Chapter I

Banking Developments and Perspectives

In recent years, the banking industry has been undergoing rapid changes, reflecting a number of underlying developments. The most significant has been advances in communication and information technology, which have accelerated and broadened the dissemination of financial information while lowering the costs of many financial activities. A second key impetus for change has been the increasing competition among a broad range of domestic and foreign institutions in providing banking and related financial services. Third, financial activity has become larger relative to overall economic activity in most economies. This has meant that any disruption of the financial markets or financial infrastructure has broader economic ramifications than might have been the case previously.

1.2 These developments have manifold consequences for the institutional and systemic structure of the financial sector in general and banking in particular. Directly issued securities are replacing bank deposits as a vehicle for savings. Markets for risk have emerged in which exposures to specific market or credit risks can be bought and sold separately from the underlying financial assets. The business profile of financial institutions is also undergoing change. The service traditionally associated with 'banking' is being offered by institutions not normally characterised as banks, while banks have gradually made forays into non-banking activities. Mergers and takeovers of smaller institutions have led to the emergence of transnational conglomerates, offering services ranging from traditional commercial banking to investment banking and insurance.

1.3 With increasing globalisation and blurring of distinction between different segments of financial intermediaries, there is a growing recognition that safeguarding the health of the financial system is of paramount importance for maintaining financial stability. Not surprisingly, the financial sector especially the banking sector in most emerging economies is passing through a process of change and India is no exception. With the banking sector being the mainstay of financial intermediation in emerging economies, developing a sound and healthy banking system through promotion of prudent financial practices is viewed as a *sine qua non* for safeguarding financial stability. The banking sector accounts for over half of the assets of the financial sector and remains dominant in India.

1.4 This Chapter provides an overview of the policy initiatives undertaken in the banking sector during the year 2000-01 and a perspective towards developing a stable, healthy, robust and efficient banking system.

1. Policy Environment Monetary and Credit Policy

1.5 The measures announced in the Monetary and Credit Policy Statement of April 2001 continued to focus on strengthening the financial system and improving the functioning of the various segments of financial markets driven primarily by four objectives:

(i) Deregulation of the operation of institutions subject to appropriate guidelines, within the Reserve Bank's regulatory ambit so as to enable them to evolve as efficient organisations in a competitive environment;

(ii) Tightening of the prudential norms within institutions to limit and manage risk in an optimal manner and to improve supervisory oversight so as to ensure the protection of interests of small deposits in the operations of individual institutions and stability of the system as a whole;

(iii) Increasing the transparency and improving the market practices with a view to improving overall efficiency as well as stability of markets; and

(iv) Enhancing the technological and institutional infrastructure for the financial markets, especially the money market with a view to, *inter alia*, increasing the effectiveness of monetary policy.

1.6 Important measures taken during the year to strengthen the prudential and supervisory norms and increase operational effectiveness of monetary policy are as follows:

(a) Liquidity Adjustment Facility

1.7 In April 2000, the Reserve Bank had announced a transition to a full-fledged Liquidity Adjustment Facility (LAF) in three progressive stages. The first stage involved the replacement of the Additional Collateralised Lending Facility (ACLF) for banks and level II liquidity support to Primary Dealers (PDs) by reverse repo auctions and the fixed rate repo by variable rate repos, effective June 5, 2000. The second stage envisaged replacement of Collateralised Lending Facility (CLF) and Level I support to PDs by variable rate repo auctions. After extensive consultations with experts and market participants, the policy statement of April 2001 announced the decision to move over to the second phase in graduated steps. For more effective functioning of LAF, certain changes were effected in the operating procedures. These included recasting of auction methods and periods, a strategy for smooth transition of call money market to pure inter-bank market and a comprehensive and coherent programme for rationalisation of liquidity support available to the system. Certain complementary and associated measures in money and government securities markets were also introduced so as to provide considerable operational flexibility to the market participants and facilitate further integration of money market. The second stage of LAF came into operation from May 8, 2001. The third stage envisages multiple auctions intra-day, which will become feasible with the proposed introduction of electronic transfers of funds and securities.

(i) Changes in Standing Liquidity Facilities and Introduction of Back-Stop Facility

1.8 The standing liquidity facilities available from the Reserve Bank have been split into two parts, *viz*., (i) normal facility and (ii) back-stop facility. Of the total limits of liquidity support available to PDs and banks, the normal facility constitutes about two-thirds and back-stop faciltity about one-third. The normal facility is being provided at the Bank Rate. The back-stop facility is being provided at a variable daily rate linked to cut-off rates emerging in regular LAF auctions and in the absence of such rates, to National Stock Exchange-Mumbai Inter-Bank Offer

Rate (NSE-MIBOR).

1.9 The limits to refinance of export credit have been fixed on the basis of total outstanding export credit eligible instead of the incremental export credit eligible over a base date. With effect from the fortnight beginning May 5, 2001, scheduled commercial banks are being provided export credit refinance to the extent of 15.0 per cent of the outstanding export credit eligible for refinance as at the end of the second preceding fortnight. The existing refinance limit as on May 4, 2001, as per the old formula would, however, constitute the minimum limit available for a bank up to March 31, 2002.

(ii) Changes in LAF Operating Procedures

1.10 The minimum bid size for LAF was reduced from Rs. 10 crore to Rs. 5 crore to add further operational flexibility to the scheme and enable participation by small level operators. To provide quick interest rate signals, when necessary, and to meet unexpected domestic or external developments, the Reserve Bank has an additional option to switch over to fixed rate repos. In addition to overnight repos, the Reserve Bank also has the discretion to introduce longer-term repos up to 14 days as and when required. Multiple price auctions (in place of the then existing uniform price auction) were introduced on an experimental basis for one month period during May 2001, and, on a review the practice has since been continued.

(b) *Complementary Measures for Efficient Functioning of LAF*

1.11 As a part of streamlining the LAF and improving the transmission channel of monetary policy, the following complementary and associated measures in respect of money and government securities markets were announced.

(i) Moving towards Pure Inter-bank Call Money Market

1.12 As announced in the Mid-term Review of October 2000, permission to corporates to route their call transactions through PDs was terminated effective July 1, 2001. Access of other non-bank institutions (*viz.,* financial institutions, mutual funds and insurance companies) to directly lend in call/notice money market would gradually be reduced in four stages. In the initial stage, effective from May 5, 2001, non-banks have been allowed to lend upto 85.0 per cent of their average daily lendings in the call market during 2000-01. From a date to be notified by the Reserve Bank, after the on-set of the last stage, non-banks would not be permitted to lend in call/notice money market.

(ii) Shortening of Minimum Maturity Period of Term Deposits

1.13 With a view to moving further towards deregulation and providing opportunities for non-banks to invest short-term surplus funds in a more flexible manner, and to enable banks to have more flexibility in their Asset-Liability Management (ALM), it was decided to reduce the minimum maturity period for wholesale term deposits of Rs. 15 lakh and above to 7 days from the earlier 15 days maturity, at the discretion of individual banks.

(iii) Relaxation in Daily Minimum Cash Reserve Ratio Maintenance Requirement

1.14 Effective from the fortnight beginning August 11, 2001, the maintenance of daily minimum requirement of Cash Reserve Ratio (CRR) has been lowered from 65.0 per cent to 50.0 per cent for the first seven days of the reporting fortnight while continuing with the minimum requirement of 65.0 per cent for the rest of the fortnight.

(iv) Interest on Cash Balances Maintained with the Reserve Bank under Cash Reserve Ratio

1.15 It was decided to align the interest rate paid on CRR to the Bank Rate in two stages. In the first stage, with effect from the fortnight beginning April 21, 2001, the interest paid on eligible balances was increased to 6.0 per cent. With effect from the fortnight begining November 3, 2001 the interest paid on eligible cash balances will be at Bank rate (i.e., 6.5 per cent).

(v) Exemption of Inter-bank Term Liability from Minimum Cash Reserve Requirement

1.16 Effective from the fortnight beginning August 11, 2001, inter-bank term deposits/term borrowings liabilities of original maturity of 15 days and above upto one year have been exempt from the prescription of minimum CRR requirement of 3.0 per cent. Besides, marginal saving on cost to banks, this measure is expected to help in developing inter-bank term money market.

(vi) Change in Treasury Bills Auction

1.17 With effect from the week beginning May 14, 2001, the auctions of 14-day and 182-day Treasury Bills were discontinued and the notified amount for the 91-day Treasury Bills auctions was increased to Rs. 250 crore from Rs. 100 crore. The notified amount in the auctions of 364 - day Treasury Bills continues to remain at Rs. 750 crore.

(vii) T plus 1 Settlement for SGL Settled Transactions

1.18 In anticipation of a move towards a Negotiated Dealing System (NDS), to be directly linked to the settlement system, all transactions settled through the Delivery *versus* Payment (DVP) system of the Reserve Bank were to be on T *plus* 1 basis with effect from June 2, 2001. Based on the feedback received from market participants, it was decided to postpone the date for introduction of T *plus* 1 settlement for SGL transactions in Government securities to make it coterminous with the introduction of NDS.

(viii) Rationalisation of Interest Rates on Export Credit

1.19 As regards the interest rate on export credit extended by banks, it was decided that a ceiling rate in respect of all categories was to be indicated, so that interest rate charged by the banks can be lower than the prescribed rate. It was decided to link such ceiling rates to the prime lending rates (PLRs) of respective banks available to their other domestic borrowers. The application of interest rates on export credit by banks will be on the basis of the relevant PLR prescribed by the bank. With the ceiling rate on Foreign Currency Non-Resident (Banks) (FCNR (B)) deposits being changed to London Inter-Bank Offer Rate (LIBOR) (instead of LIBOR *plus* 0.5 percentage point), the ceiling rate on foreign currency loans for exports by banks was revised to LIBOR *plus* 1.0 percentage point, to make this rate even more competitive. With effect from September 26, 2001, the Reserve Bank announced a reduction in the ceiling rate for export credit by 1.0 percentage point across the board for period upto March 31, 2002. Accordingly, the maximum rate that the bank could charge to exporters was revised to 2.5 percentage points below its PLR for pre-shipment credit upto 180 days and for post-shipment credit upto 90 days.

1.20 The salient features of the Mid-term Review are presented in Box I.1.

Government Securities Market

1.21 Several measures were taken to continue the momentum initiated by Reserve Bank for developing the Government securities market. One of the important steps is setting up of the Clearing Corporation of India Ltd. (CCIL) with State Bank of India (SBI) as the chief promoter and five other banks and financial institutions as co-promoters. The CCIL will act as a central counter-party in the settlement of all trades in Government securities, Treasury Bills, Repos and foreign exchange. The CCIL will facilitate clearing and settlement of Government securities and foreign exchange transactions by reducing the counter-party risk through multilateral netting of transactions. CCIL will clear transactions in repos and Government securities between its members reported on the Negotiated Dealing System (NDS) of the Reserve Bank and also the rupee-U.S. dollar spot and forward deals. The Reserve Bank has already opened current account and SGL account for CCIL and given approval for its membership to Indian Financial Network (INFINET). CCIL is putting in place the hardware and software and has held many meetings with banks for finalising operational procedures/modalities, changes to systems of member banks, etc. The first phase of the project is expected to go live in November 2001, alongwith the expected commencement of parallel run of NDS.

Box I.1: Major Policy Measures Announced in the Mid-term Review of Monetary and Credit Policy for the year 2001-02

I. Monetary Measures

(1) The Bank Rate was reduced by 0.50 percentage point from 7.0 per cent to 6.5 per cent with effect from the close of business on October 22, 2001.

(2) The Cash Reserve Ratio (CRR) was reduced by 200 basis points to 5.50 per cent from 7.50 per cent of net demand and time liabilities (NDTL). Effective from the fortnight beginning November 3, 2001, CRR would stand reduced to 5.75 per cent; and effective fortnight beginning December 29, 2001, the CRR will be reduced further to 5.50 per cent of NDTL. All the exemptions on the liabilities were withdrawn except inter-bank liabilities, for the computation of NDTL (for the purpose of maintenance of CRR) with effect from fortnight beginning November 3, 2001.

(3) With effect from the fortnight beginning November 3, 2001, the interest paid on eligible cash balances maintained with the Reserve Bank would be at the Bank Rate (i.e., 6.5 per cent).

II. Prudential Measures

(1) As a first step towards activating the Credit Information Bureau (CIB), it was decided to initiate the process of collection and dissemination of some Relevant information, within the existing legal framework. The Reserve Bank accordingly decided to constitute a Group drawing representation from CIB, Indian Banks' Association (IBA), select banks and FIs to examine the possibility of the CIB performing the role of collecting and disseminating information on the list of suit-filed accounts and the list of defaulters, including willful defaulters, which is presently handled by the Reserve Bank. The Group will also examine the other aspects of information collection and dissemination, such as, the extent, periodicity and coverage including

the feasibility of supplying such information on-line, to members in future and submit its Report within a month.

(2) In order to contain the risks arising out of non- SLR investment portfolio of banks and FIs, in particular through the private placement route, it was proposed to issue further prudential guidelines to be observed by banks. These guidelines, *inter alia*, would cover: (i) the need for strengthening of internal rating systems, periodically tracking the rating changes in respect of issuers; (ii) fixing of prudential limits, with separate sub-limits for unrated, unquoted and privately placed instruments; (iii) review by Board on total investments/disinvestments, regulatory compliance, rating changes in respect of issuers and non-performing investments; and (iv) disclosures in 'Notes on Accounts' regarding issuer composition and non-performing investments. It was also proposed to constitute a Working Group, which would submit its report within a month, to evolve a framework for collecting and sharing by banks/FIs of information on private placement of debt with CIB as a convenor, and representatives, *inter alia*, of banks, FIs and the Reserve Bank.

(3) It was decided that banks should furnish the following additional disclosures in the 'Notes on Accounts' in their balance sheets, from the year ending March 2002: (i) movement of provisions held towards NPAs and (ii) movement of provisions held towards depreciation on investments.

(4) Based on the feedback on the recommendations of the Working Group constituted by the Reserve Bank to evolve asset-liability management (ALM) guidelines for UCBs, guidelines will be issued to scheduled UCBs. In order to strengthen the supervisory mechanism, the Reserve Bank has since introduced off-site monitoring system for scheduled UCBs.

(5) It was proposed to allow UCBs to grant loans to individuals against security of shares, subject to the following parameters:

(a) Loans against shares/debentures may be granted to individuals to meet contingencies and personal needs or for subscribing to rights or new issues of shares/debentures or for purchase in the secondary market. Loans against primary/ collateral security of shares/debentures will be limited upto Rs.5 lakh, if the security is in physical form, and upto Rs.10 lakh, if the security is in demat form. Aggregate of all such loans should be within the overall ceiling of 20.0 per cent of the owned funds of the bank, and margin of 40.0 per cent should be maintained in all cases of such loans.

(b) It is essential that before accepting shares as security, UCBs should put in place a risk management system. UCBs should also have Audit Committee of their Boards of Directors and all the approved loan proposals should be placed before the Audit Committee at least once in two months. Details of loans sanctioned should be reported to the Board in the subsequent Board meeting. The Management and Audit Committees should ensure that all loans against shares are made only to those individuals who are not in any way connected with any stock-broking activity or stock-broking entity.

(c) UCBs which have outstanding loans to individuals can renew them upto permissible amounts beyond the contracted date on merits, subject to the above conditions.

(d) UCBs should ensure that there is no direct investment by them in either primary or secondary market under any circumstances.

(6) The time-frame for achieving the prescribed levels of SLR holding by UCBs was altered as follows:

Table : Category of UCBs Minimum SLR holding in government and other approved securities as per cent of NDTL

Category of UCBs	Minimum SLR holding in government and other approved securities as per cent of NDTL			
	Present	Earlier Proposed for March 31, 2002	Now Proposed for March 31, 2002	Now Proposed for September 30,2002
Non-Scheduled UCBs				
1. UCBs with NDTL of Rs.25 crore and above	10.0	15.0	12.5	15.0
2. UCBs with NDTL of less than Rs.25 crore	NiL	10.0	7.5	10.0
Scheduled UCBs	15.0	20.0	17.5	20.0*

(7) Banks were given the freedom to change the composition of working capital by increasing the cash credit component beyond 20 per cent, or to increase the 'loan component' beyond 80 per cent, as the case may be, for working capital limits of Rs.10 crore and above, if they so desire. Banks are expected to appropriately price each of the two components of working capital finance, taking into account the impact of such decisions on their cash and liquidity management.

* It may be clarified that so far as scheduled UCBs are concerned, with effect from April 1, 2003, the entire prescribed level of 25 per cent SLR holding has to be only in government and other approved securities.

1.22 The Reserve Bank has commenced an integrated project for complete automation of the operations of its Public Debt Office (PDO) which involves NDS and securities settlement systems (SSS). NDS will be an interface between the members (SGL account holders) and the PDO. NDS will facilitate electronic bidding in the primary market in Goverment securities and secondary market in Government dated securites, Treasury bills, Repos, call money, Notice/Term money, Commercial Paper, Certificates of Deposit, Interest Rate Swaps and Forward Rate Agreements. The entire system will operate in a networked environment and INFINET will provide the backbone for communication. The NDS fully integrated with the computerised PDO and CCIL, will lead to higher efficiency in trading, settlement and other improvements in services to investors in Government securities. In this regard, it has been decided to closely coordinate the work relating to NDS with the CCIL, and, in fact, place the whole system within the overall technological and institutional infrastructure for transactions in the financial sector, with which the Reserve Bank is intimately concerned. The NDS software application has been installed in LAN environment for testing and over 80 institutions have tested the software and given suggestions for improvements.Subsequently, the system is being tested in WAN environment with 5 market participants connected to the network.

2. Commercial Banking System-Supervisory Initiatives during the Year

Board for Financial Supervision

1.23 The members of the Board for Financial Supervision (BFS) and its Sub-Committee (Audit) appointed initially continued till the reconstitution of the Central Board of the Reserve Bank on November 27, 2000. Effective from December 21, 2000, a new Board has been formed comprising four Directors of Central Board of the Reserve Bank as members. The new Board would function for a period of two years. The BFS has reconstituted the Sub-Committee (Audit) on January 10, 2001.

1.24 During the period July 2000 to June 2001, the Board reviewed Inspection Reports of 27 public sector banks, a consolidated Report of Local Head Offices (LHOs) of SBI, 26 private sector banks, 50 foreign banks and six financial institutions. The Board also reviewed the monitoring relating to bank frauds and housekeeping in public sector banks, including reconciliation of entries in inter-branch accounts, inter-bank accounts (including nostro accounts) and balancing of the books of accounts. In addition, the Board reviewed the monitoring in respect of select all-India financial institutions and NBFCs. Besides delineating the course of action to be pursued in respect of institution-specific supervisory concerns, the Board also provided guidance on several regulatory and supervisory policy decisions.

1.25 The Board considered the Report of the "Informal Working Group on Supervision of Foreign Branches of Indian Banks". It was decided that scrutiny of foreign branches of Indian banks should be carried out by the Reserve Bank once in three years. The basic responsibility of inspection of their overseas branches has been left to the parent banks. The report along with a draft copy of memorandum containing implementation guidelines has been forwarded to the concerned banks. They have been advised to implement the reporting system with effect from April-June 2000 quarter. The banks with high percentage of NPA/ loss making feature are being monitored on a quarterly basis.

1.26 In the course of implementing the recommendations of the Working Group on Supervision of Overseas Branches of Indian Banks, all Indian banks having foreign branches were advised regarding the personnel policies to be followed in respect of officials posted to these foreign branches. Banks were required, in the light of these guidelines, to take adequate measures by amending their existing contractual agreements governing overseas postings / staff regulations / pension regulations, in consultation with their own legal experts.

1.27 The supervisory rating exercise of banks in vogue since the inspection cycle of 1998-99 was reviewed by a working group and on the basis of its recommendations, a revised rating model has been evolved which has reduced the, subjectivity elements.

1.28 A system of prompt corrective action (PCA) based on a pre-determined rule-based structured early intervention, has been proposed to be instituted as part of the constant efforts to enhance the existing supervisory framework. Under the proposed PCA, a schedule of corrective actions has been suggested based on three parameters, namely, Captial to Risk-weighted Assets Ratio (CRAR), net NPAs and return on assets (RoA). Certain trigger points have been determined for the PCA framework under the three parameters taking into account the practicability of implementation of certain measures in the Indian context. For every trigger point, a set of mandatory and discretionary actions has been proposed. These actions have been further divided into those which would be recommended to the Government for implementation and those which could be taken by the Reserve Bank. A copy of the scheme was sent to all scheduled commercial banks. Comments and suggestions received from various banks had been examined. As some of the actions under PCA will require approval on the part of Government of India, the proposed scheme has been forwarded to the Government for their views.

1.29 The position of reconciliation of outstanding entries under inter-branch accounts was submitted quarterly to the Board and based on the directions the position is monitored on a continuing basis. There has been considerable improvement in respect of reconciliation of entries pertaining to the period over six months.

Up-gradation of Off-site Monitoring and Surveillance Function

1.30 The off-site monitoring and surveillance system (OSMOS) was set up in 1995 with the primary objective of analysing the financial condition of banks in between on-site examinations. Banks are required to submit a total of 14 off-site returns to Reserve Bank. These returns include 7 returns in the first tranche that were introduced in March 1996, 4 ALM returns comprising the second tranche introduced in June 1999 and 2 annual returns *viz.*, balance sheet and bank profile statements prepared on the basis of audited figures. The last off-site return, introduced in September 2000, pertains to operations of domestic subsidiaries of banks.

1.31 In view of the enhanced data processing requirements, the increased number of users as well as the need for more sophisticated analytical tools, the Reserve Bank, with assistance from Department for International Development of the United Kingdom, launched a project in 1999 for upgradation of its off-site monitoring and surveillance function. The Systems Requirements Analysis report was prepared by M/s PricewaterhouseCoopers, London and the work pertaining to development of software for the project was out-sourced. The new OSMOS system having a data-warehousing component was successfully commissioned in January 2001. This has enhanced data storage, information retrieval and analytical capabilities.

Introduction of Half-Yearly Review for Public Sector Banks (PSBs)

1.32 Keeping in view, a long period of one year between the availability of two audited financial statements and with a view to getting timely feed-back about the financial position of the public sector banks, it was decided to introduce a system of half-yearly review of accounts of these banks, with effect from the half year ended September 30, 2001. The review would cover advances, provision for non-performing assets (NPAs), investments, income and expenditure items, etc., with the major thrust on verification of income and expenditure items rather than on balance sheet items. All PSBs are required to submit half-yearly review/report to the Reserve Bank in the format finalised in consultation with the Securities and Exchange Board of India (SEBI), within a period of 60 days from the close of the half year. Further, in compliance to clause 41 of the listing agreement, these review/reports are to be submitted by PSBs to the concerned Stock Exchange(s) where the PSBs shares have been listed.

Norms for the Statutory Central Auditors to be Appointed for the Private Sector Banks

1.33 There was no uniformity amongst private sector banks in regard to the appointment of their statutory central auditors (SCAs). Considering the fast changes that are taking place in the financial sector in general, and in the field of banking in particular, as also use of latest technology by some of the new private sector banks in their day-to-day operations coupled with the introduction of innovative products, the issue of prescribing minimum eligibility standards for the audit firms before approving their names as SCAs for Indian private sector banks was examined. Accordingly, with effect from 2001-02, the audit firms recommended by Indian private sector banks for appointment as their SCAs would have to satisfy prescribed standards relating, *inter alia*, to minimum standing, minimum number of full time partners associated with the firm, minimum number of chartered accountants exclusively associated with the firm, number of professional/audit staff as well as minimum statutory central audit experience. With a view to applying the prescribed minimum standards, Indian private sector banks have been classified into two categories on the basis of their asset size as on March 31 of the previous year, i.e., banks with an asset size up to Rs. 5,000 crore and those with assets above Rs. 5,000 crore.

Strengthening the Banking System

Capital Adequacy

1.34 Effective from the year ended March 2000, stipulation on minimum CRAR of scheduled commercial banks was increased by one percentage point to 9 per cent.

1.35 In addition to the existing 100 per cent risk-weight for credit risk, banks are required to assign a risk-weight of 2.5 per cent to cover market risk in respect of all securities including securities outside the SLR from the year ended March 2001.

1.36 The risk-weight of 100 per cent prescribed on staff advances was reviewed in the light of the safeguards available to the banks to effect recovery. It was decided that banks need to assign 20 per cent risk-weight on all loans and advances granted to their staff, which are fully covered by superannuation benefits and mortgage of flat/house.

1.37 Deposits placed with NABARD/SIDBI in *lieu* of the shortfall in banks' advances to the priority sector *vis-à-vis* the prescribed target were assigned a 100 per cent risk-weight as these deposits are in *lieu* of assets that carry a similar risk-weight.

Provisioning Norms

1.38 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. While recognising the need to give autonomy to banks for the assessment of risks associated with their asset portfolios, it was emphasised that provisions in excess of the amount required could be made by banks, keeping in view their own risk perceptions.

Recovery Management

1.39 In pursuance of the announcement in the Union Budget for 1999-2000, guidelines were framed for the constitution of Settlement Advisory Committees (SACs) for compromise settlement of chronic NPAs of small sector which were valid till September 30, 2000. While banks were required to take effective measures to strengthen the credit appraisal and post-credit monitoring to arrest the incidence of fresh NPAs, a more realistic approach was needed to reduce the stock of existing and chronic NPAs in all categories. The guidelines were, therefore, modified in July 2000, which provided a simplified, non-discretionary and non-discriminatory mechanism for recovery of NPAs. The revised guidelines, operative till March 31, 2001, were subsequently extended upto June 30, 2001 and for processing applications / cases, banks were given time up to September 30, 2001. All public sector banks were required to uniformly follow these guidelines, to maximise recovery of NPAs within the stipulated time.

Exposure Norms

1.40 As a prudential measure intended for better risk management and avoidance of concentration of credit risks, banks were advised to fix limits on their exposure to i) individual borrowers and group borrowers in India, ii) specific industry or sectors, and iii) unsecured guarantees and unsecured advances. Besides, banks are also required to observe certain statutory and regulatory exposure limits in respect of ‘advances against shares, debentures and bonds’ and ‘investments in shares, debentures and bonds’.

Credit Exposures to Individual/Group Borrowers

1.41 With effect from April 1, 2000, the ceiling on a bank’s exposure to an individual borrower was lowered to 20 per cent of the capital funds from the existing limit of 25 per cent with a view to moving closer to the international standard of 15 per cent in phases.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 the 20 per cent limit over a two-year period, (*i.e.,* by end-October 2001).

1.42 In April 2001, the Reserve Bank announced fresh guidelines in respect of the concept of ‘capital funds’, and measurement of credit exposure and the level of the exposure limit. The exposure ceiling is to be computed in relation to total capital in India as defined under capital adequacy standards (tier I and tier II), effective March 31, 2002. As in the case of funded exposure, non-fund based exposures are also to be reckoned at hundred per cent (as against 50 per cent for non-fund based exposures earlier) and in addition, banks should include forward contracts in foreign exchange and other derivative products like currency swaps and options at their replacement cost value in determining the individual/group borrowers exposures, effective April 1, 2003. Banks were advised to reduce exposure to a single borrower to 15 per cent from the existing level of 20 per cent of the bank’s capital funds with effect from March 31, 2002. Similarly, group exposure was to be brought down to 40 per cent of the capital funds from the existing 50 per cent with effect from March 31, 2002. In the case of financing of infrastructure projects, the group exposure limit is extendable by an additional 10 per cent, *i.e.*, up to 50 per cent.

1.43 Based on the recommendations of the Standing Technical Committee of RBI-SEBI officials on banks’ financing of equities and investments in shares, banks’ exposure to capital market was reviewed and guidelines were issued on November 10, 2000. Within the overall exposure to sensitive sectors, a bank’s exposure to the capital market by way of investments in shares, convertible debentures and units of equity-oriented mutual funds should not exceed 5 per cent of outstanding domestic credit (excluding inter-bank lending and advances outside India) as on March 31 of the previous year. As announced on November 10, 2000, these guidelines were reviewed again by the RBI-SEBI Technical Committee, in the light of actual experience over six months, and revised guidelines were issued on May 11, 2001. As per the guidelines, banks could acquire shares, debentures and units of mutual funds, etc., for direct investment in shares/ debentures, etc., at their own risk and for granting loans and advances to individuals and share-broking entities for investment in capital market on their own account. Shares/ debentures may be assigned to banks by individuals and corporates as collateral and additional security for certain approved purposes which do not involve stock broking or investment in the capital market. Therefore, banks’ exposure to capital market in all forms was restricted to 5 per cent of total outstanding advances (including commercial paper) as on March 31 of the previous year. The ceiling of 5 per cent would cover (i) direct investments in equity shares and convertible bonds and debentures; (ii) advances against shares to individuals for investment in equity shares (including IPOs), bonds and debentures, units of equity-oriented mutual funds; and (iii) secured and unsecured advances to stock brokers and guarantees issued on behalf of stock brokers. A uniform margin of 40 per cent was prescribed on all advances/financing of IPOs/guarantees. A minimum cash margin of 20 per cent (within the margin of 40 per cent) was prescribed in respect of guarantees issued by banks.

1.44 In September 2001, the Reserve Bank, on an experimental basis, as recommended by the RBI-SEBI Standing Technical Committee and keeping in view circumstances prevailing in the equity markets, permitted banks to extend finance to stockbrokers for margin trading within the overall ceiling of 5 per cent prescribed for exposure of banks to the capital market. Banks could accordingly provide finance to brokers for margin trading in actively traded scrips forming part of the NSE Nifty and the BSE Sensex, subject to certain guidelines. These guidelines will be valid for a period of 60 days (*i.e.* upto November 22, 2001) and will be reviewed in the light of actual experience.

1.45 With regard to the valuation and disclosure requirements, equity shares in the banks' portfolios, whether held as primary security or as collateral for advances or guarantees, or as investment, should be marked to market, preferably on a daily basis, but at least on a weekly basis. Banks are required to disclose the total investments made in equity shares, convertible bonds and debentures, units of equity-oriented mutual funds and aggregate advances against shares in the 'Notes on Accounts' to their balance sheets.

Credit Exposure to Industry or Certain Sectors

1.46 Apart from limiting the exposures to individual or group of borrowers, the banks were advised to also consider fixing internal limits for aggregate commitments to specific sectors (e.g., textiles, jute, tea, etc.) so that the exposures are evenly spread over various sectors. These limits could be fixed, by the banks, having regard to the performance of different sectors and the risks perceived. The banks may review the limits so fixed at periodic intervals and revise, as necessary.

Underwriting of Bonds of Public Sector Undertakings

1.47 The banks were advised to formulate their own internal guidelines as approved by their Boards of Directors on investments in and underwriting of PSU bonds, including norms to ensure that excessive investment in any single PSU is avoided and that due attention is given to the maturity structure of such investments. Banks would also need to take into account the fact that such investments are subject to risk-weight and necessary depreciation is to be fully provided for. Further, such investments in PSU bonds including shares and debentures and subscription to commercial papers of PSUs should be reckoned for the purpose of arriving at prudential norms of credit exposure for single borrower and group of borrowers.

Asset Classification –"Past Due" Concept

1.48 Under the earlier guidelines, an asset was classified as NPA if the amounts due in the account remained 'past due' for more than two quarters. It was clarified on December 17, 1992 that an amount should be considered 'past due' when it remains outstanding for 30 days beyond the due date. Due to the improvements in the payment and settlement systems, recovery climate, upgradation of technology in the banking system, etc., it was decided to dispense with 'past due' concept, with effect from March 31, 2001. Accordingly, effective that date, an advance has to be classified as NPA, if interest and/or instalment of principal remain overdue for a period of more than 180 days in respect of a term loan, and the account remains ‘out of order’ for a period of more than 180 days, in respect of an Overdraft/Cash Credit (OD/CC). With a view to moving towards international best practies and to ensure greater transparency, the intention to adopt the 90 day norm for recognition of loan impairment from the year ending March 31, 2004 was announced in the statement on Monetary and Credit Policy for the year 2001-02.

Treatment of Restructured Accounts

1.49 The issue of restructuring credit facilities due to unexpected decline in anticipated cash flows, particularly in project assistance has implications for asset classification norms. It was felt that these stipulations deter the banks from restructuring of standard and sub-standard loan assets, even though the modification of terms might not jeopardise the assurance of repayment of dues from the borrower. Accordingly, the norms were reviewed in the light of the international best practices and changes were effected in the norms relating to restructuring/rescheduling/ renegotiation of terms of the standard and substandard loan assets. The stages where restructuring/rescheduling/renegotiation of the terms of loan agreement could take place are: (i) before commencement of commercial production; (ii) after commencement of commercial production, but before the asset has been classified as sub-standard; and (iii) after commencement of commercial production and the asset has been classified as sub-standard.

1.50 A rescheduling of the instalments of principal alone, at any of the aforesaid first two stages would not cause a standard asset to be classified in the sub-standard category, provided the loan/credit facility is fully secured. Likewise, a rescheduling of interest element would not necessitate an asset to be downgraded if the element of interest, measured in present value terms, is either written off or provision is made to the extent of the sacrifice involved.

1.51 In the case of restructured sub-standard accounts also, a sub-standard asset is eligible for continuation in the sub-standard category for the specified period, provided the loan/credit facility is fully secured. The rescheduling of interest element would render a sub-standard asset eligible for continuance of classification in sub-standard category for the specified period. This is subject to the condition that the amount of sacrifice, if any, in the element of interest, measured in present value terms, is either written off or provision is made to the extent of the sacrifice involved. Even in cases where the sacrifice is by way of write off of the past interest dues, the asset should continue to be treated as sub-standard.

1.52 The sub-standard assets would be eligible to be upgraded to the standard category only after the specified period, i.e., a period of one year after the date when first payment of interest or of principal, whichever is earlier, falls due, subject to satisfactory performance during the period. In case, however, the satisfactory performance during the one-year period is not evidenced, the asset classification of the restructured account would be governed as per the applicable prudential norms with reference to the pre-restructuring payment schedule. These changes in the norms would be applicable only to the standard and substandard accounts which are subjected to restructuring/ rescheduling/renegotiation of terms during the financial year 2000-01 and thereafter.

1.53 Banks should also disclose in their published Annual Accounts, under the Notes on Accounts, certain information in respect of restructuring undertaken during the year. The disclosures include among others (a) the total amount of loan assets subjected to restructuring; (b) the total amount of standard assets subjected to restructuring; and (c) the amount of substandard assets subjected to restructuring.

Guidelines on Categorisation and Valuation of Banks' Investment Portfolio

1.54 The process of marking to market of the investment portfolio required bifurcation of investments into 'permanent' and 'current' categories. Banks have made substantial progress in this respect. A number of banks have fully marked the portfolio to the market and the remaining have reached the prescribed level of 75 per cent for approved securities.

1.55 Accordingly, the guidelines on classification and valuation of investments by banks have been revised on the basis of the recommendations of an Informal Working Group in order to bring them in consonance with the best international practices. The revised guidelines were made effective from September 30, 2000. The banks are required to classify their entire investment portfolio, under three categories *viz.*, 'held to maturity', 'available for sale' and 'held for trading'. In the balance sheet, the investments would continue to be disclosed as per the existing six classifications *viz.*, i) Government securities, ii) other approved securities, iii) shares, iv) debentures and bonds, v) subsidiaries/ joint ventures, vi) others (commercial papers, mutual fund units, etc.).

1.56 The investments under the 'available for sale' and 'held for trading' categories should be marked to market at yearly and monthly intervals, respectively, or at more frequent intervals. The investments under the 'held to maturity' category need not be marked to market, as in the case of 'permanent' securities at present. Such investments will not exceed 25 per cent of the total investments.

1.57 The guidelines cover classification of investments, shifting of investments among the three categories, valuation of the investments, methodology for booking profit/ loss on sale of investments and providing for depreciation. The risk-weights assigned to the various securities at present, including those for 'market risk', remain unchanged.

1.58 Banks were advised to formulate an investment policy with the approval of their Board of Directors to take care of the requirements on classification, shifting and valuation of investments under the revised guidelines. The policy should adequately address risk-management aspects and ensure that the procedures to be adopted by the banks under the revised guidelines are consistent, transparent and well documented to facilitate easy verification by inspectors and statutory auditors.

Transfer of Profits to Reserve Funds

1.59 All scheduled commercial banks operating in India (including foreign banks) are required to transfer not less than 25 per cent of the net profit (before appropriations) to the Reserve Fund with effect from the year ending March 31, 2001. The transfer to the reserves may be made ‘after adjustment/provision towards bonus to staff’.

Voluntary Retirement Scheme Expenditure -Accounting and Prudential Regulatory Treatment

1.60 Faced with the problem of surplus manpower resources, several public sector banks introduced a voluntary retirement scheme (VRS) as a measure of cost reduction. The scheme brought to the fore certain accounting issues relating to booking of VRS related expenditure such as *ex-gratia* payment and other terminal benefits. Consequently, the accounting treatment of VRS expenditure was specified in consultation with the Institute of Chartered Accountants of India (ICAI). In particular, the banks were advised that unless expensed in the same period, the entire *ex-gratia* amount as a result of VRS could be treated as an extra-ordinary item and as Deferred Revenue Expenditure (DRE). Banks were advised that in view of the extra-ordinary nature of the event, VRS related DRE would not be reduced from tier I capital. The position will stand regularised by the end of the accounting year in which the deferred expenses are totally wiped out. The banks are required to disclose in the balance sheet the accounting policies followed in respect of VRS expenditure. The period of deferment would be restricted to a maximum of 5 years including the year of acceptance of VRS application by a bank.

Consolidated Supervision

1.61 The adoption of Basel *Core Principles for Effective Banking Supervision* requires adherence to the principles of consolidated accounting and supervision of the affairs of the bank’s subsidiaries. With a view to moving towards international best practices, banks were advised on May 3, 2000, to voluntarily build in the risk-weighted components of their subsidiaries into their own balance sheet on notional basis, at par with the risk-weights applicable to the bank’s own assets and earmark additional capital in their books, in phases, beginning from the year ending March, 2001. Furthermore, in order to bring more transparency to the balance sheets, public sector banks were advised to annex the balance sheet in respect of each of their subsidiaries, to their own balance sheets beginning from the year ending March, 2001. The accounting year of the entities which are banking subsidiaries, should normally be coterminous with that of the parent bank and the date of the annual accounts of such subsidiaries, annexed to the parent’s balance sheet, should coincide with the date of annual accounts of the parent. In respect of subsidiaries which may have an accounting year different from that of the parent bank, the annual accounts annexed should not relate to a date earlier than six months prior to the date of the annual accounts of the parent bank.

Move towards Risk-based Supervision

1.62 In the Monetary and Credit Policy of April 2000, the Reserve Bank had announced its intention to move towards a risk-based approach to supervision of banks with the assistance of international consultants. The switchover to risk-based supervision (RBS) from the current CAMELS based approach will enhance supervisory standards and practices in alignment with the international best practices. M/s. PricewaterHouse Coopers (PwC), UK, were engaged as consultants to facilitate the transition to RBS under assistance from the Department for International Development (DFID), UK.

1.63 The consultants submitted the final deliverables in May 2001. The RBS model suggested by them consists of (i) a formal risk assessment of a bank by producing a detailed risk profile, (ii) developing a unique supervisory action plan for each bank based on the risk profile, (iii) defining the scope and extent of supervision, and (iv) setting up quality assurance and enforcement functions to maintain objectivity and neutrality in application of supervisory standards. The project has entered the implementation phase from June 2001 and a dedicated Project Implementation Group has been set up in the Reserve Bank to address the transitional and change management issues for switchover to RBS.

1.64 The RBS approach will involve allocation of supervisory resources in accordance with the risk profile of a bank. A high-risk bank will be subjected to enhanced supervisory focus through a shorter supervisory cycle and greater use of various supervisory tools like targeted inspections, intensive off-site surveillance, structured meetings with the bank management, etc. On the contrary, a low risk bank will be subjected to a longer supervisory cycle and use of fewer supervisory tools. Thus, the RBS approach will lead to an optimum use of supervisory resources by focusing them on the targeted banks and the specific areas within the banks that pose the greatest risk to the system and to the supervisory objectives.

1.65 The implementation of RBS approach calls for certain preparedness on the part of commercial banks like setting up comprehensive risk management systems, switching to a risk-based audit system, upgrading the management information and Information Technology-based systems, setting up dedicated compliance units and addressing issues related to HRD and skill development. A discussion paper on RBS giving a background of the approach, its objectives, the processes involved and the specific bank level preparedness required for successful implementation has been issued to the banks and they will be involved in the switchover through a consultative process. The RBS approach is planned to be put in operation after the pilot run in the last quarter of the financial year 2002- 03.

Credit Information Bureau

1.66 With a view to developing an institutional mechanism for sharing of information on borrowers/ potential borrowers among banks and financial institutions, the Credit Information Bureau (India) Ltd. (CIBIL) has been set up in August 2000 for collecting, processing and sharing credit information on the borrowers of credit institutions. In order to strengthen the legal mechanism for making the functioning of CIBIL effective, a draft master legislation covering responsibilities of the Bureau, rights and obligations of the member credit institutions, safeguarding of the privacy rights, is under preparation by the Government.

Report on Borrowal Accounts Classified as Doubtful or Loss and Suit-filed Accounts of Rs.1 crore and above

1.67 A scheme has been put in place to collect and disseminate, amongst banks/ notified all-India FIs, the details about borrowers of banks and FIs with outstanding aggregating Rs. 1 crore and above which are classified as ‘doubtful’ or ‘loss’ or where suits have been filed. So far, information up to the half-year ended September 30, 2000 has been disseminated. The list of borrowal accounts against which banks and FIs have filed suits for recovery of their dues aggregating Rs. 1 crore and above as on March 31, 2001 is available on the Reserve Bank website (www.rbi.org.in). Information on cases of wilful default with outstanding balance of Rs. 25 lakh and above up to the quarter ended March 31, 2001, has also been furnished to the banks and notified all India FIs. The list of wilful defaulters of Rs. 25 lakh and above against whom suits have been filed is published along with the list of suit filed accounts of Rs. 1 crore and above and is also available on the RBI website.

Guidelines for Entry of New Private Sector Banks

1.68 Following the recommendations of the Working Group to review the licensing policy for setting up new private sector banks, in consultation with the Government of India, guidelines were issued in January 2001 for entry of new banks in the private sector. The guidelines retained certain existing conditions on the entry of new banks such as promoters' capital share at 40 per cent, opening of new branches, etc. The proposed bank needs to observe the prescribed targets in respect of priority sector lending (40 per cent of net bank credit) as applicable to other domestic banks. The major changes in the revised guidelines are:

(i) The initial minimum paid up capital for a new bank should be Rs. 200 crore, which shall be increased to Rs. 300 crore in subsequent three years after commencement of business.

(ii) The guidelines also enable a NBFC to convert into a commercial bank, if it satisfies the prescribed criteria of a) minimum net worth of Rs. 200 crore, b) a credit rating of not less than AAA (or its equivalent) in the previous year, c) capital adequacy of not less than 12 per cent, and d) net NPAs not more than 5 per cent.

(iii) A large industrial house should not promote any new bank. Individual companies, directly or indirectly connected with large industrial houses may however, be permitted to participate in the equity of a new private sector bank up to a maximum of 10 per cent, but would not have controlling interest in the bank. The bank shall not extend any credit facilities to the promoters and companies investing up to 10 per cent of the equity.

(vi) Preference would be given to promoters with expertise of financing priority areas and in setting up banks specialising in the financing of rural and agro-based industries.

1.69 The guidelines also prescribed March 31, 2001 as the last date for receipt of applications. At the first stage, the applications were screened by the Reserve Bank to ensure *prima facie* eligibility of the applicants. Thereafter, the applications were referred to a high-level Advisory Committee (Chairman: Dr.I.G.Patel), which submitted its recommendations to the Reserve Bank on June 29, 2001. Further detailed information and analysis of the applications, in the light of the Advisory Committee's recommendations is in progress and a decision to issue 'in-principle' approval for setting up of a private sector bank would be taken by the Reserve Bank.

Supervisory Initiatives Relating to Foreign Branches of Indian Banks

1.70 A revised reporting system has been introduced for collecting data on foreign operations of Indian banks from June 2000. The new reporting system is designed to capture additional risks/information pertaining to (a) interest rate risks, (b) liquidity risks, (c) non-performing investments, (d) information on frauds, and (e) detailed data on profitability.

Ownership Function

1.71 The Reserve Bank holds at present shares in State Bank of India (SBI), National Housing Bank (NHB), Infrastructure Development Finance Company (IDFC), Deposit Insurance and Credit Guarantee Corporation (DICGC), NABARD, Bharatiya Reserve Bank Note Mudran Ltd. (BRBNML), Discount and Finance House of India (DFHI) and Securities Trading Corporation of India (STCI). The Committee on Banking Sector Reforms (Chairman: M. Narasimham) 1998, was of the view that appropriately, the Reserve Bank should not own the institutions it regulates. Furthermore, in January 1999, the RBI Discussion Paper on ‘Harmonising the Role and Operation of Development Financial Institutions and Banks’ had suggested that the owership of financing institutions could ideally be delinked from the Reserve Bank through transfer of such ownership to the Government. The Reserve Bank accepted the recommendation for transfer of ownership of its shares in SBI, NHB and NABARD to the Central Government. Given the crucial importance and bearing of the issue, the matter has to be decided in consultation with the Government of India. In respect of DICGC, Reserve Bank had already submitted proposal to the Government for framing a new Act to make it consistent with financial sector liberalisation. In respect of BRBNML, there is no intention to divest the shareholding of the Reserve Bank at this stage, since the RBI is a captive customer and there are no regulatory implications. Currently, the Reserve Bank holds only 10.50 per cent of the shares in DFHI and 14.40 per cent of the shares in STCI. It has decided to completely divest these shareholdings in the current year.

Legal Reforms

1.72 The experience of the financial restructuring process initiated since early-1990s indicates that the success of financial sector reforms often hinges crucially on appropriate reforms of the underlying legal framework. Keeping this in view, important legal reforms initiated in the banking sector in the recent months include areas such as security laws, Negotiable Instruments Act, fraud on banks and regulatory framework of banking. The Reserve Bank has forwarded its recommendations to the Central Government for comprehensive amendments to the Reserve Bank of India Act, 1934 and the Banking Regulation Act, 1949. In view of the increasing level and complexity of frauds in the banking industry, a Committee on legal aspects of bank frauds has been constituted to define financial frauds, lay down procedural laws, examine the process of investigation of bank frauds and prosecution of persons involved.

1.73 The Government of India constituted an Expert Committee (Chairman: Shri T. R. Andhyarujina) on legal reforms, which submitted its report in February 2000. As a follow up measure, the Government constituted a Working Group on Asset Securitisation (Chairman: Shri S. H. Bhojani) in July 2000. This Working Group has submitted a draft Bill to the Government. In order to examine the vesting of powers with banks and financial institutions for taking possession and sale of securities without intervention of the courts and to draft a Bill for consideration, another Working Group was constituted by the Government in July 2000 (Chairman: Shri M. R. Umarji). The Working Group submitted its Report to the Government alongwith the draft Bill in May 2001.

New Capital Accord

1.74 The Basel Committee on Banking Supervision (BCBS) released the second consultative document on the proposed draft New Capital Accord in January 2001 (Box I.2). The New Accord places greater emphasis on banks' own assessment of their risks in calculating their capital requirements. The new Accord will be effective from 2005. The feedback received from a few banks on the same indicated that they would have to substantially upgrade their existing MIS, risk management practices and procedures and technical skills of the staff. Banks would, therefore, need to initiate necessary steps to ensure that they are equipped to adopt the new Accord as and when approved.

Interest Rate Policy

1.75 One of the main objectives of financial sector reforms has been to provide operational flexibility to the banks. Deregulation of interest rates has been a major step in this direction. A move was taken in October 1994 with the introduction of the Prime Lending Rate (PLR) as the minimum rate chargeable by banks to their borrowers with credit limit above Rs.2 lakh. Thereafter, banks have been given autonomy to fix their own PLR and maximum spread thereon. Currently, banks can determine their own Prime Term Lending Rate (PTLR) and they are also permitted to offer tenor linked PLRs. Effective April 19, 2001, commercial banks have been permitted to lend at rates below PLR to exporters and other creditworthy borrowers including public enterprises on the lines of a transparent and objective policy approved by their Boards.

Flexibility to Banks in Terms of Interest Rate on Term Deposits

1.76 As the premature withdrawal of term deposits may adversely impact the ALM functions of the banks, based on communications received from banks on this issue, banks were given the freedom to exercise their discretion to disallow premature withdrawal of large deposits held by entities other than individuals and Hindu Undivided Families (HUF). Furthermore, renewal of overdue deposits at the rate of interest prevailing on the date of maturity would now be allowed only for an overdue period of 14 days. In case the overdue period exceeds 14 days, the deposits should be treated like fresh term deposits and banks may prescribe their own interest rate for the overdue period.

Interest Rate on FCNR (B) Deposits

1.77 Banks are free to accept FCNR (B) deposits for a maturity period of 1 to 3 years and offer fixed or floating rates. Till April 2001, floating rate deposits could be offered with an interest reset period of six months, subject to the ceiling of LIBOR/SWAP rates plus 50 basis points for the corresponding maturity. Based on the feedback received from the banks, it was decided to revise the above ceiling downward to LIBOR/SWAP rates for the corresponding maturity.

Restructuring of Weak Public Sector Banks

1.78 The recommendations of the Working Group on restructuring weak public sector banks (Chairman: Shri M. S. Verma) were examined by the Reserve Bank and the Reserve Bank's views were conveyed to the Government in December 1999. The three areas which need to be considered in this context are recapitalisation, setting up of financial restructuring authority and other measures.

(i) Recapitalisation

1.79 As a sequel to the recommendations of the Working Group, the Union Budget 2000–01 announced that Government would consider recapitalisation of weak banks to achieve the prescribed capital adequacy norms. Such recapitalisation, however, would be made subject to a viable restructuring programme to be drawn by the concerned banks that would be acceptable to both the Government of India and the Reserve Bank. The Government of India did not provide recapitalisation assistance to any of the weak banks during 1999-2000 and 2000-01. While UCO Bank and United Bank of India have maintained the prescribed CRAR of 9 per cent as on March 31, 2001, Indian Bank continued to have negative net worth and negative CRAR. In accordance with the Government's directions, the three banks submitted restructuring plans for 2000-01 to 2002-03. The recapitalisation requirements of the banks based on the plans and assessed by a High Level Committee appointed by the Government in December 2000 are currently under consideration of Government of India.

(ii) Setting up of Financial Restructuring Authority

1.80 The Government of India had announced that Financial Restructuring Authority (FRA) comprising experts and professionals could also be set up for individual banks, if necessary, to turn around weak banks after due amendments are carried out in the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/1980. A draft of the proposed amendments to Banking Companies Act (Acquisition & Transfer of Undertakings) Act of 1970/1980 was forwarded to Government in April 2000. The Government has since introduced the Banking Companies (Acquisition and Transfer of Undertakings) Bill, 2000 in Parliament, which seeks to empower the Central Government to supersede (based on the recommendations of the Reserve Bank) the Board of Directors of any nationalised bank and constitute the Financial Restructuring Authority.

(iii) Other Measures

1.81 The three weak banks have implemented VRS and have achieved significant reduction of excess staff. The banks have taken steps to rationalise their branch network and abolish Zonal Offices. These banks are also taking various measures such as reduction of NPAs, lowering cost of deposits, increasing productivity and profitability for bringing about sustained improvement in their financial strength. The Reserve Bank and Government of India are monitoring the progress achieved against performance targets fixed in consultation with the banks in respect of all the above areas.

Frauds in Banks

1.82 During the year 2000-01, banks and financial institutions reported 50 cases of large value frauds (Rs. 1 crore and above) involving Rs.506.34 crore, as against 49 cases involving Rs.431.59 crore, during the previous year. The major factors which facilitated the perpetration of frauds during the year included, among others, non-observance of the laid-down systems and procedures by the bank functionaries, nexus or collusion of bank staff with the

borrowers/depositors, negligence on the part of the dealing officials/branch managers, commission of fraud by the bank staff themselves, failure of internal control system and inadequate appraisal of credit proposals and ineffective supervision over advances.
1.83 Out of 50 cases of large value frauds reported during the year, in 5 cases, bank officials themselves perpetrated the frauds. In as many as 10 cases, nexus or collusion of bank officials with the fraudsters was observed. In respect of a few cases of fraud involving pay orders reported by certain banks recently, nexus of a co-operative bank with the perpetrators of the fraud was also observed.

1.84 The Committee on Legal Aspects of Bank Frauds (Chairman: Dr. N. L. Mitra) constituted by the BFS submitted its Report in September 2001. The terms of reference included charting procedural laws to deal with financial frauds, examining the process of investigation of bank frauds, providing suggestions to operationalise the recommendations of previous Committees relating to legal aspects of bank frauds and examining the role of Reserve Bank with regard to frauds reported by banks. The Report highlighted the limitations of the existing legal provisions to deal with such cases in an effective manner and emphasised that efforts should be made, both to prevent frauds and to deal firmly with incidents of financial frauds. It recommended that financial institutions should develop, implement and monitor a Best Practice Code (BPC). Citing cross-country examples, the Committee categorised different types of frauds and proposed legislative attention to deal with the serious ones separately. It recommended that serious financial frauds should be treated as criminal offence and the burden of proof should be shifted on the accused to prove absence of fraud. The Report also recommended establishment of Special Bureau, Court and prosecutors to deal with major frauds and provided certain operational guidelines for the Bureau, Court and the recovery of the defrauded amount. In order to facilitate the operation of the Bureau, it recommended the establishment of a Statutory Fraud Committee under the chairmanship of the Reserve Bank nominee with representation from other financial supervisory authorities.

Technology in Banking

Payment and Settlement Systems

1.85 As part of restructuring of the banking sector, special emphasis has been accorded to improvements in payment and settlement systems. Prominent among the measures initiated in these areas include introduction of Electronic Funds Transfer (EFT), Real Time Gross Settlement System (RTGS), Centralised Funds Management System (CFMS), the NDS and the Structured Financial Messaging Solution (SFMS). The SFMS would be the backbone for all message-based communication over the Indian Financial Network (INFINET).

Electronic Funds Transfer (EFT)

1.86 The EFT scheme enables transfer of funds within and across cities and between branches of a bank and across banks. The scheme, which is operated by the Reserve Bank is available for funds transfer across thirteen major cities in the country, as on September 30, 2001. The facility is being extended to two more centres. The scheme was originally intended for small value transactions. However, with effect from October 1, 2001, even large value transactions (as high as Rs. 2 crore) have also been permitted.

Real Time Gross Settlement System (RTGS)

1.87 The work on operationalisation of RTGS system continued during the year. The major project components completed during the year included the finalisation of the design for RTGS system, issue of the tender for the development of the software, evaluation of the technical components of the bids received, site visits and evaluation of the commercial proposals. The implementation of RTGS is targeted to be accomplished within 12 to 15 months of award of the contract for software development and implementation.

Centralised Funds Management System (CFMS)

1.88 The CFMS would enable the funds and treasury managers of commercial banks to obtain the consolidated account-wise, centre-wise position of their balances with all the 17 Deposit Accounts Departments (DAD) of the Reserve Bank. The system has been tested prior to installation and phase-wise implementation commenced from November 2001. The CFMS would enable better funds management by constituent current account holders of the Reserve Bank.

Structured Financial Messaging Solution (SFMS)

1.89 At the base of all inter-bank message transfers using the INFINET is the SFMS. SFMS would serve as a safe, secure communication carrier built with templates for transmission of intra and inter-bank messages in fixed message formats, which would facilitate “Straight Through Processing”. SFMS comprises the central server in the form of a hub located at the Institute for Development and Research in Banking Technology (IDRBT), Hyderabad and individual bank gateways to which the branches of the banks would be connected with a provision for banks to have multiple bank level gateways. The SFMS would provide for all inter-bank transactions to be stored and switched at the central hub, while intra-bank messages will be switched and stored by the bank gateway. Adequate security in the form of smart card authentication apart from the Public Key Infrastructure (PKI) would be an integral part of the SFMS. All these would result in the security levels matching those of international standards.

Working Group on Improvements in Monitoring of Clearing Systems

1.90 Following the recent developments in the banking sector, a Working Group on ‘Improvements in Monitoring of Clearing Systems’ was constituted by the Reserve Bank to examine the major issues pertaining to management and operation of the Clearing Houses and make necessary recommendations. The Group submitted the Report in May 2001. The recommendations of the Group were discussed with a select group of bankers and regulators. Based on these discussions, a roadmap has been drawn for implementation of these recommendations which fall under the following major areas of control / monitoring *viz*., (a) monitoring presentations by banks; (b) monitoring returns by banks; (c) accounting of the clearing settlements; (d) formation of an Internal Group at each Regional Office of the Reserve Bank to review the trends reported by the clearing house and plan follow up action as deemed necessary; (e) formation of a central monitoring cell to monitor the trends on a national basis and provide warning signals wherever necessary; and (f) implementation of MIS to serve as early warning signals for better surveillance over the activities of the clearing member banks.

1.91 The recommendations which could be implemented immediately are being taken up with the four major metropolitan clearing houses managed by the Reserve Bank. Action on implementing these at the clearing houses managed by State Bank of India / other banks would also be taken up concurrently.

Imaging of Instruments

1.92 A process of capturing the images of the instruments as they are being processed was introduced during the year at the four metropolitan National Clearing Cells managed by the Reserve Bank. Imaging facilitates in quicker balancing during the cheque-processing cycle and also in reducing clearing reconciliation differences.

Electronic Clearing Services

1.93 Emphasis on widespread usage of Electronic Clearing Service (ECS) is being prescribed by the Reserve Bank to encourage non-paper based funds movement. The prime thrust areas forming part of this vital activity include the extension of ECS to more centres, inclusion of more customers under the ambit of the scheme and provision of a centralised facility for affording payments.

Indian Financial Network (INFINET)

1.94 The INFINET has been operational for almost two years. Started as a closed user group communication network for the banking sector in India, the members of this network are the public sector banks. During the year 2000-01, the membership was opened up for other banks and financial institutions that need to communicate with one another.

Computerisation in Public Sector Banks

1.95 The progress in implementation of the directive of the Central Vigilance Commission (CVC) on the need to computerise 70 per cent of the banking business by public sector banks before January 1, 2001 revealed that as on December 31, 2000, 13 banks had achieved the desired level. Figures as at end of March 2001, indicated that 23 banks have achieved the target, while two banks have computerisation levels ranging between 60 per cent and 70 per cent and two others were at a level below 60 per cent.

Cheque Clearing

1.96 Magnetic Ink Character Recognition (MICR) based cheque-clearing accounts for about 65 per cent of the value of cheques processed in the country. In addition, Magnetic Media Based Clearing Systems account for about 10 per cent of the remaining value while claim-based processes cover the rest of clearing. It may be pertinent to note that growth in cheque volumes has decelerated to 10 per cent in 2000-01 from 12 per cent during the previous year. This is reflective of general trends the world over, indicating the migration towards electronic funds transfer mechanisms.

Progress of the Committees Associated with Different Areas of Banking Supervision

Working Group on Consolidated Accounting

1.97 A multi-disciplinary Working Group has been set up to look into the introduction of consolidated accounting and other quantitative methods for consolidated supervision of banks and bank groups. The recommendations of the Group are expected to be finalised shortly. The adoption of consolidated approach to supervision of banks would also be in line with the requirements relating to Consolidated Supervision enunciated in the *Core Principles of Effective Banking Supervision*, put forth by the Bank for International Settlements.

Informal Group to Review Regulatory and Supervisory Arrangements

1.98 World over, financial innovations, technological development and blurring of distinction between financial institutions have resulted in increasing integration of financial services and markets. Technical advances have also resulted in accelerated pace and complexities in financial products besides the manifold increase in volumes and turnover. Indian financial system is catching up fast with these developments in the post-reform period. The regulatory regimes and supervisory systems in the changing environment face new challenges in safeguarding the integrity, efficiency, soundness and stability of the financial system. In India, the regulatory and supervisory arrangements have been rendered complex in view of the existence of various types of financial intermediaries with different charters. In the above background, an Informal Group was constituted to prepare a Discussion paper on regulatory and supervisory arrangements in the financial sector. The paper would include theoretical perspective, international practice and financial innovations along with its associated problems. It would also cover the growing complexities of regulation and supervision and the existing Indian position.

Internal Working Group on Control over Cost of Funds in Public Sector Banks

1.99 As per the directions of BFS, an internal Working Group was formed in August 2000 to undertake a study on control over cost of funds in public sector banks. The Working Group submitted its report along with recommendations and the same was placed before the BFS in May 2001. The Board has directed to forward the study to banks and to conduct a high-level seminar on the issue so as to arrive at the best solutions.

Working Group on Non-SLR investments of Banks

1.100 A Working Group was constituted to study, *inter alia*, the methods of acquisition of non-SLR investments by banks. Subsequently, instructions were issued for classification and valuation of investments in such securities held by banks. Further, with a view to ensuring that the investment by banks in non-rated issues through private placement, both of the borrower customers and non-borrower customers, do not give rise to systemic concerns, guidelines were issued in June 2001 on measures to be taken by banks, including guidelines on use of a suitable format of disclosure in respect of private placement issues. Banks and financial institutions were advised that effective October 2001, they would be permited make fresh investments and hold bonds and debentures, privately placed and otherwise only in dematerialised form. Outstanding investments should also be converted into demat form by June 2002.

Working Group to Review Rating Model

1.101 A system of supervisory rating of banks operating in India has been in vogue since inspection cycle of 1998-99. The objective of introducing the system of supervisory rating of banks is to summarise the performance of individual banks and also to assess the aggregate strength and soundness of the banking system. The Indian banks are rated as per CAMELS model covering capital adequacy, asset quality, management, earnings, liquidity and systems and control, while the branches of foreign banks in India are rated as per CACS model covering capital adequacy, asset quality, compliance and systems. Each of the components is rated on a scale of 1 to 100 marks, which are apportioned among various sub-parameters. The weighted average of the rating of components is arrived at using respective weights assigned to each component reflecting its importance. On the basis of weighted average of the rating of components, composite rating is determined on a scale of A to D in the descending order of performance of banks.

1.102 Recently, a Working Group comprising officials of the Reserve Bank, scheduled commercial banks, ICAI, and Credit Rating and Investment Services India Limited (CRISIL) reviewed the rating models for bringing about improvements. The purpose of this review was to minimise the element of subjectivity in certain rating components and to make the composite rating more broad based. On the basis of the recommendations of the Group, a rating model has been evolved.

Rural Credit, Housing Finance and Credit to Small Scale Industries

Special Agricultural Credit Plans

1.103 The Reserve Bank has advised PSBs to prepare Special Agricultural Credit Plans (SACP) for increasing the credit flow to agriculture. The plan prepared on annual basis indicate the self-set targets for disbursement to agriculture. For the financial year 2000-01, the disbursement to agriculture under this plan was Rs. 24,654 crore as against the projection of Rs. 25,893 crore. For the financial year 2001-02, the target for disbursement has been set at Rs. 30,818 crore.

Small Scale Industries Sector

1.104 Commercial banks have been advised to dispense with collateral requirements for the tiny sector for loans up to Rs.5 lakh. Similarly, to promote credit flow to small borrowers, composite loan limit for providing working capital and term loan through single window has been increased from Rs.10 lakh to Rs.25 lakh.

Specialised SSI bank branches

1.105 Public sector banks have been advised to make concerted efforts to operationalise at least one specialised small scale industry (SSI) branch in every district and centres having cluster of SSI units. The convenor of State Level Bankers Committee (SLBC) in each State has been asked to monitor the progress in the operationalisation of specialised SSI branches. As at the end of March 2001, there were 390 specialised SSI bank branches in the country.

Task Force to Study the Functioning of Co-operative Banks and Suggest Measures for their Strengthening

1.106 The Task Force to study the co-operative credit system (Chairman: Shri Jagdish Capoor) submitted its Report in July 2000. The recommendations were discussed in a consultation meet organised by NABARD in December 2000 and in a Conference of Chief Ministers held in August 2001. While consensus was reached on several recommendations, divergent views were expressed by the States on the proposed rehabilitation package, selection criteria for revitalisation and delayering of the rural co-operative credit structure. The Government of India, therefore, announced the formation of a Joint Committee under the Chairmanship of the Minister of State for Finance to consider these issues.

Standing Advisory Committee for Small Scale Industries

1.107 A Standing Advisory Committee, under the Chairmanship of a Deputy Governor was constituted in September 2000 to review the flow of institutional credit to the SSI sector. The terms of reference of the Committee are to:

? review the flow of credit to the SSI sector and problems being faced by this sector in securing adequate credit;
? suggest improvements in the procedure of commercial banks and modification in their policies as also those of the Reserve Bank, to the extent desirable, in catering to the credit needs of the SSI sector;
? examine other related issues; and
? make recommendations which are related to or incidental to the above items.

Khadi & Village Industries Commission

1.108 A Consortium Scheme with the corpus of Rs.1,000 crore has been set up for the banking system to provide finance to the *Khadi* and Village Industries Boards (KVIBs). As at the end of September 2001, an amount of Rs.437 crore was outstanding out of an amount of Rs.738 crore disbursed by the consortium under the scheme.

Relief Measures

1.109 In view of the devastating effect of earthquake in the State of Gujarat in January

2001 resulting in widespread damage to the properties and heavy loss of life, the Reserve Bank announced a package of relief measures for the State. The loan classification status in case of borrowers affected by the earthquake is frozen on an 'as-is-where-is' basis until March 31, 2003. In regard to standard assets, no demand for recovery would be made for two years, while in regard to loans not classified as standard assets no penalties would be levied in the event of non-receipt of repayments due during the next two years.

1.110 Notwithstanding the present loan classification status, the affected small traders, small business, self-employed and small road transporters, etc., would be sanctioned fresh loans up to Rs. 1 lakh for the purpose of restoration/rehabilitation of their business at interest rates not exceeding PLR. Banks have also been advised to grant loans up to Rs. 2 lakh at interest rate not exceeding PLR for repairs/ reconstruction of houses/shops damaged by the earthquake. Loans for repair/construction of houses and shops and to small traders, small business, self-employed and small road transport operators, etc., would be reckoned as priority sector lending. In respect of agricultural loans, banks are not to recover principal or interest from the affected farmers for a period of two years with a provision for rescheduling up to 7 years. On the request from NHB, the Reserve Bank has sanctioned a long-term loan of Rs.1,000 crore at 6.0 per cent rate of interest per annum repayable over 18 years (inclusive of moratorium period of 3 years) solely for the purpose of extending finance/refinance for the reconstruction of houses etc., in the earthquake affected areas of Gujarat.

1.111 The interest on additional limits would be at PLR up to Rs. 10 lakh and at banks' discretion beyond Rs.10 lakh. The interest on rescheduled loans would be charged at 10 per cent per annum at simple rate up to end-March 2003 and thereafter at PLR. For purposes of interest rate on loans to affected borrowers, all banks would uniformly apply PLR of the SBI. Relief/concessions for affected exporters include extending the period of packing credit at concessive rate of interest upto 360 days from date of advance, conversion of overdue packing credit into short-term loans repayable in suitable instalments and relaxation in NPA classification norms.

Housing Finance

1.112 Certain types of credit extended by commercial banks for housing is now reckoned as priority sector. These include both direct and indirect housing finance. The types of direct finance which have been brought under the ambit of priority sector include loans up to Rs. 5 lakh in rural and semi-urban areas and up to Rs. 10 lakh in urban and metropolitan areas for construction of houses granted to individuals. It also includes loans up to Rs. 50,000 for repairs to damaged houses by individuals. The types of indirect housing finance which have been made part of priority sector lending include assistance given to any governmental agency or for construction of houses or for slum clearance and rehabilitation of slum dwellers subject to a ceiling of Rs. 5 lakh per housing unit. Assistance given to a non-governmental agency approved by the NHB for the purpose of refinance for construction of houses or for slum clearance and rehabilitation of slum dwellers subject to a ceiling of loan component of Rs. 5 lakh per housing unit is also included in the scheme. Furthermore, subscription to bonds issued by NHB and Housing and Urban Development Corporation (HUDCO) exclusively for financing of housing, irrespective of the loan size per dwelling unit, would also be considered as loans to priority sector.

3. Perspectives

1.113 The banking sector has come into increased focus in recent years. The problems in southeast Asian economies, the recessionary trends in the Japanese economy, the financial sector problems encountered in Latin American economies and more recently, in some central European economies have provided graphic evidence of how a weak banking sector can undermine confidence in macroeconomic policies. It is, therefore, no longer possible for developing countries to delay the introduction of structural reforms, stricter prudential and supervisory norms, greater transparency and increased accountability not only to ensure the stability of the financial system, but also to enhance competitiveness. Since the initiation of reform process in India, considerable attention has been devoted to improve the efficiency and health of the banking sector.

1.114 Towards this end, the recent policy measures have continued to focus on structural measures to strengthen the financial system and to improve the functioning of the various segments of the financial markets. The Union Budget for 2000-01 carried forward reform in public sector banking by announcing intention for a more diversified ownership for public sector banks, establishment of financial restructuring authority, debt recovery tribunals, credit information bureaus and legislative amendments to accord greater operational flexibility to the Reserve Bank. At the same time, several Expert Groups/Advisory Groups submitted their recommendations on various facets of the financial sector and various policy measures were accordingly initiated.

1.115 In the light of positioning of appropriate measures towards safeguarding the health and stability of the banking sector, there are several issues that need to be pro-actively addressed. These issues can be broadly categorised under three major heads:

a) strengthening of prudential norms;
b) redefining of the regulatory role of the Reserve Bank in order to make it more efficient and purposeful; and,
c) introduction of structural changes in the system.

(a) Strengthening of Prudential Norms

Capital Adequacy

1.116 Imposition of minimum capital adequacy requirements promotes prudent management of commercial banks. As at end-March 2001, out of 27 PSBs, as many as 25 had CRAR exceeding the stipulated minimum of 9 per cent. Only two PSBs had CRAR below the stipulated minimum, but they accounted for 4.3 per cent of total assets of PSBs as at end-March 2001.

1.117 The Basel Committee on Banking Supervision (BCBS) had released its comments on the new Capital Accord in January 2001, which is expected to be more sensitive to the level of underlying economic risks. In addition to the minimum capital standard taking into account the credit rating, the new norms give emphasis on supervisory oversight of capital adequacy at the level of an individual bank together with market discipline and better public disclosure. The range of options for capital provisioning would facilitate banks with varying degrees of sophistication to adopt appropriate methods with supervisory validation (Box I.2).

Box I.2: The New Basel Capital Accord

The structure and operations of banks have undergone a rapid transformation in recent years. Consequent upon the revolution in information technology and the associated increase in competition, both at national and international levels, financial intermediaries have become increasingly global in geographical coverage and universal in their financial operations, encompassing a wide range of activities including banking, securities markets activities and insurance. In the face of widespread concerns about declining profitability of banks, especially in the 'eighties, the Basel capital adequacy norms were enacted in 1988.

Although the Basel norms helped to arrest the erosion of banks' capital ratios, concerns were raised regarding the mere applicability of baseline capital ratios in the changed environment of operations. The blurring of both functional as well as national divisions among the financial intermediaries, and the speed and complexity of adjustment made it difficult for regulators to keep up with the growing pace of change. In particular, the rule of 'one-size-fits-all' aspect of the capital adequacy ratio was the subject of intense debate and recent banking crises only emphasised the point that baseline capital adequacy norms were not adequate to hedge against failures. In response to the same, the Basel Committee on Banking Supervision (BCBS) came out with the new Consultative Paper on Capital Adequacy in June 1999 and invited suggestions from the policymakers, academia and other institutes all over the world by March 2000. After taking into consideration the manifold suggestions of the various organisations, the second Consultative Paper on Capital Adequacy was released in January 2001. The new rules will take effect by 2005.

The Accord rests on three pillars: the first pillar of minimum capital requirement, the second pillar of supervisory review process and the third pillar of market discipline. The *first pillar* sets out the minimum capital requirements. The new framework maintains both the current definition of capital and the minimum requirement of 8 per cent of capital to risk-weighted assets. The revised Accord will be extended on a consolidation basis to holding companies of banking groups. The Accord stresses upon the improvement in the measurement of risks. The credit risk measurement methods have been made more elaborate than those in the existing Accord. The new framework also emphasises the measurement of operational risk. For measuring credit risk, two options have been proposed. The first is the standardised approach and the second is the internal rating based (IRB) approach. Under the standardised approach, the existing approach for credit risk remains conceptually the same, but the risk-weights have been enlarged to encompass exposures to a broad category of borrowers with reference to the rating provided by rating agencies. For example, for corporates, the existing Accord provides only a single uniform risk-weight of 100 per cent, but the new Accord provides four categories-20 per cent, 50 per cent, 100 per cent and 150 per cent, based on the rating of the corporate. Under the IRB approach, on the other hand, banks will be allowed to use its internal estimates of the borrower's creditworthiness to assess credit risk in the portfolio subject to strict methodological and disclosure standards.

The *second pillar* would seek to ensure that each bank has sound internal processes in place to assess the adequacy of capital based on a thorough evaluation of its risks. The new framework focuses on the importance of bank management in
developing an internal capital assessment process and setting targets for capital that are commensurate with the banks particular risk profile and control environment. Supervisors would be responsible for evaluating how well the banks are assessing the capital adequacy needs relative to their risks. The internal processes would then be subjected to supervisory review and intervention, when appropriate.

The *third pillar* aims at bolstering market discipline through enhanced disclosure by banks. Effective disclosure is essential to ensure that market participants can better understand banks risk profile and the adequacy of their capital position. The new framework sets out disclosure requirements in several areas, including the way in which banks calculate their capital adequacy and their risk assessment methods.

The new Accord, when implemented, is expected to have far-reaching implications. The banks ever-increasing awareness of credit risk and the higher reliance on advanced risk management techniques could lead to further consolidation through mergers and acquisitions. It is essentially the emerging economies, which are still encountering several structural issues, and where banks remain the dominant financial intermediaries, which might encounter problems in implementation of these standards and therefore would require some flexibility in their approach. First, the New Accord is quite complex in view of its sophistication and could, over the next couple of years, shift scarce supervisory resources away from direct supervision towards implementation of these specific proposals. Secondly, as a corollary of the earlier point, this complexity of the New Accord would demand enormous skill, which domestic banks may find hard to obtain. Thirdly, because of the increased flow of resources to capital regulation, bank capital may be seen as a panacea for the prevention of bank failure and supervisory oversight in respect of other bank-specific parameters might become common, more so in the belief that adequate capital would keep banks insulated from failure. As observed in the second Consultative Paper, increased capital ratios should not be viewed as the only option for addressing increased risks confronting the bank. Other methods for addressing risk, such as strengthening risk management, applying judicious exposure limits and improving internal controls should be considered as well. Fourthly, increased reliance on external rating agencies could lead banks to loosen their own credit rating models and place explicit responsibility on supervisors to take such agencies into their regulatory fold.

References:

Basel Committee on Banking Supervision (2001), '*The New Basel Capital Accord*', Bank for International Settlements, Switzerland.
Mayer, L. (2001), '*The New Basel Capital Proposal*', BIS Review No. 40.

1.118 In its comments on the New Accord, the Reserve Bank has underlined the need for the new Accord to be initially applied to internationally active banks (defined as banks with cross-border banking business exceeding 15 per cent of their total business). Secondly, the Reserve Bank has observed that External Credit Assessment Institutions (ECAIs) should not be assigned the direct responsibility for assessing risk of banking book assets. This view stems from the fact that in the recent past, the credit rating agencies had resorted to sudden downgrading of certain countries, which experienced financial crises, that exacerbated the tendency of financial institutions for rapid withdrawal. Thirdly, the Reserve Bank has noted that risk-weighting of banks should be de-linked from that of the sovereign in whose jurisdiction they are incorporated. Instead, preferential risk-weights should be assigned on the basis of their underlying strengths and creditworthiness. As regards claims on corporates, the Reserve Bank has proposed that while internationally active banks may be required to follow the Internal Rating Based (IRB) approach, a simplified standardised approach may be evolved for other banks, whereby standardised risk-weights ranging from 20 to 150 per cent could be assigned on the basis of internal ratings of banks.

1.119 The new capital norms, when implemented, may demand a greater amount of capital for the banking system as a whole. The capital of the PSBs has increased in three ways: Government capital infusion, equity issues to the public and retained earnings. The Government's total contribution of over Rs.20,000 crore between 1992-93 and 1998-99, equivalent to an annual average of nearly 0.3 per cent of GDP, has primarily been in the form of non-marketable Government bonds paying 10 per cent. Equity issues by 12 PSBs till 2000-01 have aggregated Rs.6,527crore, with the State Bank of India going to the market twice, in 1993 and thereafter in 1996. The banks also raised tier-II capital. In order to discourage issue of tier-II capital bonds to other banks, a ceiling of 10 per cent of the investing banks' total capital has been prescribed for its aggregate investments in the tier-II capital of banks.

Non-performing Assets

1.120 Non-performing assets have been substantially reduced since regulation was tightened in 1993, but improvement has recently slowed down and the levels of NPAs remain high compared to international standards. In 2001, the commercial banking system's gross NPA to gross advances ratio was 11.4 per cent; net of provisions it was 6.2 per cent. The public sector banks' NPAs witnessed a decline in 2001, with the gross NPA to gross advances ratio being 12.4 per cent, as compared with14.0 per cent in 1999-2000; net of provisions, the corresponding figures were 6.7 per cent and 7.4 per cent, respectively.

1.121 An effective resolution of the problem of NPAs is hampered on account of a sizeable overhang component arising from infirmities in the existing process of debt recovery, inadequate legal provisions on foreclosure and bankruptcy and difficulties in the execution of court decrees. Any solution to the overhang problem of large magnitude requires well-crafted medium to long-term actions, devoted to specific definition of goals and negotiation of the process rather than *ad hoc* approaches.

1.122 Needless to mention, a lasting solution to the problem of NPAs can be achieved only with proper credit assessment and risk management mechanisms. For instance, in a situation of liquidity overhang, the enthusiasm of the banking system to increase lending could compromise on asset quality, raising concerns about adverse selection, and the potential danger of addition to the stock of NPAs. It is, therefore, necessary that the banking system is equipped with prudential norms to minimise, if not completely avoid the problem.

1.123 As regards internal factors leading to NPAs, the onus for containing the same rests with the banks themselves. This would necessitate organisational restructuring, improvement in managerial efficiency, skill upgradation for proper assessment of creditworthiness and a change in the attitude of the banks towards legal action, which is traditionally viewed as a measure of the last resort.

Prudential Norms for Loan Classification

1.124 With a view to moving towards international best practice and to ensure greater transparency, the Reserve Bank has announced the intention of moving towards the norm of 90 days classification from the year ending March 31, 2004. Banks have been advised to incorporate a condition in the loan agreement for obtaining the consent of the borrowers to disclose their names in the event of their becoming defaulters. Considering that higher loan loss provisioning adds to the overall financial strength of the banks and the stability of the financial sector, banks are urged to voluntarily set apart provisions much above the minimum prudential levels as a desirable practice.

Legal Framework

1.125 The issue of NPAs is closely related to the state of legal framework. The legal framework sets standards of behaviour for market participants, details about rights and responsibilities of transacting parties, assures that completed transactions are legally binding and provides regulators with the backing to enforce standards and ensure compliance and adherence to law.

1.126 At the policy level, there is the need for legislation, which will make recovery processes smoother and legal action quicker. Banks have been provided with a menu of alternatives such as Debt Recovery Tribunals (DRT), *Lok Adalats* and Asset Reconstruction Companies. A Credit Information Bureau has been established with a paid-up capital of Rs.25 crore, in order to coordinate sharing of information on the borrowers of credit institutions. The Reserve Bank has also provided indicative guidelines for compromise settlement of chronic NPAs in the small-scale sector. Settlement Advisory Committees have also been formed at regional and head office levels. Another method which has been proposed is Corporate Debt Restructuring (CDR) (Box 1.3). These alternatives will create the enabling environment for the appropriate legal reforms, which are being addressed jointly by the Reserve Bank and the Government of India.

Universal Banking

1.127 The policy regarding approach to Universal Banking was enunciated in the annual monetary and credit policy Statement of April 2000. The salient operational and regulatory issues to be addressed by the financial institutions for conversion into a universal bank were also communicated through a circular in April 2001. These issues relate to, among others, reserve requirements, permissible activities, disposal of non-banking assets, composition of the Board, prohibition on floating charge of assets, nature of subsidiaries, restrictions on investments, connected lending, licensing, branch network, assets in India, formats of annual report, priority sector lending and prudential norms. In the Mid-term review Statement of October 2001, the Reserve Bank has stated that the applications received from the concerned institutions would be processed in the light of considerations outlined in RBI's circular to FIs on approach to Universal Banking in April 2001.

1.128 In processing a specific proposal, the overwhelming consideration will be to meet the strategic objectives of the concerned financial institution for meeting the varied needs of different categories of customers, while at the same time ensuring healthy competition in the financial system through transparent and equitable regulatory framework applicable to all the participants in banking business. It needs to be recognised that the movement towards universal banking should foster stability and efficiency of the financial system, but by itself it cannot provide a viable or sustainable solution to the operational problems of individual institutions arising from low capitalisation, high level of NPAs, large asset–liability mismatches, liquidity, etc. While taking a flexible view on each application, particular attention will be paid to the primary need to ensure safety of public deposits, especially of small depositors, and to promote the continued stability of the financial system as a whole, and of the banking system in particular.

Recapitalisation

1.129 The experience of bank recapitalisation in several parts of the world has demonstrated that the exercise of recapitalisation does not necessarily prevent banks from getting into trouble again. In fact, it often serves to distort the incentive structure, erode discipline and reaffirm the faith of these institutions in the 'deep pockets' of the Government. Recapitalisation of weak banks using public money is also a costly and unsustainable option, in view of the increasing strains on the Government exchequer. Till 1999-2000, the

Box 1.3: Corporate Debt Restructuring

One of the methods suggested for the reduction of non-performing assets is Corporate Debt Restructuring (CDR). The process is primarily rescheduling the debt portfolio of the borrowers among its creditors to help the borrowers in the revival of projects and continue operations through reductions in existing debt burden and establishment of new credit lines with implied assumption that the lender would prefer reduction in risk to optimization of returns. The objective of the CDR is to ensure a timely and transparent mechanism for restructuring of the corporate debts of viable corporate entities affected by internal and external factors, outside the purview of BIFR, DRT or other legal proceedings, for the benefit of all concerned.

Recent guidelines on CDR put forth by the Reserve Bank indicate that the CDR is to have a three tier structure: (a) CDR Standing Forum, (b) CDR Empowered Group and (c) CDR Cell. The CDR Standing Forum would be a self-empowered body, which would lay down policies and guidelines and guide and monitor the progress of corporate debt restructuring. The CDR Empowered Group, on the other hand, will decide on individual cases of corporate debt restructuring, which will consider preliminary report of all cases of requests of restructuring submitted to it by the CDR Cell. The Empowered Group would be mandated to look into each case of debt restructuring, examine the viability and rehabilitation potential of the company and approve the restructuring package within a specified time of 90 days, or at best 180 days of reference to the Empowered Group. The lowest of the three tiers would be the CDR Cell, which would make the initial scrutiny of all proposals received from borrowers/lenders by calling for proposed rehabilitation plan and other information and put up the matter before CDR Empowered Group, within one month to decide whether rehabilitation is *prima facie* feasible.

The major features of the CDR mechanism are (a) it would be a voluntary system based on debtor-creditor agreement and inter-creditor agreement, (b) the scheme will not apply to accounts involving only one financial institution or one bank; instead, it will cover multiple banking accounts/ syndication/consortium accounts with outstanding exposure of Rs. 20 crore and above by banks and institutions, (c) the CDR system would only be applicable to standard and substandard accounts, with potential cases of NPAs getting a priority.

References:

Deshpande, N.V. (2001), Indian Banking Emerging Challenges Strategies and Solutions-Legal Perspective, *IBA Bulletin*, March.
Reserve Bank of India (2001), Corporate Debt Restructuring (www.rbi.org.in)

Government has recapitalised nationalised banks to the tune of Rs.20,446.12 crore (Table I.1). However, even after allowing for additional infusion of capital through internal generation and access to subordinated debt, the gap between the capital required by these banks and the leeway available to raise the same from market sources, is likely to remain significant. The question which merits attention is whether the gap should be filled by the Government or alternately, whether the legislative ceiling for public subscription should be raised.

1.130 In this context, the Government has indicated that it will adopt a gradual privatisation agenda where its ownership of PSBs will be reduced over a period of time. Accordingly, the Government has introduced the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/80 and Financial Institutions Laws (Amendment) Bill, 2000 in Parliament which seeks to reduce the minimum shareholding by Government to 33 per cent to enable PSBs to raise fresh equity from the capital market. Assuming that the economy grows at the current rate and capital adequacy norms are the same as at present, it is estimated that the banks (barring the three weak banks) would require Rs.10,000 crore over the next five years.

Risk Management

1.131 An open and competitive environment of operations provides opportunities as well as challenges to banks. As narrowing spreads compel banks to assume more risks, it becomes necessary to ensure an appropriate trade-off between risks and returns. Recognising the need for effective risk management systems, in October 1999, the Reserve Bank issued detailed guidelines for risk management system in banks, embracing broadly the areas of credit, market and operational risks. With regard to credit risk, it was suggested that banks should put in place the loan policy, approved by the Board of Directors, covering the methodologies for measurement, monitoring and control of credit risk. The guidelines also require banks to evaluate portfolio on an on-going basis, rather than near about the balance sheet date. As regards off-balance sheet exposures, the current and potential credit exposures may be measured on a daily basis. Banks have also been asked to fix a definite time-frame for moving over to duration and Value-at Risk (VaR) approaches for measurement of interest rate risk.

Table I.1: Nationalised Banks whose capitals were subscribed by the Government of India out of Budget provisions/Banks whose investments were written down/Banks whose capital was returned to Government

(Rs. crore)

Sr. No.	Name of the/ Bank	Capital subscribed/written down (*)/Capital Returned to Government (**)											
		2000-01	1999-2000	1998-99	1997-98	1996-97	1995-96	1994-95			1993-94	Upto 1992-93	Total
								Tier-I		Tier-II			
1	2	3	4	5	6	7	8	9	10	11	12	13	14
1.	Allahabad Bank			-	-	532.00*	160.00	-	356.20	101.61	90.00	171.33	
2.	Syndicate Bank			942.62*	-	-	172.00	-	278.59	88.79	680.00	148.50	
3.	Bank of Maharashtra			418.18*	-	-	80.00	94.61	239.58	-	150.00	182.08	
4.	Punjab and Sind Bank			462.47*	-	150.00	72.00	-	116.03	-	160.00	205.61	
5.	UCO Bank			200.00	350.00	54.00	110.00	235.56	279.96	-	535.00	492.00	
6.	United Bank of India			100.00	-	338.00	256.00	67.44	471.43	-	215.00	360.19	
7.	Andhra Bank	47.95**		243.37*	-	165.00	-	75.72	108.60	-	150.00	89.00	
8.	Central Bank of India			-	-	500.00	-	-	632.46	-	490.00	175.74	
9.	Vijaya Bank		297.07*	-	-	302.00	-	-	62.31	-	65.00	125.72	
10	Bank of Baroda			-	-	381.00**	-	-	-	-	400.00	163.00	
11.	Canara Bank			507.10*	600.00	-	-	-	-	-	365.00	112.50	
12.	Corporation Bank			-	-	30.00**	-	-	-	-	45.00	65.40	
13.	Bank of India			-	-	93.47**	1,369.91*	-	848.38	348.22	635.00	455.00	
14.	Dena Bank			-	-	-	136.29*	-	6.11	72.28	130.00	145.63	
15.	Indian Bank			100.00	1,750.00	-	-	-	230.96	180.94	220.00	194.00	
16.	Indian Overseas Bank			-	-	1,000.00*	-	-	258.60	132.74	705.00	357.00	
17.	Oriental Bank of Commerce			-	-	-	-	-	-	-	50.00	76.90	
18.	Punjab National Bank			-	138.33**	-	-	-	425.43*	-	415.00	165.00	
19.	Union Bank of India			-	-	-	-	-	-	-	200.00	132.00	
Capital Subscribed				**400.00**	**2,700.00**	**1,509.00**	**850.00**	**473.33**	**3,889.21**	**924.58**	**5,700.00**	**4,000.00@**	**20,446.12**
Capital Written down			**297.07**	**2,573.74**	**-**	**1,532.00**	**1,506.20**	**-**	**425.43**		**-**		**6,334.44**
Capital Returned to Govt.		**47.95**			**138.33**	**504.47**							**690.75**

* Written down ** Capital Returned to Government
@ Including an amount of Rs. 183.40 crore towards capital subscription by the Government to the erstwhile New Bank of India.

Corporate Governance

1.132 Corporate governance acts a 'coping mechanism' in order to enable the participants to reap the full benefits of reforms. Corporate governance has as its backbone a set of transparent relationships between an institution's management, its Board, shareholders and other stakeholders. It should therefore take into account a number of aspects such as enhancement of shareholder's value, protection of rights of shareholders, composition and role of Board of Directors, integrity of accounting practices and disclosure norms and internal control system. As far as the banking industry is concerned, corporate governance relates to the manner in which the business and affairs of individual banks are directed and managed by their Board of Directors and senior management. It also provides the structure through which objectives of the institution are set, the strategy of attaining those objectives is determined and the performance of the institution is monitored.

1.133 The paper of the Basel Committee for Banking Supervision (BCBS) on the subject envisages certain strategies and techniques basic to sound corporate governance in banks. Basic elements of corporate governance are capable and experienced Directors in the Board, efficient management, coherent strategy and business plan and clear lines of responsibility and accountability. While the primary responsibility for good corporate governance in banks rests with the Board of Directors, the roles played by the Government, regulator, auditors and banking industry associations are equally important.

1.134 The Advisory Group on Corporate Governance (Chairman: Dr. R.H.Patil) had observed that since most of the Indian companies belong to the East Asian insider model, where the promoters dominate governance, it is essential to bring reforms quickly so as to make boards of corporates/ banks/financial institutions/public sector enterprises more professional and truly autonomous. As the statutory framework for corporate governance has already been provided in the Companies Act, the Group felt that it is desirable to amend the Companies Act suitably for enforcing good governance practices in India. Contextually, the Advisory Group on Banking Supervision (Chairman: Shri M.S.Verma) had also made certain recommendations relating to corporate governance in banks (Box II.4).

(b) Redefining the Regulatory Role of the Reserve Bank

Regulation and Supervision

1.135 Prudential regulation and supervision have formed a critical component of the financial sector reform programme since its inception, and India has adopted international prudential norms and practices with regard to capital adequacy, income recognition, provisioning requirement and supervision. These norms have been progressively tightened over the years, particularly against the backdrop of the Asian crisis. Recently, the required capital adequacy ratio has been increased to 9 per cent, from 8 per cent, in the banking sector. The mark-to-market practice for valuation of government securities has been gradually enhanced from 30 per cent in 1992-93 to 75 per cent in 1999-2000 and subsequently, revised guidelines for valuation and classification of investments have been implemented to align with international best practices.

1.136 In the area of supervision, a full-fledged institutional mechanism has been developed keeping in view the needs of a strong and stable financial system. The system of off-site surveillance has been combined with periodical on-site supervision for monitoring the risk profile of banks and their compliance with prudential guidelines. The assessment had shown that most of the *Core Principles for Effective Banking Supervision* are already provided in our existing legislation or current regulations and attempts are underway to rectify the gaps between existing practice and principles in areas where certain shortcomings exist.

1.137 Keeping in line with the emerging regulatory and supervisory standards at international level, the Reserve Bank has initiated some macro level monitoring techniques to assess the true health of the supervised institutions. The format of balance sheets of commercial banks have now been prescribed by the Reserve Bank with disclosure standards on vital performance and growth indicators, provisions, net NPAs, staff productivity, etc. appended as 'Notes to Accounts'. To bring in further transparency in the banks' published accounts, the Reserve Bank has also advised the banks to disclose data on movement of NPAs and provisions as well as lending to sensitive sectors. These proposed additional disclosure norms would bring the disclosure standards almost on par with the international best practices.

1.138 The Reserve Bank has instituted a mechanism for critical analysis of the balance sheet by the banks themselves and the presentation of such analysis before their boards to provide an internal assessment of the health of the bank. The analysis which is made available to the Reserve Bank forms a supplement to the already stabilised system of off-site monitoring of banks.

Co-operative Banking

1.139 The year under review witnessed an emergence of several challenges, especially in the urban co-operative banks (UCBs). This segment has been exposed to certain weaknesses that need to be remedied on an urgent basis. Apart from the multiple regulatory authorities involved in their supervision and inspection, the sheer numbers and their dispersed and local character, with a different niche clientele can affect the regular programming of inspections by supervisors. In view of the above, supervision of UCBs often proves to be a challenging proposition for the Reserve Bank. In this context, the Monetary and Credit Policy of April 2001 has emphasised the creation of a separate apex supervisory authority which can take over the entire inspection/supervisory functions in relation to scheduled and non-scheduled UCBs with manpower and other assistance to the new supervisory body, when created. Greater co-ordination and information sharing will also be required among regulators in view of the increasing integration of the various segments of the financial market and overlaps in the areas of operation of different types of financial institutions.

International Financial Standards and Codes

1.140 Recent experiences that have demonstrated the vulnerabilities of financial systems to contagion from across national borders and the close correlation of the risks faced by financial systems across countries, have highlighted the necessity for greater homogeneity in the supervisory norms and practices of various countries and closer co-ordination between countries in terms of regulation of their financial systems.

1.141 India, while supporting the need to observe certain minimum universally accepted standards in areas relevant to the maintenance of stability in the international monetary system, has advocated a voluntary approach taking into account the institutional framework, legal infrastructure and stage of development of various countries. India's approach to the process of convergence has been two-fold. At the international front, India has been closely associated with international bodies involved in the process of setting standards and formulating practices for effective supervision of financial systems and has sought to voice its opinion during the process of formulation of new standards. Thus, India has been closely associated with standard setting bodies such as the Core Principles Liaison Group and Group on Joint Task Force on Securities Settlement Systems constituted by the Committee on Payment and Settlement Systems (CPSS) and International Commission of Securities Commissions (IOSCO).

1.142 On the domestic front, the Reserve Bank, in consultation with the Government of India, set up a Standing Committee on International Financial Standards and Codes under the Chairmanship of Dr. Y.V. Reddy, Deputy Governor (and the Finance Secretary as Alternate Chairman) to guide the process of convergence to international financial standards and codes. In the face of rapid changes in the banking sector in the recent years, the Committee envisaged a systematic approach to implementation of international standards and codes consisting of recognition, identification and recording of standards and codes in the relevant areas, followed by detailed assessment of the present status of compliance, applicability, relevance and feasibility of compliance. Preparation of roadmaps and recommendations of possible time-frame for convergence to such standards as are relevant, applicable and feasible constitute the other steps in the process. The next stage in the process involves making efforts for the widest possible dissemination of the expert opinion so as to involve public authorities and other stakeholders and generate an informed debate to sensitise public opinion on the subject.

Macro-prudential Indicators and Micro-prudential Framework

1.143 The health and stability of the econonmy has traditionally been measured by Macroeconomic Indicators (MEIs). Financial sector supervisors have been using their own set of Microprudential Indicators, based on CAMELS framework. Following the east-Asian crisis, the interest in a combine of Aggregated Microprudential Indicators (AMPIs) and MEIs has increased. Such indicators, referred to as Macroprudential indicators, are pointers of the health and soundness of financial systems and allow policymakers to gauge the extent of vulnerability of a system or an institution to financial crises (Box I.4). The dual approach takes cognizance of the fact that banking and financial institutions are greatly affected by the real economic environment in which they operate. Macroprudential indicators allow for assessments to be based on objective measures of financial soundness.

1.144 In view of the increasing competition and diversification of operations in the Indian banking sector as well as the increasing globalisation of the financial sector, it was deemed fit to expand the supervisory approach to include identification and monitoring of macroprudential indicators. In October 2000, it was decided to prepare a half-yearly financial stability review using macroprudential indicators for internal circulation in the Reserve Bank and an inter-departmental group was constituted for the purpose. A pilot review of macroprudential indicators for the half-years ended March 2000 and September 2000 were prepared. The review for March 2001 has subsequently been prepared and put up to the Board for Financial Supervision.

1.145 In order to orient the system to the requirements of the Indian banking sector, the microprudential framework for supervision of individual institutions uses a set of indicators aimed at: (i) peer group analysis based on critical financial ratios, and (ii) development of supervisory bank rating systems involving assignment of rating based on the behaviour of certain indicators in relation to pre-specified norms/ benchmarks. The indicators used for both these approaches are based on the CAMELS model, where the ‘S’ stands for systems and procedures. A prompt corrective action framework based on certain indicators like CRAR, net NPAs and return on assets is also expected to be operationalised in the near future.

(c) Effecting Structural Changes in the System

Internal Controls

1.146 The experience reveals that the operational rules and norms of banking have not kept pace with the developments taking place in the banking sector. The cumbersome loan and documentation procedures in banks, which partly arise from legislative and regulatory requirements, impinge on the efficient functioning of the banking sector.

1.147 It is, therefore, very vital that the internal controls which consist of a wide spectrum of internal inspection and audit, submission of control returns by branches/ controlling offices to higher level offices, visits by controlling officials to the field level offices, risk management system, simplification of documentation procedures and efficient interoffice communication channels, are strengthened. The implementation of such a control system would necessitate revisions in the ‘Operational Manuals’, audit procedures and better evaluation of clients. Some steps have already been initiated in this direction. Besides, banks have been advised to constitute Audit Committees of the Boards to enable focused attention by the Boards of the banks on internal control systems.

Box I.4: Macroprudential Indicators

Aggregated Microprudential Indicators

Capital Adequacy
Aggregate capital ratios.
Frequency distribution of capital ratios

Asset Quality
Lending Institution
Sectoral credit concentration.
Foreign currency denominated lending.
Non-performing loans and provisions.
Loans to loss-making public sector entities.
Risk Profile of Assets.
Connected lending.
Leverage Ratios

Borrowing Entity
Debt-equity ratios.
Corporate profitability

Macroeconomic Indicators

Economic Growth
Aggregate growth rates.
Sectoral slumps.

Balance of Payments
Current account deficit.
Foreign exchange reserve adequacy.
External debt (including maturity structure).
Terms-of-trade.
Composition and Maturity of capital flows

Inflation
Volatility in inflation.

Interest and Exchange Rates
Volatility in interest and exchange rates.

Other indicators of corporate conditions.
Household indebtedness.

Management Soundness
Expense Ratios.
Earnings per employee.
Growth in the number of financial institutions.

Earnings and Profitability
Return on Assets.
Return on Equity.
Income and Expense ratios.
Structural profitability indicators.

Liquidity
Central bank credit to financial institutions.
Deposits in relation to monetary aggregates.
Segmentation of inter-bank rates.
Loans-to-deposits ratios.
Maturity structure of assets and liabilities.
Measures of secondary market liquidity.

Sensitivity to Market Risk
Foreign Exchange risk.
Interest rate risk.
Equity price risk.
Commodity price risk.

Market based Indicators
Market prices of financial instruments, including equity.
Indicators of excess yields.
Credit Ratings.
Sovereign yield spreads.

Level of domestic real interest rates
Exchange rate sustainability
Exchange rate guarantees.

Lending and asset price booms
Lending booms.
Asset price booms.

Contagion Effects
Financial market correlation.
Trade spillovers.

Other factors
Directed lending and investment.
Government recourse to banking system.
Arrears in the economy.

Source : Evans, O., A.M. Leone, M.Gill and P.Hilbers (2000), *"Macroprudential Indicators of Financial System Soundness"*, IMF Occassional Paper, No.192.

Information Technology

1.148 Information Technology and the communication Networking Systems have revolutionalised the functioning of banks and other financial institutions the world over. In the highly industrialised countries, access to financial entities is on an on-line basis. Banks as well as other financial entities in India have only recently entered the world of information technology and computer networking. The introduction of liberalisation measures in the banking sector and the emergence of new private sector and foreign banks equipped with latest technology, have led to an increase in competition and a reduction in costs in the banking sector. Technology upgradation is taking place in PSBs in a phased manner. Computerisation is increasingly being applied in day-to-day deposit and loan operations, but the pace at which it has moved so far, has been somewhat limited. Moreover, there is a need for computerisation in a large number of areas of operations of banks, with customer service as the main focus. Management information system could be further improved by using modern information technology methods. In the case of many industrial countries, due to advancement of information technology, virtual banking has gained more prominence and in the days to come, banks have to hasten the process of computerisation with a view to improving competitiveness. There is evidence to show that it has been possible for public sector and old private banks to improve their productivity and efficiency over a period of time, through stepping up of IT investments. Increasing use of information technology in finance is inevitable and it is expected that more and more transactions will take place across the Internet and the Web in the near future. At the same time, stronger supervision, surveillance and regulation of transactions conducted electronically or over the Web would be required.

1.149 Strengthening of information technology in commercial banks would also be an important prerequisite to implement an effective ALM system in banks. The database of banks has to cover all operations of branches for a detailed analysis of assets and liabilities and for forecasting liquidity conditions under various scenarios. The success of ALM would hinge critically on the availability of trained and skilled manpower. The guidelines on risk management have placed the primary responsibility of laying down risk parameters and establishing the risk management and control system on the board of directors. The responsibility of day-to-day implementation of the integrated risk management has been assigned to risk management committees or a committee of top executives that reports to the board. The risk management guidelines also require banks to constitute a high level credit policy committee to deal with issues pertaining to credit sanction, disbursement and follow-up procedures and to manage and control credit risk for the bank as a whole. The Reserve Bank has further asked banks to concurrently set up an independent credit risk management department to enforce and monitor compliance of the risk parameters and prudential limits set by the board/credit policy committee.

Deposit Insurance

1.150 In India, at present, the deposit insurance premia is a flat rate, irrespective of the risk profile of the financial entity. This creates a moral hazard problem in that depositors have limited incentive to monitor the condition of the financial institution. This has raised the obvious question as to whether the premia should be risk-based which requires establishment of an agreeable basis of assessment of risk profile of banks. Various alternate choices such as Federal Deposit Insurance Corporation (FDIC) model of supervisory rating (CAMELS), risk-adjusted assets basis and options pricing model exist. There is also the question of whether the onus of monitoring the bank should fall on the Deposit Insurance Corporation and whether it should be conferred legal status to take penal action including liquidation. Another issue relates to the size of deposit that is insured. Many of these issues have been discussed in the Report on Reforms in Deposit Insurance in India (1999). From the point of view of legal requirements, the scope of revision of the present deposit insurance setup will have to deal with a number of statutory amendments. Several enactments, including the Bank Nationalisation Act and the State enactments on cooperatives present difficulties for the Deposit Insurance Corporation to act as a receiver/liquidator in the case of failure of insured entity. These issues would also be addressed while adopting a revised deposit insurance scheme, which is being contemplated.