstatement could change the assessment or decision of a user relying on that information.

The goal of achieving transparency has become more challenging in recent years as banks' activities have come to include many new areas of financial operations and become more complex and dynamic. The Narasimham Committee II, recognising the importance of adequate disclosure norms for the Indian banking sector, noted that there is a need for disclosure, in a phased manner, of the maturity pattern of assets and liabilities, foreign currency assets and liabilities, movements in provision account and NPAs. The Reserve Bank accordingly, instructed banks to provide information regarding these items, except movements in provisions, in their 'Notes on Accounts' to their balance sheets with effect from March 31, 2000. The Committee also suggested that full disclosure would also be required of connected lending, lending to sensitive sectors and loans given to related companies in the banks' balance sheets. Banks would be required to publish half-yearly disclosure statements. There should be a general disclosure, providing a summary of performance over a period of time, say 3 years, including the overall performance, capital adequacy, information on the bank's risk management systems, the credit rating and any action by the regulator/supervisor. The disclosure statement should be subject to full external audit and any falsification should invite criminal procedures. The Reserve Bank agreed with these recommendations in principle and referred them to the Audit Committee of the Board of Financial Supervision. With a view to discouraging false/inaccurate disclosures by banks, the Reserve Bank can impose a penalty, as recommended by the Committee. The banks had earlier been advised to disclose CRAR, the level of net NPAs, the ratio of net NPAs to net advances, break-up of the provisions made towards NPAs and depreciation on investments.

Consequent to the implementation of the recommendations of the Narasimham Committee II, the standards of disclosure of Indian commercial banks have moved closer to the international best practices including the standards set by the BCBS. The process of expansion of the ambit of statutory disclosure continues.

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issued guidelines in June 1999 to banks to strengthen the internal control system by setting up Electronic Data Processing audit cell in computerised branches/offices. Besides, banks have been advised to constitute Audit Committees of the Boards to enable focussed attention by the Boards on internal control systems. It is now time that such a control system is implemented, even though they necessitate revisions in the 'Operational Manuals', audit procedures and better evaluation of clients. A few banks seem to have already initiated steps in this direction but these efforts need to be enhanced throughout the banking system.

Information Technology

1.96 Information technology (IT) has wide ramifications for an entire gamut of issues concerning the banking sector. The growing internationalisation of banking operations necessitates flexibility in financial policies to raise and sustain economic growth. In this context, the switchover from manual operations to reliable and time-saving operations has to be rendered possible through appropriate application of IT. Secondly, seamless integration of applications and systems is crucial to ensure smooth passage of inter-related transactions over the electronic medium

for facilitating greater integration of various markets. Thirdly, developments in IT have contributed to devising complex financial products, such as, derivatives which in turn, has expanded the options for both savers and investors, in terms of asset preferences and risk profiles. Coupled with improvements in communications infrastructure, this is expected to give rise to efficiency advantage over a period of time and to act as a driving force for gradually reducing the digital divide between the rural and urban segments of the society.

1.97 However, several areas would need to be addressed before IT can act as a catalyst for enhancing financial development. In the highly industrialised countries, access to financial entities is increasingly on an on-line basis with virtual banking gaining in prominence. In India, while the pace of technological upgradation would need to be accelerated to attain international standards, large investment requirements of the IT sector, particularly in banking, often acts as an impediment towards undertaking full-fledged computerisation of branches. It would be useful if banks devise a roadmap for networking 'critical offices', defined in terms of their volume, diversity and scope of work, so as to ensure coverage of a certain minimum quantum of business, with customer service as the main focus in the medium-term. Secondly, under the payment system, claims to various parties are interlinked which create potential risk problems, especially if the systems are too 'open'. As a result, smooth functioning of the payments system requires the integration of work processes, communication linkages and integrated delivery systems with focus on stability, efficiency and security. While adopting the relevant security standards for India, the specific requirements of the Indian banking system would need to be kept in view. Finally, to enhance further appreciation of IT applications, banks would need to proactively address issues that help set up an efficient MIS through adoption of modern IT methods. To ensure sustained use of IT, institution of appropriate systems and procedures in commercial banks, and effecting requisite shifts from the written manuals to manuals in electronic form would be imperative.

Entry of Banks into Insurance Business

1.98 The IRDA Act, 1999, has been enacted against the background of the widely recognised need for opening up of the insurance sector. Banks, with their wide branch network, particularly in the rural areas, and with available manpower, would like to utilize this opportunity in mobilising sizeable funds of long-term nature, which could finance infrastructure projects having long gestation periods. However, international experience clearly reveals that insurance business may not break-even during the initial years of operations. It would, therefore, be necessary for banks to have adequate financial strength to commence this activity. Insurance business also requires product designing skills and actuarial expertise, and banks may be required to enter into joint ventures with foreign insurance partners. The entry of banks into insurance would, however, raise a number of other issues of overlap between banking and insurance business which have been recognized in India as very critical. These would need to be addressed as experience is gathered and as situations develop in this overlapping business activity (Box I.8).

Financial Innovations

1.99 The financial services industry in India has witnessed a phenomenal growth, diversification, transformation and specialisation since the initiation of financial sector reforms. The industry has gained in depth and sophistication following the entry

of new products, including, among others, take-out finance and securitisation.

Take out Finance

1.100. In order to meet long term financing requirements of infrastructure projects, FIs/ banks have been taking recourse to new products and in this context, take-out finance is one of the emerging products. The Reserve Bank has issued guidelines to banks

Box I.8: Insurance and Banking – Issues of Overlap

Insurance may be defined as a 'social device whereby a large group of individuals, through a system of contributions, may reduce or eliminate certain measurable risks of economic loss common to all members of the group'. Insurance involves the transfer of *potential* losses to an insurance pool. The pool combines all the potential losses and then transfers the cost of the *predicted* losses back to the exposures. Thus, insurance involves the transfer of loss exposures of several entities into a common pool, and the redistribution of the cost of actual losses among the members of the pool. The intermediary in the process, which collects premia (payment for the purchase of insurance) from individual entities with risk exposures and pays compensation to the ones that actually suffer the loss insured against, is the insurer. The insurer is a risk taker who accepts the risks of others and earns a profit given by the difference between the total premium collected from the buyers of insurance and the total payment made on account of compensation for losses.

Whenever the contract period of an insurance contract covers a long time, as is the case with life insurance, premium payments have two components. The first is the payment for risk coverage and the second goes towards savings. The saving component of life insurance results in enhanced competition between the insurer and other financial intermediaries like banks offering different savings instruments. It may be noted here that the combination of risk coverage and savings is peculiar to life insurance, especially in developing countries.

The progressive expansion of the insurance sector in India has certain implications for the banking industry. The overlaps between banking and insurance business implies that, on the one hand, the two can be competitors and hence substitutes of each other, and on the other hand, they can complement each other as well.

Banks are the chief purveyors of financial services to a very large number of individuals and small borrowers. On account of their geographical reach and access to customers, banks could be used as channels for the distribution of insurance products. Since banking services, insurance selling and fund management are all interrelated activities and have inherent synergies, selling of insurance by banks would be mutually beneficial for banks and insurance companies. In Europe this synergy between banking and insurance has given rise to a novel concept called '*bankassurance*'. Also known as 'Alfinanz', bankassurance can be defined as a package of financial services that can fulfil both banking and insurance needs at the same time. For instance, financial services companies offer a whole gamut of financial products that include banking services, motor insurance, home finance, life insurance and pensions.

Many European markets have put bankassurance into practice. In France more than 50 per cent of life insurance is sold through banks. In the United Kingdom a large number of banks deal with insurers as providers of products. In the USA, banks lease space to insurers and retail products of multiple insurers. In India too, banks have been offering personal accident and baggage insurance directly to their credit card holders as value addition to their products.

In developed economies, the collaboration between banking and insurance is brought about by several means. Banks like the Deutsche Bank and the Credit Agricole have entered the insurance market by starting their own insurance companies. Others like SE Banken (Sweden) and Lloyds Bank have chosen to buy stakes in already existing insurance companies. A third group of banks have chosen to swap shares with insurance companies, while some banks have resorted to mergers as means of making inroads into the insurance sector.

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Initiatives in this direction have not been one sided either. Insurance companies have also sought to acquire stakes in some banks.

In India the concept of bankassurance has been recognised with its inclusion in the broader ambit of universal banking. The Discussion Paper (RBI, 1999) states that in a very broad sense, 'Universal Banking' refers to the combination of commercial banking and investment banking. In other words, universal banks refer to those banks that offer a wide range of financial services, beyond commercial banking and investment banking, such as insurance.

The guidelines issued by the Reserve Bank in April 2000 permitting banks to enter the insurance market emphasise the symbiotic aspect in the relationship between commercial banks and insurance companies. As per the guidelines, commercial banks, depending on their satisfying specified eligibility criteria, can take any of the three routes: i) undertake distribution of insurance product as an agent of insurance companies on fee basis, ii) make investments in an insurance company for providing infrastructure and services support, or iii) set up a joint venture company for undertaking insurance business with risk participation. The Advisory Group on Insurance Regulation (Chairman: Shri R.Ramakrishnan), in its Report submitted to the Chairman of the Standing Committee on International Financial Standards and Codes in September 2000, noted the possible future role of co-operative credit institutions in spreading insurance business in rural areas. Similarly, the distribution of insurance products was one of the areas that co-operative banks could undertake to diversify their portfolios as per the recommendations of the Task Force to Study the Co-operative Credit System and Suggest Measures for its Strengthening (Chairman: Shri J.Capoor).

As per the Reserve Bank guidelines, banks are not allowed to conduct insurance business departmentally. Nor can they set up a separately capitalised subsidiary. There has to be an 'arms length' relationship between the bank and the insurance entity, so that risks inherent in insurance business do not contaminate the bank's balance sheet. Second, the guidelines have made a distinction between the banks which, by setting up joint venture companies, can 'underwrite' or perform the principal function and those banks which could only distribute insurance products, i.e., the agency function. Third, insurance companies will benefit from the wide net work of rural branches of commercial banks in India through the agency route while enabling banks to earn fee income.

The issue of regulatory overlap also comes to the fore when banks enter insurance business through setting up of joint venture companies. The guidelines, however, seek to eliminate any concern on this account. Whereas the holding of equity by a promoter bank in an insurance company or participation in any form in the insurance business is subject to compliance with the Government/IRDA regulations, the authority to grant case-by-case permission to banks to enter insurance business is vested with the Reserve Bank.

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and FIs on take-out finance. The FI/bank that finances infrastructure projects could have an arrangement with any FI for transferring to the latter the outstandings in respect of such financing in their books on a pre-determined basis. Take-out finance would be of help to banks in ALM, since the financing of infrastructure is long-term in nature against their predominantly short-term resource base. Take-out finance could be either unconditional of conditional. The take-out-finance products involve three parties *viz*., the project company, taking over institution and the lending banks/FIs. Banks, however, would have to assign the risk weights for calculation of CRAR and application of other prudential norms, as advised by the Reserve Bank.

Securitisation

1.101. A prominent development in international finance in recent years has been the growing importance of securitisation. Securitisation can be best described as structured financing in which assets, having a stable and predictable stream of cash payments, can be monetised through a public offering or private placement of securities in the capital markets and which are secured by, and dependent in part upon, the assets securitised and their related cash flows. In effect, securitisation is a combination of traditional secured financing and securities offering, involving the issuance of asset-backed securities. Virtually every asset that has a predictable stream of cash payments could be securitised (Box I.9).

1.102 The Reserve Bank, considering the evolving situation in this area and the need for reducing risks for the banks, appointed an in-house Working Group on Asset Securitisation (Chairman: Shri V.S.N. Murty) in June 1999 to examine the applicability of securitisation to the Indian financial system. The Group, in its Report submitted in December 1999, categorised the recommendations into short-term, medium-term and long-term, with a definite time frame for implementation in each category. It suggested that securitisation should be appropriately defined to lend uniformity of approach and restrict the benefits provided by law/regulation for genuine securitisation transactions. The recommendations also include rationalisation/ reduction of stamp duties, inclusion of securitised instruments in Securities Contracts (Regulation) Act, 1956, removal of prohibition on investment in mortgage-backed securities by mutual fund schemes, tax neutrality of SPV, etc. As medium-term measures, the Working

Box I.9: Securitisation

Securitisation involves the process of pooling and re-packaging of homogeneous illiquid loans into marketable securities and distributing to a broad range of investors through capital markets. In the process, the lending institution's assets are removed from its balance sheet and are instead funded by investors through a negotiable financial instrument. Increased pressure on operating efficiency, market niches, competitive advantages and capital strength provide impetus for change. Securitisation has emerged as one of the solutions to these challenges.

Although relatively new in European and other countries, asset securitisation as a structured financing technique had its genesis in the US in the late 'seventies. Securitisation evolved rapidly throughout the 'eighties and 'nineties to become one of the dominant means of capital formation. As of 1995, securitisation accounted for more than US $ 450 billion of financing per year and more than US $ 2 trillion in financing outstandings in the US.

The core concept of securitisation pertains to the segregation of the assets to be securitised from the credit risk of entities involved in financing, except,

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in some instances, for FIs, which provide credit enhancement for the securitised assets. Assets to be securitised are transferred by the asset owner (the originator or transferor) to a special purpose vehicle (SPV) as the asset purchaser. The SPV may be a corporation, trust or other independent legal entity. The SPV issues securities to public or private investors in the capital markets, which are backed (i.e. secured) by the cash payment streams generated by the assets securitised and by the assets themselves. The net proceeds received from the issuance of the securities are used to pay the transferor for the assets acquired by the SPV.

The principal advantage of securitisation is the separation of the transferor's credit risk from that of the SPV. By segregating its credit risk in securitisation, a transferor can access the capital market at a lower cost of financing because (a) significant differential exists between the stream of cash payments that can be generated by the assets segregated and the cost of securitisation, and (b) the credit of securitisation is based primarily on the credit of the source of the cash payment streams generated by the assets segregated and on credit enhancement, if any. In securitisation, investors focus mainly on the credit and liquidity of the assets securitised and on the structure of the financing - not on the transferor's credit risk.

Assets that have been securitised in structured financings in the US include, among others, mortgages, automobiles, aircraft, equipment and municipal leases, credit card receivables, hospital, retail and trade receivables, real estate, purchase contract for natural resource assets such as oil, gas and timber, student and home equity loans.

The principal disadvantage of securitisation is its complexity. Securitisation, typically being 'transaction-specific', is more costly to structure and implement than other more traditional forms of secured financing. Therefore, securitisation is an appropriate alternative to traditional secured financings only if the securitisation costs are lower than the cost of funds accessed in the public or private capital markets or if other material benefits are realised from the securitisation deal.

Most securitisation deals in India have been related to transport sector financing, while there have been some towards housing receivables. In India, securitisation dates back to 1991 when Citibank securitised auto loans and placed a paper with GIC Mutual Fund. Since then, a variety of deals have been undertaken. According to some estimates, 35 per cent of all securitisation deals between 1992 and 1998 were related to hire purchase receivables of trucks and the rest towards other auto/ transport segment receivables. These apart, SBI Caps structured an innovative deal in 1994-95, where a pool of future cash flows of high value customers of Rajasthan State Industrial and Development Corporation was securitised. The recent securitisation deal of Larsen and Toubro has opened a new vista for financing power projects. National Housing Bank (NHB) has also been making efforts to structure the pilot issue of mortgage backed securities (MBS) within the existing legal, fiscal and regulatory framework.

In October 1999, the Parliament was presented with amendment to the Securities Contracts (Regulation) Act that seeks to redefine 'securities'. The amended definition is broad and covers securitisation instruments also. The results of the amendment, when finally adopted, is expected to bring securitisation public offers under the regulation of the securities regulatory body.

In future, financial entities will be judged more by the informal strength and capital base rather than by the external support from the central bank or the government. Market penetration of financial institutions in the area of loan origination in future will be determined more by the volume of loans originated during a period than by the amount of loans owned at a particular point of time. As the structure of the financial system evolves over time, it is expected that securitisation will play a much more important role in the future.

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Group suggested the increased flow of information through credit bureaus, standardisation of documents, improvement in the quality of assets, upgradation of computer skills and exploring the possibilities of securitising NPAs. As a long-term measure, the Group underscored the need to develop insurance/guarantee institutions to give comfort to investors, especially in infrastructure/ mortgage sectors. Adequate disclosure norms have also been suggested to facilitate informed decision-making by investors. The Report also suggested that the Government might consider bringing out an umbrella legislation covering all aspects of securitisation. The Reserve Bank has set up an Implementation Committee for suggesting the framework for giving effect to the above recommendations.