Chapter I
Banking Development and Perspectives

Banking has traditionally remained a protected industry in many emerging economies. Regulated deposit and lending rates and restrictions on competition enabled comfortable spreads. There was limited pressure on banks to come out of this quiescent and protected world. A combination of developments have compelled bankers to change the old ways of doing business. These include, among others, technological advancements, disintermediation pressures arising from a liberalised financial marketplace, increased emphasis on shareholder value, and macroeconomic pressures and banking crises in the 1990s. The scope, timing and speed of this process, however, have not been uniform across countries or segments of the industry, reflecting the differing objectives of intervention and diverse initial conditions.

1.2 As a consequence of the transitional developments that are taking place, the dividing lines between financial products, types of financial institutions and their geographical location have become less relevant than in the past. At the same time, the growing size of financial activity relative to overall economic activity in a closely integrated world has implied that disruptions in financial markets or infrastructure in any economy can engender contagion, which can spread rapidly and have far greater adverse economic ramifications than was the case earlier. Consequently, while lending and deposit-taking have continued to remain the mainstay of banking business, the greater globalisation of banking operations in an increasingly market-driven environment has made risk management critical.

1.3 Globally, while banking operations have been undergoing drastic metamorphosis, financial stability has come to occupy centre-stage as one of the prime policy concerns facing central banks worldwide. Given the predominantly bank-based nature of financial systems in emerging markets, there is growing realisation that the preservation of the safety and soundness of individual financial institutions, especially banks, and of the financial system as a whole is important not only for conducting business across national borders, but also for preserving financial stability. Not surprisingly, therefore, the banking sector in most emerging economies, including India, is passing through challenging times.

1.4 Against the above backdrop, this Chapter provides an overview of policy initiatives undertaken in the Indian banking system during 2001-02 and a perspective towards developing an efficient and globally competitive banking system.

1. Policy Environment

Monetary and Credit Policy

1.5 Recent experiences in conducting monetary policy have highlighted the imperative need for strategic adjustments so as to enable the policy to respond effectively to market disturbances as the economy becomes increasingly integrated with global financial markets. The development of a sound and healthy banking system through promotion of prudent financial practices has become essential to sustain financial stability. It has been recognised that the Indian banking system should be in tune with well-laid down international standards of capital adequacy and prudential norms.

1.6 The annual monetary and credit policy Statements as well as the mid-term Reviews of the Reserve Bank of India (RBI) have, therefore, been focusing on the structural and regulatory measures needed to strengthen the financial system and improve the functioning of various segments of the financial market. These measures, introduced after extensive consultations with experts and market participants, have the objectives of:

- increasing operational effectiveness of monetary policy,
- redefining the regulatory role of the RBI,
- strengthening prudential and supervisory norms,
- improving credit delivery system, and
- developing technological and institutional infrastructure of the financial sector.

1.7 Technology has broadened the horizon of banking business and in the context of deregulation, it has contributed to the emergence of a more open, competitive and globalised financial market. While this has contributed to improvements in the efficiency in the economy, it has also underscored the need for greater vigilance and prudence in managing banking operations.

1.8 The Monetary and Credit Policy, announced in April 2002, reiterated the objective of achieving convergence between Indian standards and international practices and focused, among others, on issues related to prevention of money laundering, corporate debt restructuring, investment fluctuation reserve and technology upgradation.

Interest Rate Structure

Bank Rate and Repo Rate

1.9 On the basis of the review of the macroeconomic and monetary developments, the Bank Rate was reduced to 6.50 per cent effective October 23, 2001. The April 2002 Monetary and Credit Policy statement also announced that in case the overall liquidity and credit situation warranted it and inflation rate continued to remain low, a reduction in the Bank Rate by up to half a percentage point (50 basis points) would be considered. Liquidity conditions, by and large, remained favourable, reflected in higher daily average outstanding amount of repos in response to which, the repo rate was brought down to 5.75 per cent on June 27, 2002. In the mid-term Review for 2002-03, the Bank Rate was reduced by 0.25 percentage point from 6.50 per cent with effect from the close of business on October 29, 2002. At this level, it is the lowest Bank Rate since 1973. The repo rate was reduced by 0.25 percentage point for the LAF on October 30, 2002.

Liquidity Adjustment Facility (LAF)

1.10 The LAF, an important indirect instrument for the conduct of monetary policy, operated through daily repo and reverse repo auctions, is assigned the objective of meeting day-to-day liquidity mismatches in the system, smoothening volatility in short-term money market rates and steering these rates consistent with monetary policy objectives.

1.11 In the second stage of LAF commencing May 2001, rationalisation in the operating procedures of LAF was effected. The minimum bid size was reduced from Rs.10 crore to Rs.5 crore to enable small level operators to participate in LAF auctions. The auction format for LAF was changed from the uniform price auction method to the multiple price auction method to

ensure more responsible bidding. The timing for LAF auctions was advanced by 30 minutes, to provide additional time to unsuccessful bidders in LAF auctions to cover up their positions in the short-term money market. A system of information dissemination on aggregate cash balances maintained by scheduled commercial banks (SCBs) with RBI, on a cumulative basis during the reporting fortnight, was introduced with a view to stabilising market expectations and dampening volatility in call rates. Furthermore, RBI introduced longer-term repos up to 14 days and has resorted to fixed rate repos on overnight basis on one occasion. Since February 15, 2002, the members of Negotiated Dealing System (NDS) submit LAF bids on electronic platform instead of physical form.

1.12 The second stage of LAF was introduced in synchronisation with the rationalisation of standing liquidity facilities. In the second stage of LAF, operating since May 8, 2001, the standing liquidity facilities have been split into normal and backstop components. The switchover to the modified operating procedures so far has been smooth. The medium-term objective is to move gradually towards a full-fledged LAF and to do away with various sector-specific standing liquidity facilities.

Deposit and Lending Rates

1.13 The policy measures focused on imparting greater flexibility and transparency to the interest rate structure so that interest rates evolve in alignment with the behaviour of domestic and international macroeconomic and financial conditions.

1.14 One of the major objectives of the progressive deregulation of interest rates was to provide considerable flexibility to banks in deciding their deposit/lending rate structures and managing their assets/liabilities. On the deposit side, except for savings deposits on which the interest rate is fixed at 4 per cent, banks are free to offer fixed/floating rates. To impart flexibility, banks are encouraged to consider introducing flexible interest rate systems for all new deposits, in addition to the fixed rate option already available to depositors. Illustratively, banks may offer longer-term deposits at a floating rate and simultaneously offer fixed rates for similar maturity, with higher or lower interest rates depending on the period of deposit and banks' perception regarding inflation and interest rate outlook over the longer period. Banks were urged to devise schemes encouraging depositors to convert their existing long-term fixed rate deposits into variable rate deposits. Commercial banks were advised to consider the option of paying depositors at the contracted rate for the period of deposit already run and waive the penalty for premature withdrawal if the same deposit is renewed at the variable rate. Interest rate ceilings for foreign currency non-resident (banks) [FCNR (B)] deposits were revised downwards to LIBOR/SWAP rates of corresponding maturities minus 25 basis points. The mid-term Review for 2002-03 relaxed the ceiling rate for Japanese Yen deposits.

1.15 On the lending side, banks are free to prescribe respective prime lending rates (PLRs) across various tenors, as also lend at sub-PLR rates. To extend the benefits of lower interest rates to a wider spectrum of borrowers, banks were urged to review and disclose the maximum spreads over PLR and reduce them if unreasonably high, so as to enhance transparency and ensure credit availability at reasonable rates. In order to ensure appropriate pricing of loans, banks are encouraged to review both their PLRs and spreads and align spreads within reasonable limits around PLR subject to approval of their Boards.

1.16 In the interest of customers, and also to enhance competition, banks are expected to

provide necessary information on deposit rates for various maturities, effective annualised return to depositors and maximum and minimum interest rates charged to their borrowers. Moreover, banks were urged to switch over to "all cost" concept for borrowers through explicit declaration of processing, service charges, etc. To further enhance transparency, it was proposed to consolidate this information and post it on the RBI's website after the data system has stabilised.

1.17 In tandem, in order to accord greater flexibility to co-operative banks and to enable them to attract good/prime borrowers in a competitive environment, the stipulation of minimum lending rate (MLR) for all co-operative banks was withdrawn. Co-operative banks are now free to determine their lending rates taking into account the cost of funds, transactions costs, etc. Furthermore, to ensure that the interest rates charged are transparent and known to all customers, co-operative banks have to publish minimum and maximum rates charged, and display this information in every branch.

Export Credit Interest Rates

1.18 In order to infuse competition and to provide exporters wider choice, the rupee export credit interest rate structure was linked to the PLR of banks. Ceiling rates applicable on pre-shipment credit upto 180 days and post-shipment credit (demand bills and usance bills) upto 90 days, were set at 150 basis points below PLR. In consideration of the special unusual international developments that occured in September 2001 and their consequent implications for Indian trade, the ceiling rate on export credit was reduced to 250 basis points below PLR for the above period, effective September 26, 2001, extended till end-September 2002 and further upto end-April 2003. Likewise, the ceiling for interest on foreign currency loans was reduced to LIBOR plus 0.75 percentage points in April 2002, in consonance with the reduction of 25 basis points on the interest to be paid on FCNR (B) deposits. The concessionality in interest rates for deemed exports is widely publicised by banks so that the advantage can be availed by all sections of exporters.

Export Credit Refinance

1.19 Beginning May 5, 2001, scheduled banks were provided export credit refinance facility 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 or the existing limits as on May 4, 2001, whichever was higher. The old formula, based on an increment of export credit eligible for refinance over the base date, did not reflect the extent of total credit support being provided by banks to exporters, especially in cases where the base levels were high. The limit prevailing on May 4, 2001 constituted the minimum limit available to a bank up to March 31, 2002. Effective April 1, 2002, export credit refinance is being provided to scheduled banks at 15 per cent of their outstanding export credit eligible for refinance as at the end of the preceding fortnight.

Liberalisation of Investment Norms of Funds
Mobilised under FCNR(B) Deposits

1.20 To avoid asset-liability mismatches, and also to be consistent with the prevalent risk management guidelines, banks were permitted to invest FCNR(B) deposits in longer term fixed income instruments provided these instruments have ratings comparable to those prescribed for the money market instruments. Banks have to obtain prior approval from their Boards with

regard to type/tenor of instruments along with relevant rating and likely cap on such investments within the asset-liability management (ALM) guidelines in force.

Relaxation on Borrowing from and Investment in Overseas Markets by Banks

1.21 To enhance operational flexibility banks have been permitted to borrow up to 25.0 per cent of their unimpaired tier I capital from overseas markets. Concurrently, the extant limit of 15.0 per cent of unimpaired tier I capital for investment in overseas market was also raised to 25.0 per cent. The borrowings and investments in money market instruments will be within the existing open position limit and maturity mismatch limits (gap limits). These measures are expected to enhance the integration of the Indian financial market with global markets, as also the different segments of the domestic market.

Crystallisation of External Commercial Borrowings

1.22 Overseas branches of authorised dealers (ADs) in foreign exchange customarily extend external commercial borrowings (ECBs) to Indian corporates against guarantees/letters of comfort issued by their branches in India. In cases of default of payment of interest/ instalment on due date, the branches in India have to honour the commitment. In cases where the accounts have become non-performing asset (NPA), the branches have to continue to service the loan in forex. To accord greater freedom and flexibility to banks in their fund management, permission was granted with appropriate safeguards for crystallisation of ECBs into rupee loans where considered necessary by banks.

Cash Reserve Ratio (CRR)

1.23 The RBI has been pursuing its medium-term objective of reducing the CRR to its statutory minimum level of 3.0 per cent. The CRR was reduced from 11.0 per cent in August 1998 to 7.5 per cent by May 2001. In October 2001, the CRR of SCBs (excluding Regional Rural Banks (RRBs)) was rationalised along with a reduction of 200 basis points to 5.5 per cent of net demand and time liabilities (NDTL). For strengthening the LAF and introducing better prudential standards, the CRR was reduced further to 5.0 per cent effective June 1, 2002. In the Mid-term Review of Monetary and Credit Policy for the year 2002-03, it was announced that the CRR would be reduced to 4.75 per cent effective from the fortnight beginning November 16, 2002.

1.24 Rationalisation of CRR was also initiated by withdrawing various exemptions given to banks on certain specific categories of liabilities for the CRR requirement. Subsequently, all categories of scheduled banks, including cooperative banks, were also subjected to the same CRR prescription as applicable to SCBs. These measures were designed to facilitate development of a short-term yield curve, develop the money market, enhance availability of lendable resources with banks and improve the efficacy of indirect instruments in the conduct of monetary policy.

Statutory Liquidity Ratio (SLR)

1.25 There has been no change in the statutory minimum requirement of SLR of 25 per cent of NDTL for commercial banks. Scheduled Urban Co-operative Banks are required to maintain the entire prescribed 25 per cent SLR holding only in Government and other approved securities

from April 1, 2003. For RRBs, balances maintained in call money or fixed deposits with their sponsor banks were hitherto treated as 'cash' and hence reckoned towards their maintenance of SLR. As a prudential measure, RRBs are now required to maintain their entire SLR holdings in Government and other approved securities. The RRBs were allowed to convert existing deposits with sponsor banks into Government securities by March 31, 2003. Subsequently, the SLR holdings of RRBs in the form of deposits with sponsor banks maturing beyond March 31, 2003 were allowed to be retained till maturity.

Policy Perspectives Associated with Money Market Developments

Money Market

Moving further towards Pure Inter-bank Call Money Market

1.26 The intention to move towards a pure inter-bank call/notice money market by gradually phasing out non-bank participation was enunciated in April 2001. Accordingly, a time frame was outlined with four stages for implementation. In stage I, non-bank participants were allowed to lend, on average, up to 85 per cent of their average lending during 2000-01 in a reporting fortnight. A review of progress revealed that phasing out of non-banks has not caused any strain on the market: the volatility in the call money rate has reduced and average daily turnover has gone up. Simultaneously, net lending through repo transactions by non-banking financial institutions and mutual funds has increased. Accordingly, it was decided to move towards stage II, where non-bank participants would be allowed to lend, on average in a reporting fortnight, up to 75 per cent of their average lending in call /notice market during 2000-01 with effect from a date to be announced later, depending on when NDS/CCIL becomes fully operational, and widely accessed.

Reliance on Call/Notice Money Market

1.27 Narasimham Committee II had recommended that clearly defined prudent limits should exist, beyond which banks should not be allowed to rely on call/notice money market. Moreover, access should essentially be for meeting unforeseen mismatches and not as a regular means of financing banks' lending operations. This was also recognised in the guidelines on Asset-Liability Management (ALM) system issued by RBI in February 1999 which required, *inter alia,* that mismatches during the first two time buckets, *viz.*, 1-14 days and 15-28 days should not, in any case, exceed 20 per cent of the cash outflows in each time bucket. Further, to reduce excessive reliance on short-term funding, banks were advised to set a cap on inter-bank borrowings, especially call borrowings. A Working Group with representatives from eligible entities was constituted to recommend by June 30, 2002, the criteria for fixing the limits for Primary Dealers (PDs) in call/notice money market and suggest a road map for phasing them out from the call money market.

1.28 It was felt that building up of substantial exposure relative to balance sheet size by some participants on a continuous basis has the potential not only for default and consequent systemic instability, but also impedes the development of other segments of the money market, particularly, the term money market. The Technical Advisory Committee on Money and Government Securities Markets (TAC) also suggested linking of borrowing and lending in call/notice money market to the size of the balance sheet. Accordingly, it was decided to impose

prudential limits on exposure to call/ notice money market in a symmetric way so as to preserve the integrity of the financial system.

1.29 In the first stage from the fortnight beginning October 5, 2002, lending by SCBs on a fortnightly basis in the call/notice money market should not exceed 50.0 per cent of their owned funds (paid-up capital plus reserves) as at the end of March of the previous financial year; however, banks are allowed to lend a maximum of 100.0 per cent of their owned funds on any day during a fortnight. Borrowing by SCBs, on the other hand, in call/notice money market, on a fortnightly average basis, should not exceed 150.0 per cent of their owned funds or 2.0 per cent of aggregate deposits as at the end of March of the previous financial year, whichever is higher; however, banks are allowed to borrow a maximum of 250.0 per cent of their owned funds on any day during a fortnight.

1.30 In the second stage, with effect from the fortnight beginning December 14, 2002, lending of SCBs, on a fortnightly average basis, should not exceed 25.0 per cent of their owned funds; however, banks are allowed to lend a maximum of 50.0 per cent on any day during a fortnight. Similarly, borrowing by SCBs should not exceed 100.0 per cent of their owned funds or 2.0 per cent of aggregate deposits, whichever is higher; however, banks are allowed to borrow a maximum of 125.0 per cent of their owned funds on any day during a fortnight. Effective October 5, 2002, PDs lendings in the call money market were limited to 25.0 per cent of their net owned fund (NOF). PDs are permitted to adhere to the limits of lending on a fortnightly average basis. The stipulated limits for borrowing in the call/notice money market will be implemented at a later stage conditional upon certain developments in the repo market.

1.31 For urban co-operative banks (UCBs), it was stipulated on April 19, 2001 that their borrowings in call/notice money market on a daily basis should not exceed 2.0 per cent of their aggregate deposits as at end-March of the previous financial year. Subsequently, the same stipulation was extended to State Co-operative Banks (StCBs) and District Central Co-operative Banks (DCCBs) on April 29, 2002 in that borrowings by StCBs and DCCBs in call/notice money market on a daily basis should not exceed 2.0 per cent of their aggregate deposits as at end-March of the previous financial year.

Collateralised Lending Facility (CLF)

1.32 The extent of liquidity support available to each bank out of the CLF, under which liquidity is provided against the collateral of Government of India dated securities/treasury bills held in excess of their SLR requirement, had been stipulated at 0.125 per cent of its fortnightly average outstanding aggregate deposits in 1997-98. With the progressive development of the inter-bank repo market and operationalisation of Clearing Corporation of India Limited (CCIL), limits for the CLF were reduced by 50 per cent with effect from the fortnight beginning July 27, 2002 and were withdrawn completely effective October 5, 2002.

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

Box I.1: Major Policy Measures Announced in the Mid-term Review of Monetary and Credit Policy for the year 2002-03

Monetary Measures

(a) Bank Rate

- The Bank Rate was reduced by 0.25 percentage point from 6.50 per cent with effect from the close of business on October 29, 2002. At this level, it is the lowest Bank Rate since 1973.

(b) Cash Reserve Ratio

- The CRR was reduced from 5.0 per cent to 4.75 per cent effective from the fortnight beginning November 16, 2002. With this reduction, CRR has been reduced by as much as 3.75 percentage points over the past two years.
- Banks have been advised to maintain a minimum of 80 per cent of required CRR amount on a daily basis effective from the fortnight beginning November 16, 2002. The minimum level of 80 per cent would be applicable for all the days in a reporting fortnight.

(c) Statutory Liquidity Ratio of Regional Rural Banks (RRBs)

- SLR holdings of RRBs in the form of deposits with sponsor banks maturing beyond March 31, 2003 was allowed to be retained till maturity. These deposits may be converted into government securities, on maturity, in case the concerned RRBs have not achieved the 25 per cent minimum level of SLR in government securities by that time.
- Although deposits with sponsor banks contracted before April 30, 2002 would be reckoned for SLR purpose till maturity, RRBs were advised to achieve the target of maintaining 25 per cent SLR in government securities out of the maturity proceeds of such deposits with sponsor banks as well as from their incremental public deposits at the earliest.

(d) Interest Rate Policy

- In order to further improve flexibility, banks were given freedom to decide the period of reset on variable rate deposits.

- In order to ensure appropriate pricing of loans, banks were encouraged to review both their PLRs and spreads and align spreads within reasonable limits around PLR subject to approval of their Boards.
- RRBs/LABs and co-operative banks were encouraged not to pay any additional interest on the savings bank accounts over and above what is payable by commercial banks.
- Co-operative banks were encouraged not to pay interest on current accounts.
- Sponsor banks were encouraged not to pay interest on the current accounts maintained by RRBs with them.

(e) Rupee Export Credit Interest Rates

With a view to encouraging competition among banks and to increase the flow of credit to export sector, the interest rates on export credit in rupee terms were proposed to be liberalised in two phases:

- In the first phase, the ceiling rate of PLR plus 0.5 percentage point on pre-shipment credit beyond 180 days and upto 270 days and post-shipment credit beyond 90 days and upto 180 days will be deregulated with effect from May 1, 2003. Banks would have freedom to charge PLR or sub-PLR rates subject to approval of their Boards.
- In the second phase, with effect from a date to be announced later, it would be considered whether the ceiling rates on pre-shipment credit upto 180 days and post-shipment credit upto 90 days should also be discontinued to encourage greater competition in the interest

of exports.

(f) Flexibility in the Repayment of Export Credit

- In order to impart flexibility in the repayment of export credit, it was decided that subject to mutual agreement between the exporter and the banker, the repayment/ prepayment of pre-shipment credit would henceforth be permitted. For this purpose, balances held in the EEFC account of the exporter can also be used.

(g) Interest Rate on FCNR(B) deposits

- In respect of interest rates on FCNR(B) deposits, the ceiling rate for Japanese Yen deposits was relaxed. Banks are free to decide FCNR(B) deposit rates denominated in Japanese Yen which may be equal to or less than LIBOR/SWAP rates of corresponding maturities till further notice. Interest rate ceiling on FCNR(B) deposits denominated in other currencies will remain unchanged at the prevailing level of LIBOR/SWAP rates of corresponding maturities minus 25 basis points.

(h) Rationalisation of Standing Facilities

- With a view to furthering the progress of phasing out sector-specific standing facility in an environment of low CRR, it was decided that the apportionment of normal and back-stop facilities, which presently is in the ratio of two-thirds to one-third (67:33) would be changed to one-half each (50:50) from the fortnight beginning November 16, 2002.

(i) Certificates of Deposit (CDs)

- In order to provide more flexibility for pricing of CDs and to give additional choice to both investors and issuers, banks and FIs may issue CDs on floating rate basis provided the methodology of computing the floating rate is objective, transparent and market-based.

(j) Government Securities Market

In order to provide further transparency and stability in government securities market, the following measures were announced:

- In order to enlarge the number of participants and to provide countrywide access to government securities, anonymous screen-based order-driven trading in government securities on the stock exchanges was proposed to be introduced.
- It was decided to extend repo facility to select category of non-SGL account holders with adequate safeguards to ensure ‘Delivery Versus Payment’ and transparency.
- RBI proposes regulatory and prudential norms for introduction of Collateralised Borrowing and Lending Obligation (CBLO), a product developed by CCIL, as a money market instrument with original maturity between one day and upto one year.

(k) Priority Sector Lending

- In order to improve credit delivery to the priority sector and in particular to agriculture, the limit on advances granted to dealers in drip irrigation/ sprinkler irrigation system/agricultural machinery, located in rural/semi-urban areas would be increased from Rs.10 lakh to Rs. 20 lakh under priority sector lending for agriculture.
- In order to further increase credit flow to the small business and to weaker sections, the existing overall limit of Rs.10 lakh in respect of small business is increased to Rs.20 lakh without any ceiling for working capital. Further, banks are free to fix individual limits for working capital depending upon the requirements of different activities.
- To increase the individual credit limit to artisans, village and cottage industries to Rs.50,000 from the existing limit of Rs.25,000. The limits will be under the overall limit

of 25 per cent advances to weaker sections under priority sector or 10 per cent of net bank credit.

- In order to increase credit flow to the housing sector, it is proposed to increase the existing limit of housing loans for repairing damaged houses from Rs.50,000 to Rs.1 lakh in rural and semi-urban areas and to Rs.2 lakh in urban areas.
- Unsecured advances given by banks to SHGs against group guarantees would be excluded for the purpose of computation of the prudential norms on unsecured guarantees and advances until further notice. The matter would be reviewed after a year in the light of growth in aggregate unsecured advances, and the recovery performance of advances to SHGs.

(l) Apex Supervisory Body

- The proposal for an Apex Supervisory Body was examined by a Committee under the Chairmanship of Hon. Minister of State for Finance. While RBI would do its best in implementing the final decisions of the Government in this regard, it may be kept in view that in case immediate measures are not taken to remove duality of control, it will be difficult to make the supervisory system effective.

Prudential Measures

- In order to have a consistent and uniform approach towards all segments of the banking system, the 90 days norm for recognition of loan impairment was extended to the State Co-operative Banks and District Central Co-operative Banks from the year ending March 31, 2006. To facilitate smooth transition, banks are advised to move over to charging interest on monthly rests effective April 1, 2004.
- As regards the adoption of 90 days norm for recognition of loan impairment, banks have been provided the option to charge interest at monthly rests effective either from April 1, 2002 or July 1, 2002 or April 1, 2003.
- In respect of advances to short duration crops and allied agricultural activities such as dairy, fishery, piggery, poultry, bee-keeping etc., banks were advised to consider the due dates fixed on the basis of fluidity with borrowers and harvesting/marketing season while charging interest and compounding the same if the loan/instalment becomes overdue.

Risk-based Supervision (RBS)

- It was stressed that RBI would switch over to RBS of banks by 2003.

Off-shore Banking Units (OBUs) in Special Economic Zones (SEZs)

- A scheme of OBUs in SEZs as branches of banks operating in India has been formulated and approval of the Central Government has been obtained. Detailed guidelines in this regard would be issued to banks shortly.

Government Securities Market

1.34 The growing market orientation of debt management policy since 1992 has placed increased emphasis on active debt management with the objective of minimising cost, while containing the refinance/rollover risk. Recognising the fact that a deep and liquid Government securities market would improve market efficiency and reduce the cost of borrowing, initiatives have been taken in recent years to consolidate debt through reissuance of existing loans and to develop benchmark securities. In order to reduce refinancing risk, greater emphasis has been placed on managing the maturity structure of Government loans. The

weighted average maturity of loans issued has been altered from 6.6 years in 1997-98 to 14.3 years in 2001-02 and 13.7 years during the current year (upto October 9, 2002).

Calendar of Auctions - Dated Securities

1.35 In order to provide greater transparency and to facilitate investment planning by market players, a calendar of issuance was announced on March 27, 2002 for Rs. 68,000 crore (for the period April to September 2002) indicating the amounts and maturities of loans to be issued as also the tentative dates in a range of 4-6 days. This represented an indicative core calendar with possible variations depending on market conditions and other factors. The budgeted gross market borrowing through issuance of dated securities for 2002-03 is Rs. 1,16,867 crore, of which Rs. 84,000 crore has been raised in the first half of the fiscal year. Subsequently, on September 18, 2002, an indicative calendar for completion of the balance of the budgeted market borrowing through dated securities for the second half of 2002-03 aggregating Rs. 32,000 crore was announced. The calendar for the second half of the year is based on the budgeted borrowing programme of the Government, which, as has been borne out by past experience, is generally expected to be completed by January.

New Instruments

1.36 On July 17, 2002, for the first time, Government of India issued a 10-year loan for Rs. 3,000 crore with embedded call and put options exercisable on or after 5 years from the date of issue. The RBI is actively pursuing the introduction of Separate Trading for Registered Interest and Principal of Securities (STRIPS), which in addition to providing more flexibility in managing interest rate risk, would also help in addressing asset-liability mismatch problem of banks. In order to enable investors to reduce their interest rate risk, floating rate bonds (FRBs) had been re-introduced during the year 2001-02. The two FRB issues in November and December 2001 had a negative cut-off spread of 5 and 1 basis points, respectively. During the current year, FRB was issued on July 1, 2002 for Rs. 3,000 crore at a spread of 34 basis points above the variable base rate, based on the average cutoff yields in the last six auctions of 364-day Treasury bills. The coupon for the first half of the year was 6.84 per cent. Banks, with typically short maturity funding, can hold short duration STRIPS (basically coupon STRIPS), while the longer duration STRIPS have a ready market from insurance, pension funds, etc. To facilitate the market for STRIPS, which are essentially zero coupon bonds (ZCBs), the tax anomaly that existed in respect of ZCBs has been addressed in February 2002. Accordingly, ZCBs are now taxed on a total return basis by treating the marked-to-market gains to the holder during the assessment year as taxable. The Working Group set up to suggest operational and prudential guidelines in respect of STRIPS, comprising banks and market participants submitted its Report which has been placed on the RBI website.

Uniform Price Auction

1.37 Based on the experience of uniform price auction in the issuance of 91-day Treasury bills (since November 6, 1998), this auction format was extended to auctions of Floating Rate Bonds (FRBs) and the Government fixed coupon securities auction held on April 4, 2002 on an experimental basis. Thereafter, the uniform price auction format was used for introduction of Government security with call and put options undertaken on July 17, 2002, issuance of a 30-year Government security for the first time on August 27, 2002 and further for the re-issuance of the same on October 8, 2002.

Negotiated Dealing System

1.38 The Negotiated Dealing System (NDS) (Phase IA) has been operationalised effective February 15, 2002. Currently, NDS provides an on-line electronic bidding facility in the primary auctions of Central/ State Government securities, open market operations (OMO)/LAF auctions, screen based electronic dealing and reporting of transactions in money market instruments, including repo, and dissemination of information on trades with minimal time lag. In addition, the NDS enables "paperless" settlement of transactions in Government securities with electronic connectivity to CCIL and the DVP settlement system at the Public Debt Office (PDO) through electronic subsidiary general ledger (SGL) transfer form. As on October 23, 2002, 141 SGL account holders have joined NDS. The next phase of operationalisation of PDO-NDS project will provide for centralised securities settlement system with distributed servicing to investors through regional PDOs. It will help in increased geographical participation in primary issuance of Government securities from terminals located at regional PDOs and member terminals connected to the system.

Clearing Corporation of India Limited (CCIL)

1.39 At the initiative of the RBI, CCIL was registered on April 30, 2001 under the Companies Act, 1956 and commenced its operations for clearing and settlement of transactions in Government securities (including repos) on February 15, 2002. Acting as a central counterparty through novation, the CCIL provides guaranteed settlement and has put in place risk management systems and also has access to lines of credit from commercial banks. While all repo transactions have to be necessarily put through the CCIL, outright transactions up to Rs.20 crore also have to be settled through CCIL. CCIL is on the threshold of launching net forex clearing in India on a guaranteed settlement basis.

2. Commercial Banking System-Supervisory Initiatives

Board for Financial Supervision

1.40 The Board for Financial Supervision (BFS) is entrusted with supervision of commercial banks, select all-India financial institutions (FIs), non-banking financial companies (NBFCs), the Clearing Corporation of India and primary dealers (PDs).

1.41 Four directors of the Central Board were nominated as members of the BFS for a period of two years, effective December 21, 2000. The focus of the supervisory strategy pursued by the BFS has been institution specific and is outlined as follows:

(a) Off-site surveillance system for banks, select all-India FIs, NBFCs including residuary non-banking companies (RNBCs).

(b) On-site inspection of banks (including associate banks of State Bank of India), select all-India FIs, NBFCs including RNBCs.

(c) Monitoring asset quality, capital adequacy measures and other prudential norms of banks.

(d) Extending the task of supervision to strengthen, among others, internal control, management information systems and fraud monitoring procedures within the supervised institutions.

1.42 During 2001-02 (July-June), the BFS held 12 meetings and reviewed 126 inspection reports of public sector banks (PSBs), local head offices of State Bank of India (SBI), private

sector banks, foreign banks, local area banks and FIs with reference to various dates during the year and some reports relating to the earlier period. The BFS also reviewed monitoring with regard to bank frauds and house-keeping in PSBs, including reconciliation of entries in inter-branch accounts, inter-bank accounts (including nostro accounts) and balancing of books of accounts. The monitoring done over all India FIs and NBFCs was also reviewed. Besides delineating the course of action to be pursued in respect of institution-specific supervisory concerns, the BFS provided guidance on several regulatory and supervisory policy decisions. The reports on Indian Banking System based on off-site half yearly data for the period ended September 2001 and March 2002, were reviewed by the BFS.

Committees Related to Banking Supervision

Working Group on Consolidated Accounting

1.43 There has been renewed focus on empowering supervisors to undertake consolidated supervision of bank groups on account of the failure of large international banks triggered by operations of their subsidiary ventures as also the concerns arising from banks entry into other lines of business. The Core principles for Effective Banking Supervision issued by the Basel Committee on Banking Supervision (BCBS) have underscored this requirement as an independent principle. Accordingly, a multi-disciplinary Working Group (Chairman: Shri Vipin Malik) set up in November 2000 submitted its Report in December 2001, which was placed on the RBI website for comments.

1.44 It has been decided to implement the recommendations of the aforesaid Working Group with suitable changes, wherever considered necessary. Three components of consolidated supervision identified are: consolidated financial statements (CFS), consolidated prudential reports (CPR) and application of prudential regulations like capital adequacy and large exposures/risk concentration on group basis. Initially, consolidated supervision is mandated for all groups where the controlling entity is a supervised institution. This would cover all banks in banking groups, i.e where the bank is the parent/controlling entity, all banks which are promoted and 'controlled' by FIs or NBFCs and all registered non-banking deposit taking financial companies which have networks of subsidiaries and are in control of the group. In respect of these NBFCs, consolidation is proposed to be applied on selective basis subject to certain conditions. The guidelines on consolidated accounting and other quantitative methods to facilitate consolidated supervision are applicable to banks which are the parent/controlling entity and banks which are promoted/controlled by FIs or NBFCs. The draft guidelines have been issued to banks for comments, and are being finalised based on the feedback received from banks. Pending legislative amendments to various Acts, in order to provide enabling provisions to facilitate consolidated accounting and quantitative methods under Indian conditions, a working arrangement with other regulators, *viz.* SEBI and IRDA, for sharing of information by way of Memorandum of Understanding (MoU) is being explored.

Working Group on Compliance by Banks with Accounting Standards

1.45 A Working Group was constituted (Chairman: Shri. N.D.Gupta) with representatives, *inter alia*, of Indian Banks' Association (IBA), banks and the RBI, to identify the compliance as also gaps in compliance with Accounting Standards (AS) issued by the Institute of Chartered Accountants of India (ICAI) and to recommend steps to eliminate/reduce the gaps.

Sub-Committee (Audit) of BFS

1.46 The Audit Sub-Committee of the BFS recommended various measures to deal with the accounting and regulatory implications of voluntary retirement scheme (VRS) implementaion in PSBs. They broadly related to disclosures, allocation of expenditure and providing relief to banks on one-time burden without compromising regulatory standards.

1.47 The format of half-yearly review report approved by the Sub-Committee was finalised in consultation with the Securities and Exchange Board of India (SEBI) and forwarded to all PSBs for introduction of half-yearly review system for the half-year ended September 30, 2001. The procedure to be adopted for recommending the names of audit firms to be appointed as statutory auditors by state financial corporations and the remuneration payable to these auditors from the year 2001-02 were reviewed.

Committee on Legal Aspects of Bank Frauds

1.48 The Committee on Legal Aspects of Bank Frauds (Chairman: Dr. N.L. Mitra) set up in September 2000 to examine, among other things, laying down procedural laws to deal with financial frauds, possibility of prohibiting alienation of assets of the accused and their relatives immediately after detection of fraud, etc., submitted its report in September 2001. The Report is available on the RBI website. The recommendations of the Committee consists of two parts: Part I dealing with the recommendations that could be implemented without any legislative changes and Part II containing recommendations which require legislative changes for implementation. The recommendations under Part I were forwarded to banks for implementation upon approval of BFS in May 2002. The recommendations under Part II were referred to the High-level group of Central Vigilance Commision (CVC) for further examination.

High Level Group to look into Frauds in the Banking Sector

1.49 The Central Vigilance Commission (CVC) had set up a High Level Group with representatives from the Ministry of Finance, CVC, Central Bureau of Investigation (CBI), banks and the RBI to examine certain matters relating to frauds in the banking sector. The Group submitted its report in April 2002 and recommended measures for reducing delay in taking action against officials involved in frauds, as also measures for strengthening internal control systems in banks. The Group's recommendations relating to penal action for delay in reporting fraud cases to RBI, delay in internal investigation and completion of departmental action against officials involved in frauds and strengthening of internal control mechanism were communicated to banks in May 2002 for implementation.

Committee on Computer Audit in Banks

1.50 A Committee comprising representatives from the RBI, ICAI, SBI, ICICI Bank and Citibank was constituted to draw up a checklist of audit controls in a standardised form so that all banks, operating in the country, can ensure that their computerised branches are applying requisite controls in the computerised environment to be verified by the branch auditors. The Report of the committee has been approved by the audit subcommittee of BFS.

Recent Developments in Banking Supervision

Long Form Audit Report

1.51 The format of the long form audit report (LFAR), in use since 1992-93, was revised, in

consultation with ICAI and a few select banks, to reflect changes in regulatory/supervisory framework of banks as also the expanded role of statutory auditors who are now required to include certain additional certifications/ validations in their report. Banks were advised to apply the revised format from the year ending March 31, 2003.

Prompt Corrective Action

1.52 A scheme of prompt corrective action (PCA) based on certain triggers is being developed as a supervisory tool (Box I.2).

Box I.2: Prompt Corrective Action

The *Core Principles for Effective Banking Supervision* of the Bank for International Settlements (BIS) mandate that banking supervisors must have at their disposal adequate supervisory measures, backed by legal sanctions, to bring about timely corrective action. If banks are not to be allowed to fail, it is essential that corrective action be taken while the bank still has a manageable cushion of capital. This is crucial since low or negative capital often tempts bank managers' to attempt 'gamble for resurrection' strategies.

Studies indicate that excessive risk-taking among undercapitalised banks is, at least, partially constrained by regulation (Shrieves and Dahl, 1992; Peek and Rosengren, 1997). Even the Basel Committee has strongly endorsed the need for supervisors to take timely corrective action when banks fail to meet capital adequacy ratios or other prudential requirements. This has led many observers to suggest that interventions should be guided by rules rather than discretion of supervisors.

Automatic rules lead to prompter action, which gains importance as the costs of restructuring the bank increase if action is delayed. Several arguments can be advanced to support this case. Forbearance, or expecting the problem to resolve by itself, is always a tempting option, especially given the usual lack of precise information about the extent of a bank's problem. If a large number of banks are simultaneously in trouble, political-economy considerations might prevent contemplating the short-run costs of radical action. As a consequence, rule-based methods of intervention, especially if enshrined in legislation, are helpful for supervisors to take decisions based on established procedures and principles.

The best-known examples of rules are the compulsory quantitative triggers (in relation to bank capital levels) for action by the supervisors set in the 1991 US Federal Deposit Insurance Corporation Improvement Act (FDICIA) [Table 1].

Table 1: United States FDICIA System

Capital Level Trigger (per cent)	Mandatory and Discretionary Actions
10>CAR>8 or 5>CORE>4	Cannot make any capital distribution or payments that would leave the institution undercapitalised
CAR<8 or CORE<4	Must submit a restoration plan; asset growth restricted; approval required for new acquisitions, branching and new lines of business.
CAR<6 or CORE<3	Must increase capital; restrictions on deposits' interest rates and asset growth; may be required to elect new Board of Directors.

CAR<4 or CORE<2	Must be placed on conservatorship or receivership within 90 days; approval of the FDIC for: entering into material transactions other than usual core business, extending credit for any highly leveraged transaction; changes in accounting methods; paying excessive compensation or bonuses

CAR: Capital Adequacy Ratio CORE: Core Capital Source: Hawkins and Turner (1999).

Table 2: Structured and Discretionary Intervention Frameworks in Select Economies

Country	**Capital Level Trigger (per cent)**	**Mandatory & Discretionary Actions**
Structured Intervention		
Argentina	CAR<11.5	Bank is fined, must submit a recapitalisation plan, limit deposit raising, pay no dividends/bonuses and is restricted in branch opening
Chile	CAR<8 or CORE<3	Bank has to raise new capital; if unable, supervisors prohibit extension of new credit and restrict the acquisition of securities (those issued by Central Bank).
Korea	8>CAR>6	Rationalisation of branch management and restrictions on investments, new business areas and dividends.
	CAR<6	Freezing new capital participation, disposal of subsidiaries, change management, draw up plan for merger.
Discretionary Intervention		
Brazil	Illiquidity, insolvency, large losses due to bad management, serious violation of laws and regulations	Intervention: suspension of normal activities, removal of Directors. After 6 months, either return to normal activities or extra-judicial liquidation or bankruptcy; temporary special management regime. The supervisor can authorise the merger, take-over of transfer of stock-holding
Hong Kong	CAR falls below the minimum (in practice, Hong Kong Monetary Authority (HKMA) sets an informal 'trigger' ratio above the statutory minimum capital ratio).	HKMA may take control of the bank. It will first discuss remedial action or give directions (e.g., to stop taking deposits). It can appoint an Adviser or Manager.

Indonesia	Earlier, Bank Indonesia would put pressure on banks whose CAR fell below 8 per cent. Presently, banks with CAR below 4 per cent may participate in re-capitalisation programme.	Banks required to implement plan to raise capital; may replace management.

1. Based on current minimum CAR of 8 per cent. 2. CAR: Capital Adequacy Ratio.
Source: Hawkins and Turner (1999)

Similar rules have been adopted in some industrial economies and in a number of emerging economies (Table 2). Once capital falls below a defined threshold, such rules typically require banks to draw up plans for recapitalisation, limit or prohibit dividends and impose limits on risk-taking. Restrictions often involve limiting new acquisitions or restricting interest rates on deposits. When capital falls to very low levels, the authorities can force mergers or acquisitions, or proceed to closure. Such rules, however, would be rarely applied to a large bank where greater discretion would inevitably condition supervisors' responses (the "too-big-to-fail" argument).

In the Indian context, the supervisory authorities released a Discussion Paper in 1999, which envisages the possibility of introducing a system of Prompt Corrective Action (PCA) for the banking system. This has been dictated by two major considerations such as the responsibility of bank supervisors to identify problem banks and to monitor the behaviour of troubled banks in an attempt to prevent failure or to limit losses. More so, if a bank is not allowed to fail, it is essential that corrective action be taken well in time.

In view of the above considerations, a system of PCA with various trigger points and mandatory and discretionary responses by the supervisors is envisaged for the banking system in India. In contrast to the framework prevalent in other countries (Table 2), which focuses on a single trigger point (i.e., CRAR), a broader PCA regime is envisaged for India so as to delineate rule-based actions not only for shortfall in capital, but also for other indicators of deficiency, so that a seamless paradigm for system in India. In contrast to the framework prevalent in other countries (Table 2), which focuses on a single trigger point (i.e., CRAR), a broader PCA regime is envisaged for India so as to delineate rule-based actions not only for shortfall in capital, but also for other indicators of deficiency, so that a seamless paradigm for corrective actions can be put in place for major deficiencies in bank functioning. Accordingly, in addition to capital adequacy (CRAR), two additional indicators, viz., Net NPA and Return on Assets, as proxies for asset quality and profitability, have been included under the broader PCA regime. Trigger points have been set under each of the three parameters, taking into consideration the practical aspects of implementation of certain measures in the Indian context. Once a bank's performance falls below certain thresholds, which activates the trigger point, a certain set of mandatory actions addressing critical areas of the bank's weakness will follow.

For every trigger point, a set of mandatory and discretionary PCAs has been laid down. The rationale for classifying the rule-based actions into mandatory and discretionary components is that some of the actions are essential to restore the financial health of banks, while other actions will be left to the discretion of the supervisors, depending on the profile of each bank.

In addition to the above, supervisors can initiate certain discretionary actions, if need be, to

pre-empt any deterioration in the soundness of banks. While the published balance sheets, off-site returns and on-site inspection reports are the primary sources for identifying banks for placement under the PCA framework, the discretion to enforce PCA will be vested with the Board for Financial Supervision (BFS). The scheme of prompt corrective action (PCA) developed as a supervisory tool based on certain trigger points, was cleared by the Government with some suggestions. An internal Group has been set up to study the impact of the PCA framework on select weak banks.

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Peek, J. and E.Rosengren (1997), 'Will Legislated Early Intervention Prevent the Next Banking Crises?' *Southern Economic Journal*, 38, 268-280.

RBI (1999), *Discussion Paper on Prompt Corrective Action*, RBI: Mumbai.

Shrieves, R. and D.Dahl (1992), 'The Relationship between Risk and Capital in Commercial Banks', *Journal of Banking and Finance*, 16, 439-457.

1.53 The scheme is aimed at taking action at an early stage, when banks show incipient signs of weaknesses. This is in addition to the existing supervisory tools. Some of the actions envisaged such as capital restoration, reduction of stake in subsidiaries, bringing in new management, merger/liquidation, etc. in the case of PSBs and merger/moratorium in the case of private sector banks involve action on the part of the Central Government. The views of the Central Government were, therefore, sought which have since been received. The scheme is being examined taking into account the suggestions of the Government.

Risk-Based Supervision

1.54 The implementation phase of the risk- based supervision (RBS) project started in June 2001. A project implementation group has been set up in the RBI to address the transitional and change management issues for facilitating a smooth switchover to RBS based on the recommendations of PricewaterhouseCoopers, London. The RBS model comprises

- development of risk profile,
- designing customised supervisory actionplan based on risk profile for each bank,
- delineating scope and extent of supervision to target high risk areas and areas of supervisory concern, and
- strengthening quality assurance andenforcement functions to maintain objectivity and neutrality in application of supervisory standards.

The implementation of RBS calls for preparedness on the part of commercial banksto take certain measures such as:

- setting up comprehensive risk management system,
- adopting risk-focused internal audit system,

- upgrading the management information and information technology-based systems, setting up dedicated compliance units, and,
- addressing issues related to human resource and skill development.

1.55 A Discussion Paper on RBS presenting the background of the approach, its objectives, processes involved and specific bank level preparedness required for successful implementation has been circulated among banks. Banks were involved in a consultative process through high-level meetings to identify areas requiring assistance/guidance. Issues relating to design of templates for risk profiling of banks, preparation of manuals for the new supervisory approach, upgradation of technical skills of both commercial bank and supervisory staff are currently in focus. RBS is intended to be implemented in phases and is expected to be taken up for implementation during the next year.

Early Warning Systems for Identifying NPAs

1.56 On the direction of BFS, a study of early warning systems (EWS) in banks for identification of NPAs and initiating prompt steps for recovery was taken up. Besides attempting to identify financial and operational early distress signals, the study also enumerated other indicators like management-related problems, weakening industry characteristics, regulatory changes, general economic conditions, etc. The study, based on data collected from banks, clearly established the need for an EWS, sensitised to all signals of credit deterioration. The BFS, in turn, observed that there ought to be a structure in banks to process EWS emanating from potential NPAs, and further directed the Indian Banks' Association (IBA) to develop suitable software for the same. IBA proposed to initially bring out a manual incorporating early warning signals for use of banks. After obtaining sufficient experience, they would proceed towards development of an appropriate software.

Implementation of ALM in Commercial Banks

1.57 The ALM systems in some private sector banks have been further refined with their asset-liability management committee (ALCO) having prescribed tolerance levels for liquidity/interest rate sensitivity mismatches in time bands not covered by the RBI guidelines. The introduction of monthly DSB returns[1] by the RBI has facilitated more frequent surveillance of asset-liability mismatches in banks.

Implementation of Risk Management Systems

1.58 There has been considerable progress with regard to implementation of risk management systems in banks. Many banks, however, need to improve the existing MIS for enhancing their risk management capability, for preparation of contingency plans to measure the bank's ability to withstand liquidity crises, to conduct stress tests to estimate future volatility in values of securities due to market movements, for creation of an operational risk management policy and for stipulating prudential limits based on operational risk, and development of internal systems for quantifying and monitoring operational risk. Some banks have set up risk management committees, which are still in formative stages and require time to be functional with requisite degree of sophistication (Box I.3).

Box I.3: Assessment, Management, Curtailment of Risks in the Indian Financial System

Risk is intrinsic to banking and of late the management of risk has gained prominence. The

growing sophistication in banking operations, derivatives trading, securities underwriting and corporate advisory businesses, improvements in information technology, on-line electronic banking, provision of bill presentation and payment services have led to increased diversity and complexity of risks being encountered by banks. The major risks confronting financial institutions are credit risk, interest rate risk, foreign exchange risk and liquidity risk. Of these, credit risk remains predominant for banks.

The credit risk depends on both internal and external factors. External factors include the state of the economy, commodity and equity prices, exchange rates and interest rates. The internal factors reflect deficiencies in loan policies and administration of loan portfolio, weaknesses in prudential credit concentration limits, appraisal of borrowers' financial position, excessive dependence on collateral and inadequate risk pricing, absence of loan review mechanism and post sanction surveillance. Such risks may extend beyond the conventional credit products such as loans and letters of credit and appear in more complicated, less conventional forms, such as credit derivatives.

Interest rate risk arises because banks fix and refix interest rates on their resources and on the assets in which they are deployed at different times. Changes in interest rates significantly impact the net interest income, depending on the extent of mismatch between the times when the interest rates on asset and liability are reset. Any such mismatches in cash flows (fixed assets or liabilities) or repricing dates (floating assets or liabilities) expose banks' net interest margins to variations.

The foreign exchange risk, in turn, is the risk inherent in running open forex positions and have become more pronounced in recent years owing to the wide variation in exchange rates. Such risks arise owing to adverse exchange rate movements which may affect a bank's open position, either spot or forward, or a combination of the two, in a specific foreign currency.

Finally, the liquidity risk arises from funding of long-term assets by short-term liabilities, making liabilities subject to rollover or refinancing risk. Banks that fund domestic assets with foreign currency deposits are susceptible to such risk, especially if sharp fluctuations in exchange rates and market turbulence make it difficult to retain sources of financing.

Besides these financial risks, banks are exposed to other risks *viz.*, operating risks, legal risks, etc. Irrespective of the nature of risk, the best way for banks to protect themselves is to identify the risks, accurately measure and price it, and maintain appropriate levels of reserves and capital. The development of a holistic approach to assessing and managing the many facets of risks still remains a challenging task for the financial sector and this raises the issue of how to identify the optimal strategies to curtail these risks.

The key issue in managing credit risk is to apply consistent evaluation and rating scheme of all investment opportunities, such that consistent credit decisions are made. Prudential limits need to be laid down on various aspects of credit, *viz.*, benchmark current debt/equity and profitability ratios, debt service coverage ratios, concentration limits for single/group borrower, maximum exposure limits to industry/sector. A comprehensive risk scoring system needs to be developed that serves as a single point indicator of the diverse risk factors.

For managing interest rate risk, most commercial banks make a clear distinction between their trading activity and balance sheet exposure. As regards trading book, Value-at-Risk (VaR), a standard approach, is employed to assess potential loss that could crystallise on trading position or portfolio due to variations in market interest rate and prices. For balance sheet

exposure to interest rate risk, banks rely on 'gap reporting system', which identifies the asymmetry (gap) in repricing of assets and liabilities. This is supplemented with balance sheet simulation models to investigate the effect of interest rate variation on reported earnings over a medium-time horizon.

Limits are the key elements of risk management in foreign exchange trading. Banks with active trading positions tend to adopt VaR method to measure risk associated with such exposures. For banks unable to develop VaR, stress testing is conducted to evaluate the potential losses associated with exchange rate changes.

For the measurement of liquidity risk, there are several traditional ratios such as loans to total assets, loans to core deposits, large liabilities to earning assets and loan losses to net loans. In addition, prudential limits are placed on various liquidity measures like inter-bank borrowings, core deposits *vis-à-vis* core assets.

There is unanimity of view that developing sound and healthy financial institutions, especially banks, is a *sine qua non* for maintaining overall stability of the financial system. Keeping this in view, the RBI has issued guidelines for risk management systems in banks as early as October 1999. This has placed the primary responsibility of laying down risk parameters and establishing the risk management and control system on the Board of Directors of the bank. However, the implementation of the integrated risk management could be assigned to a risk management committee or alternately, a committee of top executives that reports to the Board. Banks are required 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. Banks were further advised to concurrently set up an independent credit risk management department to enforce and monitor compliance of risk parameters/ prudential limits set by the Board/Credit Policy Committee. The present set of guidelines are purported to serve as a benchmark to banks, which are in the process of establishing an integrated risk management system.

It is, however, recognised that, in view of the diversity and varying size of balance sheets of banks, it might neither be possible nor necessary to adopt a uniform risk management system. The design of risk management framework should, therefore, be oriented towards the bank's own requirement dictated by the size and complexity of business, risk philosophy, market perception and the existing level of capital.

The assessment of *Core Principles* with regard to India by RBI in 1999 had observed there were gaps between existing practice and principle mainly in the areas pertaining to risk management in banks and consolidated supervision. The deficiencies in the area of risk management have subsequently been tackled with the issuance of comprehensive guidelines. The Report of the Working Group on consolidated accounting was submitted in December 2001. The recommendations of the Working Group together with brief background and illustrative formats for submitting consolidated financial statements have been placed on the website.

In addition to the risk management guidelines, the levels of transparency and standards of disclosure have gradually been enhanced to provide a clearer picture of the balance sheet to informed readers. Such disclosures and transparency practices are aimed at improving the process of expectation formation by market players about bank behaviour and eventually lead to effective decision-making in banks.

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Prudential Accounting Standards

Uniform Accounting of Repo/Reverse Repo Transactions between Banks

1.59 It was decided to adopt a uniform accounting methodology for inter-bank repo / reverse repo transactions, to prevent banks from indulging in regulatory arbitrage, given the prevalent divergent accounting practices. The uniform accounting methodology would lend more transparency to banks' investment account through categorisation of securities acquired under reverse repo and those offered under repo and core investment account. Moreover, the holding rate of the security would be kept unaltered after the completion of the second leg. Furthermore, the interest received and paid (including broken period interest) will be booked in a separate revenue account and capital gains/losses will not be booked. Thus, a distinction between revenue and capital account would be maintained, thereby making the balance sheet more transparent. When the repo/reverse repo transactions are accounted for as outright sale/ purchase, the lending bank (buyer) also becomes eligible to reckon the underlying securities for their SLR calculations. The draft guidelines on the proposed uniform accounting methodology for repo / reverse repo transactions between banks, were circulated among select banks. The guidelines are being finalised on the basis of feedback received from them.

Strengthening the Banking System

Capital Adequacy Measures

1.60 The investment fluctuation reserve consisting of realised gains from sale of investment would be eligible for inclusion in tier II capital.

1.61 Foreign banks, hitherto, were required to obtain prior approval for issue of subordinated debt instruments in foreign currency as well as for borrowings from head office for inclusion in tier II capital. To enhance transparency and ensure uniformity, guidelines were issued to foreign banks for raising subordinated debt through head office borrowings in foreign currency, for inclusion in tier II capital. These *inter alia* cover aspects relating to amount of borrowing, maturity period, rate of interest, repayment, documentation, disclosure, hedging, reporting, etc.

1.62 The investment in mortgage backed securities (MBS) of residential assets of housing finance companies recognised and supervised by National Housing Bank are to be assigned risk-weight of 50.0 per cent for credit risk subject to satisfying certain terms and conditions. Furthermore, housing loans to individuals against the mortgage of residential housing properties are to be assigned a risk-weight of 50.0 per cent.

'In-principle' Approval for New Banks in the Private Sector

1.63 Based on the recommendations of the High Level Advisory Committee and after

further examination, RBI granted 'in principle' approvals in February 2002 for setting up two new banks in the private sector *viz.*, M/s. Kotak Mahindra Finance Ltd. and to three banking professionals together with Rabobank, Netherlands. These approvals have a validity of one year.

Disclosure of Information about Defaulters of Banks and Financial Institutions

1.64 The details of information about borrowers with outstandings aggregating Rs. 1 crore and above, classified as 'doubtful' or 'loss', as on March 31 and September 30 every year, are disseminated to banks and FIs for confidential use. The information on said suit-filed accounts is published as on March 31 every year, as also placed on the RBI website. The updated list as at the quarter ended December 31, 2001 in respect of suit-filed accounts is available on the website.

1.65 The information on cases of wilful defaults of borrowers with outstanding balance of Rs. 25 lakh and above, is also collected and disseminated on a quarterly basis effective quarter ended June 1999. Such information as at the quarter ended December 31, 2001 has been disseminated to banks and FIs. The list of said wilful defaulters against whom suits have been filed for recovery, along with the list of suit-filed accounts of Rs. 1 crore and above is published as on March 31 every year and placed on the RBI website for wider dissemination.

Report of the Working Group on Credit Information Bureaus

1.66 In pursuance of the Central Government Budget proposal, 2000-01, Credit Information Bureau (India) Ltd. (CIBIL) was set up in January 2001 by State Bank of India in collaboration with HDFC Ltd. and M/s. Dun & Bradstreet Information Services (India) Pvt. Ltd., and Trans Union International Inc., (as foreign technology partners) with a paid up capital of Rs.25 crore, to serve as an effective mechanism for exchange of information between banks and FIs for curbing growth of NPAs. The Government of India is also examining a draft legislation covering, *inter alia*, responsibilities of Credit Information Bureaus (CIBs), rights and obligations of the member/reporting credit institutions, and safeguarding of the privacy rights that may arise in the information sharing process by CIBs. Pending the enactment of CIB Regulation Bill, as a first step towards activating the Bureau, the RBI constituted a Working Group in December 2001 to examine the possibility of the CIB performing the role of collecting and disseminating information on the suit-filed accounts and the list of defaulters, presently being reported to the RBI by banks and notified FIs. The Report of the Working Group was submitted in January 2002, and some recommendations which satisfy the existing legal framework are being implemented (Box I.6).

Corporate Debt Restructuring Mechanism

1.67 To evolve an appropriate mechanism for corporate debt restructuring, on the lines of similar mechanism in countries like the United Kingdom (U.K.), Thailand, Korea and Malaysia, the RBI, in consultation with the Central Government, had issued guidelines on corporate debt restructuring (CDR) for implementation by banks and FIs in August 2001. The objective of the CDR framework has been to ensure a timely and transparent mechanism for restructuring the corporate debts, outside the purview of Board for

Industrial and Financial Reconstruction (BIFR), debt recovery tribunal (DRT) and other legal proceedings, in respect of viable entities facing problems. In particular, the framework was intended to preserve viable corporates affected by certain internal/ external factors and minimise losses to creditors/ other stakeholders through an orderly and coordinated restructuring programme.

1.68 In view of the unsatisfactory progress of the scheme, the Central Government Budget for 2002-03 announced the setting up of a small group to suggest remedial measures to make the CDR mechanism more efficient. Accordingly, upon approval from Government, a High-Level Group (Chairman: Shri Vepa Kamesam) was constituted. The Group submitted its Report on July 31, 2002, which is under examination in RBI/Government. As on October 29, 2002, the CDR Cell has received 32 references, of which 8 restructuring packages have been approved for implementation with an aggregate exposure of banks / institutions of Rs. 2,018 crore. Of the balance 24 references, 7 have been rejected or withdrawn and the remaining cases are under various stages of processing.

International Initiatives

International Financial Architecture

1.69 Financial instability in several countries over the past few years have exposed some weaknesses in the international financial system, many of which relate to the increasing quantum of large cross-border capital flows. These crises have highlighted that global financial integration can bring both risks and benefits. There is also the realisation that the architecture of the present international financial system has to be strengthened, which is a *sine qua non* to reduce vulnerability to devastating financial crises, while allowing countries to reap benefits of globalisation. The financial architecture encompasses the institutions, markets, and practices that Governments, businesses, and individuals utilise to carry out economic and financial activities.

1.70 A major development for strengthening the international financial architecture has been the setting up of universally acceptable standards and codes for benchmarking domestic financial systems. In fact, multilateral assessments of country performance are being increasingly focused on the observance of such standards. The Basel Capital Accord, Core Principles on Banking Supervision, International Monetary Fund’s (IMF) Article IV consultations, its Financial Sector Stability Assessment and the Reports on Observance of Standards and Codes of the IMF and The World Bank indicate that a country’s adherence to benchmark standards and codes is considered integral to the preservation of international monetary and financial stability. Besides, several fora are analysing historical trends and experiences to introduce greater transparency, early detection, better supervision, higher capital requirements, more sustainable exchange rate regimes, and stronger standards and codes.

1.71 India has made noteworthy progress in generating a constructive debate on the applicability of international standards and codes to the domestic financial system. There has been participative consultation supported by internal evaluation as well as external assessment. The Standing Committee on International Standards and Codes brought in objectivity and experience into studying the applicability of relevant international codes and standards to each area of competence. Under the aegis of the Committee, roadmaps for implementation of appropriate standards and codes were elaborated in the light of existing levels of compliance with international standards *viz.*, Core principles of Basel Committee on Banking Supervision,

international accounting and auditing standards, etc. taking into account cross-country experience and the existing domestic legal and institutional infrastructure.

Foreign Direct Investment in the Banking Sector

1.72 Several steps have been taken to increase capital flows particularly foreign direct investment (FDI), and instill greater confidence in foreign investors regarding the macro-economic stability of the country. Some of these steps are: (i) in February 2002, a notification was issued permitting FDI up to 49 per cent from all sources in private sector banks on the automatic route subject to conformity with guidelines issued from time to time. Transfer of existing shares from residents to non-residents, however, requires approval of FIPB, followed by in-principle approval of the RBI, (ii) in order to provide a level playing field, the maximum limit of shareholding of Indian promoters in these banks has also been raised to 49 per cent of their paid up capital, (iii) in case of PSBs, FDI and foreign portfolio investment has been allowed upto 20 per cent.

Money Laundering and Financing of Terrorism

1.73 Recent developments have caused increasing international concern on the use of the financial system for money laundering and financing of terrorism. In recognition of the need for taking concerted action, the RBI and the Central Government initiated several measures to prevent the misuse of the financial system. The existing instructions on 'know your customer' (KYC) norms and cash transactions were reinforced to safeguard banks from being unwittingly used for transfer or deposit of funds derived from criminal activities. Accordingly, in consultation with banks, a circular elaborating the policy, procedures and controls to be introduced by banks, including strict adherence to KYC norms was issued. The anti money laundering (AML) measures to be adopted by banks comprise systems and procedures for proper customer identification while opening accounts and monitoring of activities in the accounts of customers for detection of suspicious transactions. It also involves institution of appropriate internal control and audit mechanisms for monitoring adherence to AML measures by branches. The attention of banks has been drawn to the Report of a Working Group of Bankers on Anti Money Laundering Guidelines for Banks in India, which has made several recommendations for strengthening KYC norms with focus on anti money laundering. It has, *inter alia*, suggested formats for customer profile, account opening procedures, establishing relationship with specific categories of customers, as well as outlined an illustrative list of suspicious activities for the guidance of banks.

1.74 Acknowledging the recent international developments and realising the need for a critical assessment of India's position *vis-à-vis* international standards on market integrity, the Standing Committee on International Financial Standards and Codes commissioned an internal technical group on 'Market Integrity'. The Report presents an assessment of India's position as compared to the G-7 principles on Market Integrity and Recommendations of the Financial Action Task Force (FATF) on AML and terrorist financing which serve as benchmarks in this regard. The Report provides an overview of international efforts to combat money laundering, reviews the extant laws and regulations for detection and law enforcement against criminal activities in financial sector, and notes the recent initiatives taken for prevention of money laundering. The full text of the Report on 'Market Integrity' has been placed on the RBI website for wider dissemination.

1.75 As an AML measure, the Central Government has also introduced the Prevention of Money Laundering Bill, which is awaiting Parliamentary approval.

Banks' Investment Norms

Non-SLR Investments of Banks - Guidelines

1.76 A significant proportion of banks' investments in non-SLR securities are through the private placement route. In order to allay concerns arising from the non-transparent practices prevalent in this market, guidelines had been issued in June 2001 regarding undertaking of due diligence, obtaining disclosures and credit risk in regard to privately placed investments, especially unrated instruments. Internal rating systems have to be adopted by banks for issues of non-borrowers, whether rated or otherwise, as also adopt prudential limits to mitigate adverse impact of concentration and illiquidity. Proper risk management systems also need to be established for capturing and analysing risks and entail timely remedial measures.

1.77 The ease of mobilising funds through privately placed debt issues could lead to diversion of funds for risky purposes, other than disclosed in offer document. Consequently, draft prudential guidelines were issued (seeking comments) for containing the risks arising out of non-SLR investment portfolio of banks and FIs, particularly through private placement route. These draft guidelines, *inter alia*, cover: (i) the need for strengthening of internal rating systems, and periodically tracking rating changes in respect of issuers; (ii) fixing prudential limits, with separate sub-limits for unrated, unquoted and privately placed instruments; (iii) review by the 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. The appropriate arrangements for collecting and sharing information regarding amounts of debt raised by corporates from the market, including through CPs, etc. are also envisaged in the guidelines. The draft operating guidelines would be finalised on the basis of the comments received from banks, after the RBI-SEBI Technical Committee takes a view on the disclosure and regulation of private placement.

Investment Fluctuation Reserve

1.78 Banks are advised to follow a more prudent policy for utilising the gains realised on sale of investment in securities arising from declines in interest rate and also for building up adequate reserves to guard against any possible reversal of interest rate environment due to unexpected developments. Accordingly, banks are required to transfer the maximum amount of gains realized on sale of investment in securities to the Investment Fluctuation Reserve Account (IFR). Banks have to achieve an IFR at a minimum of 5.0 per cent of all investments in 'held for trading' (HFT) and 'available for sale' (AFS) categories, within a period of 5 years. Moreover, the unrealised gains on valuation of investment portfolio are not to be taken to income account or to IFR. Furthermore, in modification of earlier instructions, banks are to 'mark-to-market' the individual scrips held under the AFS category, at least at quarterly instead of annual interval hitherto. The IFR, consisting of realized gains from sale of investments, would be eligible for inclusion in the tier II capital (Box I.4). The IFR as at end-March 2002 constituted 0.91 per cent of the investment held under HFT and AFS categories.

Box I.4: Investment Fluctuation Reserve

An investment fluctuation reserve (IFR) refers to a pool of reserves created by retaining a proportion of returns when proceeds are high which can be utilised to supplement payments when proceeds are low. This enables payments from investments to be consistent in spite of volatility in the accrual to the fund's earnings from year to year.

The progressive integration of the Indian financial sector with global markets has resulted in disruptions in local markets getting transmitted across borders with alarming rapidity. This, in its wake, has implied that the present quiescent conditions may change at a very short notice. The recognition of this factor has led to greater emphasis on the need for building up adequate reserves to safeguard against price fluctuations. With a view to ensuring that Indian banks have adequate reserves against adverse changes in the interest rate environment due to unexpected developments, they have been required to hold IFR account consisting of excess provision towards depreciation of investments and realised gains from sale of securities. In other words, in the context of the Indian banking sector, the IFR refers to a reserve meant to provide a cushion against depreciation of investments. The IFR would be eligible for inclusion in tier II capital.

At present, Indian banks are required to value their investments on the basis of international accounting standard (IAS) 39 which stipulates that investments be classified into three categories, *viz.*, available for sale (AFS), held for trading (HFT) and held to maturity (HTM). With respect to valuation, IAS 39 stipulates that the first two categories should be carried at fair value and the third at amortised cost. Indian banks are, however, required to recognise and provide for net depreciation of investments in the AFS and HFT categories, while ignoring net appreciations in the same. The book value of individual securities in these categories does not undergo any change consequent upon marking to market.

In March 1999, the RBI advised banks to appropriate the excess provisions towards depreciation of investments to IFR instead of the Capital Reserve Account. Banks were permitted to utilize the amount held in IFR to meet in future, the depreciation requirements on investments in securities. In view of the nature of the reserve, it was further decided that the existing amount of excess provision towards depreciation of investments held under the Capital Reserve Account may be transferred to the Investment Fluctuation Reserve Account as on March 31, 1999 and utilised to meet future depreciation requirement on investment in securities.

In January 2002, the RBI advised banks to build up an IFR of a minimum of 5.0 per cent of their investment portfolio within a period of 5 years. Banks were given the freedom to build up IFR to a maximum of 10.0 per cent of the portfolio depending on the size and composition of their portfolio with the approval of their Boards. Towards this end, banks were required to transfer maximum amount of gains realised on sale of investment in securities to the IFR. The IFR was to be computed with reference to investments in two categories, *viz.*, HFT and AFS, which are marked to market. As a result, it would not be necessary to include investments under HTM category, which are not meant to be traded, for purposes of computation of IFR. On the dictates of policy imperatives, at end-March 2002, the IFR constituted 0.71 per cent[2] of the investment portfolio of public sector banks (Table).

Table: Investment Fluctuation Reserves (IFR) of Public Sector Banks
(end-March)

(Amount in Rs. crore)

Name of the Bank	Investment	Investment Fluctuation Reserve (IFR)		Absolute Change	IFR as percentage to investment[2]
	(2002)	(2001)	(2002)		(2002)
1	2	3	4	5=(4)-(3)	6=(4)/(2)
State Bank Group	**1,85,587.29**	**660.26**	**1,228.61**	**568.35**	**0.66**
State Bank of India	1,45,142.03	447.36	671.16	223.80	0.46
State Bank of Bikaner & Jaipur	6,304.96	19.25	63.46	44.21	1.01
State Bank of Hyderabad	9,827.89	34.61	100.00	65.39	1.02
State Bank of Indore	4,530.76	9.01	59.60	50.59	1.32
State Bank of Mysore	4,158.84	6.76	38.76	32.00	0.93
State Bank of Patiala	5,704.96	112.09	205.58	93.49	3.60
State Bank of Saurashtra	3,545.69	0.62	37.90	37.28	1.07
State Bank of Travancore	6,372.16	30.56	52.15	21.59	0.82
Nationalised Banks	**2,68,420.61**	**632.32**	**1,994.76**	**1,362.44**	**0.74**
Allahabad Bank	10,358.03	12.14	41.47	29.33	0.40
Andhra Bank	8,419.26	28.42	59.79	31.37	0.71
Bank of Baroda	23,833.13	38.50	256.84	218.34	1.08
Bank of India	22,083.54	75.65	241.76	166.11	1.09
Bank of Maharashtra	9,909.19	52.83	72.66	19.83	0.73
Canara Bank	23,220.11	5.14	169.15	164.01	0.73
Central Bank of India	21,099.81	42.99	115.39	72.40	0.55
Corporation Bank	8,056.49	7.18	89.76	82.58	1.11
Dena Bank	7,648.06	-	-	-	-
Indian Bank	12,408.07	-	-	-	-
Indian Overseas Bank	15,069.17	18.45	53.95	35.50	0.36
Oriental Bank of Commerce	13,724.35	15.50	120.50	105.00	0.88
Punjab & Sind Bank	5,744.94	31.99	39.02	7.03	0.68
Punjab National Bank	28,207.17	134.55	310.12	175.57	1.10
Syndicate Bank	11,910.60	78.21	120.00	41.79	1.01
UCO Bank	12,301.84	10.61	96.61	86.00	0.79
Union Bank of India	15,409.69	49.98	149.98	100.00	0.97
United Bank of India	11,656.43	-	-	-	-
Vijaya Bank	7,360.73	30.18	57.76	27.58	0.78
Public Sector Banks	**4,54,007.90**	**1,292.58**	**3,223.37**	**1,930.79**	**0.71**

Source: Compiled from Balance Sheet of respective banks.

References:

Muniappan, G.P. (2002), 'Indian Banking: Paradigm Shift - A Regulatory Point of View', Speech Delivered at the Bank Economists' Conference, Kolkata.

RBI (2002), *Valuation of Investments by Banks* (www.rbi.org.in).

Technology in Banking

1.79 Technology has a definitive role in facilitating transactions in the banking sector and the impact of technology implementation has resulted in the introduction of new products and services by various banks in India. Within the RBI, technological advances have been

significant and the present processes and systems have a high technology content. Several initiatives were taken during the year with the broad objective of providing systems which impact beneficially on efficient house-keeping in banks, better customer service and overall systemic efficiency.

Payment and Settlement Systems

1.80 The payment and settlement systems are the backbone of any financial economy. Reforms in the payment and settlement systems have been a focused area of attention to ensure the establishment of systems which would provide timely settlement of funds for the banking sector based on latest technological tools available. Achievement of all this would be within the overall fundamental requirements of safety, security and conformity to well-established norms of prudence and international standards.

Centralised Funds Management System

1.81 The centralised funds management system (CFMS) which facilitates funds and treasury managers of commercial banks to obtain the consolidated and account-wise, centre-wise position of their balances with all the Deposit Accounts Departments of the RBI has been installed at the various RBI locations as also banks which were ready with the infrastructure for obtaining the data in a networked environment.

Structured Financial Messaging System

1.82 The structured financial messaging system (SFMS), the messaging software riding on the INFINET, was implemented during the year under review. Providing for safe and secure communication, the SFMS was tested at three banks during a pilot phase spanning four months from November 2001. Subsequently, it has been made operational in banks which have provided the requisite infrastructure for SFMS effective January 2002. One of the key components of SFMS is security. Apart from smart card based access – an integral component of SFMS, the requirement of digital signatures has also been suitably addressed.

Real Time Gross Settlement System

1.83 The progress towards operationalisation of the real time gross settlement (RTGS) System continued during the year. The RTGS solution comprises of the software for arriving at real-time settlement of transactions – using a queuing mechanism which would also take care of potential gridlock situations. Further, it would provide for temporary intra-day liquidity to participating members on the basis of collateralised repo facility. The RTGS solution would also provide for replacement of the existing accounting software in the Deposit Accounts Department, RBI, Mumbai. The initial testing of the modules with the members is expected to commence during the second quarter of 2003.

Policy Related Issues

Extension of Membership of INFINET to Banks and FIs

1.84 The INdian FInancial NETwork (INFINET), a wide area network based on satellite technology (using VSATs) and terrestrial modes of communication has emerged as a secure inter-bank financial communication backbone. The members of the INFINET constitute a closed user group comprising initially of PSBs. The network was opened to other banks as well, encompassing PSBs, old and new private sector banks, foreign banks and urban co-

operative banks during the year, apart from organisations such as PDs who maintain a current account or a subsidiary general ledger (SGL) with the RBI. With increase in usage levels, the membership has also risen from 27 members during the previous year to 162 as on June 30, 2002. Membership to INFINET provides users the benefits of communication facilities offered by the network; admission to each application platform on the INFINET (such as the CFMS, NDS and RTGS) is, however, governed by the rules and regulations for each such system. The network is used for common interbank applications like NDS and CFMS besides bank specific applications *viz.*, inter-branch reconciliation, message transfers, and information dissemination to branches of banks.

Digital Signatures and Certification of Electronic Messages

1.85 The messages transmitted over the INFINET are being digitally signed to ensure authentication and non-repudiation. This process has been made possible by means of the solution provided by the Institute for Development and Research in Banking Technology (IDRBT) for a public key infrastructure (PKI) based certification services. As an initial application, digital signatures are part of the NDS. The establishment of the IDRBT as the certification authority for the banking sector would provide a fillip in the usage of digitally signed electronic funds based transactions/messages. Banks are encouraged to use the PKI by creating the required registration authority.

Rural Credit and Credit to Small-Scale Industries

1.86 The scope of priority sector lending was expanded during the year to include financing of activities relating to setting up of agri-clinics and agri-business centres and purchase for agricultural purposes by small and marginal farmers. Further, the limits for financing of distribution of inputs for allied activities such as cattle feed, poultry feed, etc. under priority sector was increased to Rs. 25 lakh from Rs. 15 lakh. In order to help the farmers in marketing their products, credit limits for marketing of crops was increased to Rs. 5 lakh from Rs. 1 lakh and the repayment period for such credit was enhanced to 12 months from 6 months. To avoid double counting, it was decided that sponsor banks of RRBs, while computing their performance under priority sector lending, should exclude funds provided to the RRBs for on-lending to priority sector.

1.87 Keeping in view the stipulated two-year time frame for achievement of priority sector lending targets/sub-targets (for lending to agriculture and weaker sections), all domestic SCBs having shortfall in their lending to these sectors as on the last reporting Friday of September 2001 and March 2002 were advised to take appropriate steps to improve credit flows to the priority sector, to achieve the target/sub-targets by March 2003.

Credit to Small Scale Industries

1.88 Commercial banks have been advised to dispense with collateral requirements for the SSI sector for loans up to Rs.5 lakh. To further enhance credit flows to SSIs, the limit for dispensation of collateral requirements has been raised to Rs.15 lakh for those units having a good track record and financial position.

Specialised SSI Bank Branches

1.89 The PSBs have been advised to make concerted efforts to operationalise at least one specialised small scale industry (SSI) branch in every district and centre having cluster of SSI

units. The convenor of the state-level bankers committee (SLBC) for each state has to monitor the progress in the operationalisation of such specialised SSI branches. As at end-March 2002, there were 395 specialised SSI bank branches operating in the country. With a view to encourage banks to open more specialised SSI branches, banks have been permitted to categorise their general branches having 60 per cent or more of their advances to SSI sector as specialised SSI branches.

Standing Advisory Committee for Small Scale Industries (SSIs)

1.90 The Standing Advisory Committee was reconstituted to review the flow of institutional credit to the SSI sector. The terms of reference broadly are to review credit flow to the sector and problems encountered thereon, suggest procedural and policy improvements in catering to the credit needs of the sector, examine other connected and related issues; and make recommendations related to or incidental to the above items. So far, two meetings of the reconstituted Standing Advisory Committee were held to deliberate on above issues of SSI sector.

Khadi & Village Industries Commission

1.91 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 2002, an amount of Rs.365 crore was outstanding out of an amount of Rs.738 crore disbursed by the consortium under the scheme.

Strengthening of Credit Delivery to Women

1.92 In order to overcome the difficulties being faced by women in accessing bank credit and credit-plus services in the tiny and SSI sector, the Central Government has drawn up a 14-point Action Plan for implementation by PSBs. PSBs are required to report the progress made in implementing the Plan to the Government and the RBI on a quarterly basis commencing from the quarter ended March 2001. Furthermore, PSBs have been advised to increase the share of credit to women and to achieve a target of 5 per cent of net bank credit (NBC) by end-March 2004. As a result, credit to women which stood at 2.36 per cent of NBC at end-March, 2001 had increased to 3.25 per cent as at end-March 2002.

Credit for Sick SSIs Units

1.93 In January 2002, the RBI issued detailed guidelines to banks for early detection of sickness in SSIs and taking remedial measures for rehabilitation of sick SSI units identified as potentially viable. As per the revised definition, a unit is considered as sick when any of the borrowal account of the unit remains substandard for more than six months or there is erosion in the net worth due to accumulated cash losses to the extent of 50 per cent of its net worth during the previous accounting year and the unit has been in commercial production for at least two years. The revised guidelines also stipulate that the rehabilitation package should be fully implemented within six months from the date the unit is declared as potentially viable/ viable. During this interim period, banks/FIs are required to do "holding operation" allowing the sick unit to draw funds from the cash credit account, up to the extent of the deposited sale proceeds. The revised criteria will enable banks to detect sickness at an early stage and facilitate corrective action for revival of the unit.

3. Perspectives

1.94 The significant transformation of the banking industry in India is clearly evident from the changes that have occured in the financial markets, institutions and products. While deregulation has opened up new vistas for banks to augment revenues, it has also entailed greater competition and consequently, greater risks. Cross-border flows and entry of new products, particularly derivative instruments, have impacted significantly on the domestic banking sector, forcing banks to adjust the product mix, as also effect rapid changes in their processes and operations in order to remain competitive in the globalised environment. These developments have facilitated greater choice for consumers, who have become more discerning and demanding, compelling banks to offer a broader range of products through diverse distribution channels. The traditional face of banks as mere financial intermediaries has since altered and risk management has emerged as their defining attribute. In keeping with the changing profile of the banking industry, measures initiated in India have focused on building safety norms, anticipating problems and effecting changes to tackle disturbances, if any, in a robust manner. Contextually, the recent policy measures of RBI have focused on implementing structural measures to strengthen banking and to improve the functioning of the various segments of financial markets. These can be classified under three major heads: (a) strengthening prudential norms, (b) effecting structural changes in the system, and (c) redefining the regulatory role of the RBI.

(a) Strengthening Prudential Norms

1.95 Prudential norms have been introduced to impart strength to the banking system and to ensure safety and soundness through transparency, accountability and public credibility. These norms, not only promote cautious behaviour on the part of banks, but also ensure that arbitrary problems do not engender systemic instabilities and, if need be address such problems proactively.

Capital Adequacy and Basel Accord

1.96 Minimum capital requirements promote prudent management of commercial banks' credit risk. As at end-March 2002, as many as 25 PSBs had CRAR exceeding the stipulated minimum of 9 per cent. Only two PSBs accounting for 4.3 per cent of total assets of PSBs did not achieve the desired level of CRAR.

1.97 Internationally, capital adequacy has gained credence with the move towards the adoption of the new capital Accord. The proposed new capital Accord is both far-reaching and path-breaking. It redefines the regulatory approach to bank supervision and provides new incentives for banks to improve their risk-measurement procedures. It also takes cognizance of the fact that technology and market practices have altered substantially since the days of the old Accord and consequently, envisages a change in the oversight function of the regulatory authorities. The Accord is at an advanced stage of implementation and likely to be operationalised sometime around 2006 (Box I.5).

1.98 Three features of the new Accord are significant. The first relates to increased risk sensitivity. Inadequate differentiation in credit quality, as prevalent in the old Accord, had become increasingly apparent. It was, therefore, proposed in the new Accord to increase the scale of risk weights and employ external credit ratings to categorise credit. Illustratively, the measurement of credit risk requires to be disaggregated into individual components, *viz.*, probabilities of default, loss given default, exposure at default and correlation of defaults across exposures. The second is the wide applicability of the new Accord. The applicability

of the old Accord was uniform across institutions with varying degrees of sophistication and countries with widely differing legal traditions and business cultures, thereby resulting in a 'one-size-fits-all' approach. The answer has been to introduce a menu approach, with options capable of catering to a heterogeneous banking populace. Third, is the responsibility for measuring risk. The new Accord intends to introduce a shift in the responsibility for measuring risk away from regulators towards banks. Such a shift, inevitably necessitates strengthening oversight on banks' risk measurement and management. Consequently, two additional pillars: Pillar 2 (supervisory review) and Pillar 3 (market discipline through heightened disclosure) have been explicitly incorporated in the new Accord.

1.99 The RBI, while supporting the flexibility and national discretion in the implementation of the new Accord, emphasises the need to take into account the structural characteristics of different economies in the process of implementation. Owing to the lack of uniformity in selection of parameters and the differential mix and weightage of subjective and objective factors, the role of external credit rating agencies in assigning preferential risk weights for banking book assets is still not clear. Instead, RBI favours assessment of domestic rating agencies (which are better placed to rate domestic entities), owing to their up-to-date and ongoing access to domestic macroeconomic conditions, legal and regulatory framework and proprietary information.

1.100 The implementation of the new Accord envisages the development of a comprehensive and efficient internal system for assessment and management of risks, setting up and adhering to adequate internal exposure limits and improving internal control systems in banks. This is important not only from the viewpoint of deciding the quantum of capital allocation, but also from the systemic stability angle to ensure that there are no disruptions in the capital structure.

Box I.5: Basel II Timetable

Date	Action Point
October 2002	Basel Committee, in conjunction with national supervisors, launched quantitative impact survey (QIS 3) with a view to enable banks to conduct (within December 20, 2002) a concrete and comprehensive assessment of how the Committee's proposals would affect their particular firm.
Second Quarter, 2002	In light of responses received from QIS 3, the Committee will assess whether adjustments would be required in the proposed aggregate level of regulatory capital in the banking system and the updated version of the proposals would be released for public comment.
Fourth Quarter, 2003	Finalisation of the new capital Accord.
2004-06	Adaptation and development of necessary systems and procedures by banks and supervisors so as to bring them in conformity with the new capital Accord. The banks adopting internal rating based (IRB) approach and advanced measurement approach (AMA) will be required to conduct parallel calculations with the current Basel Accord for one year prior to implementation.
End 2006	Implementation of new capital Accord.

Source: BIS, 'Basel Committee Reaches Agreement on New Capital Accord Issues', July 2002.

1.101 India is also participating in the Quantitative Impact Study (QIS 3) being conducted by the Basel Committee to assess the impact of the new Accord. RBI has since constituted a group of seven banks (three public sector banks, two new private banks and two old private banks) that have begun participating in the exercise.

Risk Management

1.102 The continuing increase in the scale and complexity of financial entities and the pace of their financial transactions demand that institutions employ sophisticated risk management techniques and monitor the rapidly changing risk exposures. Simultaneously, advances in IT have lowered costs of acquiring, managing and analysing data, and have enabled significant and ongoing advances in risk management. In their effort to position themselves against global benchmarks, banks in India are increasing their focus on risk management to build more robust and sound financial systems.

1.103 In the context of large policy-induced changes in the interest rate environment, the interest rate sensitivity of banks' balance sheet has become important. In an uncertain interest rate scenario, maturity mismatch could entail significant balance sheet effects over time, although the actual impact might not be significant in the short-run. The impact on the bottomline of banks would depend on whether or not the future interest rate movement is in tandem with their respective expectations. It is, therefore, important that banks build up adequate cushion in a benign interest rate scenario so as to permit a 'soft-landing' once the interest rate environment turns adverse. The prescription of the investment fluctuation reserve is, thus, a case in point.

Non-performing Assets

1.104 The quality and performance of advances have direct bearing on the profitability and viability of banks. Despite the credit appraisal and disbursement mechanism, the problem often tends to manifest itself in an accretion to the stock of non-performing assets (NPAs). Although the net NPAs of the commercial banks in India have witnessed a decline over the past several years, they are still high as compared to developed country standards of around 2 per cent. Prompt remedial actions are, therefore warranted in this regard.

1.105 In market-driven systems, the seeds of credit excesses are often sown in an upswing when boom conditions prevail. Once financial excesses are unwound, however, there can be a tendency for loans to go bad, at the expense of the lender and the health of the financial system. In order to counter the benefits of faster credit growth in a boom against the costs of volatile economic cycles once the movements reverse, it is important that banks are not only equipped with balanced prudential norms, but also have forward-looking or dynamic provisioning so as to build-up a protective cushion in good times that can be drawn down in exigencies. The cumulative provisions against loan losses of PSBs in India amounted to 42.5 per cent of their gross NPAs for the year ended March 31, 2002. This is low compared to the international standards, where provisions against impaired assets are often as high as 140 per cent. There is, therefore, need for banks to improve their provisioning practices: full provisioning towards already impaired assets needs to be a priority corporate goal.

1.106 The approach to NPA management by the banks has to be multi-pronged, necessitating varied strategies suited to different stages of the passage of credit facility. Close monitoring

of the account, particularly the larger ones, is of prime importance. Emerging weakness in profitability and liquidity of corporates, recessionary trends, recovery of instalments/interest with time lag, etc. should alert and caution the banks. The loan review mechanism is to be adopted as a tool to bring about improvements in credit administration. Banks should also adopt their own risk-rating systems to assess the risk of lending. Sanctions above certain limits should be through a Committee, which can assume the status of an 'Approval Grid'. Exchange of credit information among banks would be of immense help to avoid possible NPAs. The banking system ought to be so geared that a defaulter at one place is recognised as a defaulter by the system. The system will have to provide a mechanism to ensure that the unscrupulous borrowers are unable to play one bank against the other.

1.107 It is in this context that the facility of Credit Information Bureau (CIB) becomes relevant. A CIB provides an institutional mechanism for sharing of credit information on borrowers and potential borrowers among banks and FIs. It acts as a facilitator for credit dispensation and helps mitigate the credit risk involved in lending. Based on cross-country experiences, initiatives have been taken in India to establish a credit information bureau (Box I.6).

Box I.6: Credit Information Bureau: International Experience

Banks and lending institutions have a traditional resistance, because of the confidential nature of banker-customer relationship, to share credit information on the client, not only with each other, but also across sectors. Specialised institutions, known as Credit Information Bureaus (CIBs) have, therefore, been set up to function as a repository of credit information-both current and historical data on existing and potential borrowers. These institutions maintain database on credit information on the borrower which can be accessed by the lending institutions.

CIBs have been established not only in countries with developed financial systems like USA, UK, Australia, New Zealand, France, Germany and Belgium, but also in countries with relatively less developed financial markets such as Sri Lanka, Mexico, Bangladesh and the Philippines. The Bureaus established in these countries collect information on both individual borrowers (retail segment) and the corporate sector. In general, separate Bureaus have been established by several countries (*e.g.*, USA, UK, New Zealand, Sri Lanka, Philippines) for collecting information on retail/individual borrowers and corporate customers.

Country experiences show that there is no uniformity in the ownership and operational aspects of CIBs in various countries. For example, in USA, UK, Australia and New Zealand, credit bureaus are privately owned. The two large bureaus collecting information in the retail segment in USA are *Equifax* and *Trans Union* which maintain databases at the national level. The *Dun and Bradstreet* in USA is the leading CIB maintaining database on the corporate sector. *Experian* is the leading credit referencing agency in UK, alongwith a number of smaller bureaus formed through private initiatives. In New Zealand, there are no public CIBs, but several companies like *Baycorp* which provide credit reports on individuals and corporates. In Australia, while *Credit Reference Ltd.*, provides information on small and medium-sized businesses, *Dun and Bradstreet* (Australia) provides commercial credit information on large corporates.

In several European countries such as France, Belgium and Germany, credit information

services or credit registers have been set up as divisions of the Central Banks. Illustratively, in France, the Credit Bureau Division of the Banque de France, collects information at monthly intervals from banks on their lending to corporate customers above a certain threshold. In Belgium, on the other hand, credit information offices, set up as divisions of the central bank capture defaults on instalment contracts, consumer credit, mortgage agreements, leasing and corporate borrowings. Banks and financial services institutions in Germany are required to notify the details of those borrowers whose indebtedness exceeds DM 3 million during the three calendar months preceding the reporting date.

Among Asian economies, the CIB in Sri Lanka was formed by an Act of Parliament at the initiative of the Central Bank. In Bangladesh, the CIB was formed as a department of the Central Bank and collects from commercial banks, on a monthly basis, information on corporate borrowers availing credit above *Taka* Ten lakh. It also furnishes, on demand, to any commercial bank a CIB report. The CIB in Philippines provides information on both corporates and individuals.

In the Indian context, the Central Government is examining a draft legislation covering, *inter alia*, responsibilities of CIB, rights and obligations of the member/reporting credit institutions and safeguarding of privacy rights that may arise in the process of information sharing by CIBs. Pending the enactment of CIB Regulation Bill, a Working Group was constituted in December 2001 (Chairman: Shri S.R.Iyer) to examine the possibility of the CIB performing the role of collecting and disseminating information on suit-filed accounts and the list of defaulters, presently being reported to RBI by banks and notified financial institutions. The Working Group submitted its Report in January 2002 and the recommendations which satisfy the existing legal framework are being implemented by the RBI.

Based on the recommendations of the above Working Group, banks and FIs have been directed under Section 35 A of the Banking Regulation Act, 1949 that they should submit the list of suit-filed accounts of Rs.1 crore and above as on March 31, 2002 and quarterly updates thereof till December 2002 and suit-filed accounts of wilful defaulters of Rs.25 lakh and above as at end-March, June, September and December 2002 to the RBI as well as to CIBIL for a period of one year till March 31, 2003. Thereafter, the aforesaid information should be submitted to CIBIL only and not to the RBI.

Banks and notified FIs would, however, continue to submit the data relating to non suit-filed accounts of Rs.1 crore and above, classified as doubtful and loss, as on March 31 and September 30 and also quarterly list of wilful defaulters (Rs.25 lakh and above) where suits have not been filed only to RBI as hitherto. Thus, the statement on non suit-filed accounts need not be sent by banks/FIs to CIBIL.

References:

RBI (1999), *Report of the Working Group to Explore the Possibilities of Setting up a Credit Information Bureau*
(Chairman: N.H.Siddiqui), RBI, Mumbai.

RBI (2002), *Report of the Working Group to Examine the Role of Credit Information Bureaus in Collection and Dissemination of Information on Suit-filed Accounts and Defaulters* (Chairman: S.R.Iyer), RBI , Mumbai.

1.108 From a policy perspective, it becomes imperative that a reduction in NPAs would require both a "stock" (a one-time cleansing of balance sheet) and a "flow" (preventing substantial accretion) solution. Several measures have been taken to address the 'flow' problem (*viz., Lok Adalats*, settlement advisory committees), whereas the issue of stock of NPAs has not been adequately addressed. Towards this end, the Central Government Budget for 2002-03 announced the setting up of a pilot Asset Reconstruction Company (ARC) with the participation of private and public sector banks, FIs and multilateral agencies. Accordingly, the Ordinance to regulate securitisation and reconstruction of financial assets and enforcement of security interest was promulgated on June 21, 2002 (subsequently re-promulgated on August 22, 2002). The salient features of the Ordinance are given in Box I.7.

Box I.7: The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Ordinance, 2002

Registration

According to the above Ordinance, a securitisation or reconstruction company, with owned fund of not less than Rs. 2 crore or not exceeding 15 per cent of total financial assets acquired or to be acquired as specified by the RBI, can commence or carry on business after obtaining a certificate of registration (CoR). Existing securitisation or reconstruction companies would have to apply for registration to the RBI, within six months from the commencement of the Ordinance. For grant of CoR to a company, the conditions to be satisfied include: (a) not incurred loss in any of the three preceding financial years, (b) made adequate arrangements for realisation of financial assets for securitisation or asset reconstruction, (c) pays periodical returns, and (d) complies with the prudential norms of the RBI. In addition, the Directors of the company should have adequate professional expertise and not have been convicted of any moral turpitude offence. Not more than half the Board members should be associated in any manner with the sponsor, and should not otherwise hold any controlling interest in such securitisation or reconstruction company.

Operations/Functions

The acquisition of financial assets by the securitisation/ reconstruction company would be through the issuance of debentures/bonds or agreements with banks/FIs. The notice of acquisition may be sent by banks/FIs to the concerned obligor, who, in turn, is to make payment to the concerned securitisation or reconstruction company. In case no notice of acquisition is given, then money/properties received subsequently by banks/FIs would be held in trust on behalf of the securitisation or reconstruction company. Other functions of such company would include acting as agent for banks/FIs to recover their dues from borrowers, acting as manager and receiver if appointed by court or tribunal. The disputes will be settled by conciliation or arbitration as provided in the Arbitration and Conciliation Act, 1996.

Prudential Norms

The RBI, in public interest and to regulate the financial system of the country to its advantage would, determine policy and give directions to such companies on income recognition, accounting standards, provisions for bad and doubtful debt, capital adequacy and deployment of funds.

Enforcement of Security Interest

The Ordinance empowers secured creditors to enforce any security interest credited in its favour without any intervention of court or tribunal. The secured creditor may require the borrower to discharge his liabilities within 60 days from the date of notice, failing which the secured creditor is entitled to take possession or management of the secured assets including the right to transfer by way of lease, assignment or sale or appoint any person to manage the secured asset. The borrowers are allowed to seek protection by filing an appeal in the Debt Recovery Tribunal (DRTs) along with a deposit of 75 per cent of the amount claimed with the DRT in order to prevent misuse of appeal provisions.

Offences and Penalties

There are strict provisions of penalties for offences or default by the securitisation or reconstruction company. In case of default in registration of transactions, modification of security interest or in reporting satisfaction of security interest, every company or officer would be fined upto Rs.5,000/- per day. In case of non-compliance with directions by the RBI, the company could be fined upto Rs.5 lakh and in case of continuing offence, an additional fine of Rs. 10,000 per day may be imposed.

The provisions of this Ordinance will override other laws. The application of other laws such as the Company's Act 1956, Securities Contract (Regulation) Act, 1956 and Securities and Exchange Board of India Act, 1993, however, are not barred.

The RBI has constituted two Working Groups for stipulating suitable norms for registration, prescribing prudential norms, recommending proper and transparent accounting and disclosure standards and framing appropriate guidelines for the conduct of asset reconstruction/ securitisation.

Reference:

Government of India (2002), *The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Ordinance,* New Delhi.

Prudential Norms for Loan Classification

1.109 Towards achieving an internationally competitive and sound banking system, attempts have been made to deepen and broaden prudential norms in line with the internationally recognised best practices and standards. Accordingly, banks have been advised by the RBI that, effective March 31, 2005, an asset would be classified as doubtful if it remained in the sub-standard category for 12 months; the additional provision therein would be phased over a four-year period, commencing from year ending March 31, 2005, with a minimum of 20 per cent each year. Loan classification criteria generally rely on *ex-post* signals of loan quality, which, in essence, include the number of days a loan is past due and, more broadly, the current condition of the debtor. Although not commonly practiced, it might be desirable to include other criteria, some of which exhibit forward-looking features. The US system for example classifies loans into five categories based on a set of criteria ranging from payment experience to the environment in which the debtor evolves. This system seeks to curb the risk of excessive bank discretion, although judgemental inputs play a critical role. Incorporation of such features, would, however, require an accurate assessment of the expected probability of default.

Legal Framework

1.110 The banking system requires a legal framework that facilitates the enforcement of financial contracts. Banks must be able to realise what is due to them. If they have no recourse against the borrowers who default, the latter will have reduced incentives to repay loans. Delays owing to inefficiencies or bottlenecks in the legal system can seriously jeopardise the debtor-creditor relationship and adversely impinge upon the smooth functioning of the financial system. It is, therefore, important that the judicial system displays an understanding of financial transactions for banks to rely on fair and speedy enforcement of their contractual rights and obligations.

1.111 In the context of ongoing changes in the financial sector, a number of steps have been initiated to amend the provisions of existing laws to make them compatible with the changed environment. The major legal reforms initiated in the banking sector pertain to security laws, frauds in banks and regulatory framework in banking. Illustratively, amendments have been proposed to the RBI Act, 1934 (which were sent to the Government in 2001), Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/80, Banking Regulation Act, 1949, as well as to legislations relating to State Bank group.

Corporate Governance

1.112 Corporate governance has as its backbone a set of transparent relationship between an institution's management, its Board, shareholders and other stakeholders. It, therefore, needs to 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. In a service industry like banking, 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 the objectives of the institution are set, the strategy for attaining them is determined and the performance of the institution is monitored.

1.113 The Reports of the Advisory Group on Corporate Governance (Chairman: Shri R.H. Patil) and Advisory Group on Banking Supervision (Chairman: Shri M.S. Verma) outlined several proposals to improve corporate governance without the necessity of legislative changes. It is, therefore, important to consider what improvements in corporate governance practices that may be implemented within the confines of the existing legislative framework.

1.114 Towards this end, the RBI constituted a Consultative Group of Directors of Banks and Financial Institutions (Chairman: Dr. A.S. Ganguly) to review the supervisory role of Boards of banks and FIs, to obtain feedback on the functioning of the Boards *vis-à-vis* compliance, transparency, disclosures, audit committees etc. and suggest measures for making the role of Board of Directors more effective. The Group submitted its recommendations in April 2002 after comprehensively reviewing the existing framework as well as the current practices and benchmarked its recommendations with international best practices as enunciated by the BCBS, as well as of other committees and advisory bodies, to the extent applicable in the Indian context. The major recommendations of the Group comprise the following (Box I.8).

Box I.8: Recommendations of the Consultative Group to look into the Role of Bank/FI Boards

- Appointment of one more whole-time director on the boards of large-sized nationalised banks. Further, the Government while nominating directors on the Boards of PSBs should be guided by certain broad "fit and proper" norms for the Directors, based on the lines of those suggested by the Bank for International Settlements (BIS).
- The appointment/nomination of independent/ non-executive directors to the Board of banks (both public sector and private sector) should be from a pool of professional and talented people to be prepared and maintained by RBI. Any deviation from this procedure by any bank should be with the prior approval of RBI.
- It would be desirable to take an undertaking from every director to the effect that they have gone through the guidelines defining the role and responsibilities of directors, and understood what is expected of them and enter into a covenant to discharge their responsibilities to the best of their abilities, individually and collectively.
- It would be desirable to separate the office of Chairman and Managing Director in respect of large-sized PSBs. This functional separation will bring about more focus on strategy and vision as also the needed thrust in the operational functioning of the top management of the bank. The whole-time directors should have sufficiently long tenure to enable them to leave a mark of their leadership and business acumen on the bank's performance.
- The information furnished to the Board should be wholesome, complete and adequate to take meaningful decisions. The Board's focus should be devoted more on strategy issues, risk profile, internal control systems, overall performance, etc. The procedure followed for recording of the minutes of the board meetings in banks and FIs should be uniform and formalized.

- It would be desirable if the exposures of a bank to stockbrokers and market-makers as a group, as also exposures to other sensitive sectors, *viz.*, real estate etc. are reported to the Board regularly. The disclosures of progress made towards establishing progressive risk management system, the risk management policy, strategy, exposures to related entities, the asset classification of such lendings/investments etc. should be in conformity with corporate governance standards, etc.
- Finally, the banks could be asked to come up with a strategy and plan for implementation of the governance standards recommended and submit progress of implementation, for review after twelve months and thereafter half yearly or annually, as deemed appropriate.

Besides, the recommendations also focused on the role and responsibilities of independent/non-executive directors, their training and remuneration, commonality of directors of banks and NBFCs, information flows to/from the board, etc.

References:

Basel Committee on Banking Supervision (1999), *Enhancing Corporate Governance for Banking Organisations,* Basel, Switzerland.

Jalan, B. (2002), ‘Corporate Governance and Financial Sector: Some Issues’, Inaugural Address at NIBM Annual Day. Reddy, Y.V. (2002), ‘Public Sector Banks and the Governance Challenge: Indian Experience’, *RBI Bulletin,* May, 337-356. RBI (2000), *Report on Trend and Progress of Banking in India,* RBI: Mumbai.
RBI (2002), Report of the Consultative Group of Directors of Banks/ Financial Institutions - Implementation of recommendations (Notification dated June 20), (www.rbi.org.in).

1.115 In June 2002, the RBI requested banks (excluding foreign banks, RRBs and LABs) to place the Report as well as the list of recommendations before their respective Board of Directors. Based on the decision taken by the Board, these recommendations could be adopted and implemented in the concerned bank.

Recapitalisation

1.116 Governments can cleanse banks’ balance sheets in various ways-rehabilitating assets, loss sharing, reducing debt and injecting new capital (Box I.9). The manner in which it is done depends, among other things, on the existing ownership structure of the distressed financial institutions. In the case of state-owned commercial banks, Government often needs to step in with public support. In all cases, assisted financial institutions need to draw up an acceptable business plan that encompasses capital and operational restructuring to contain costs and improve profit prospects without assuming additional risks. An overview of the capital injections by the Central Government in the banking sector upto end-March 2002 is presented in Table I.1.

Table I.1: Capital Restructuring in the Banking Sector

Institution	**Assistance**	**Provisions made in the Central Government Budget, 2002 - 03**
Nationalised Banks	Rs. 21,746 crore provided as recapitalisation support to nationalised banks upto end-March 2002.	The Central Government Budget 2002-03 has made a provision of Rs. 770 crore.
Regional Rural Banks	Rs. 2,188 crore have been infused by the share holders (Government of India, State Governments and sponsor banks) as additional capital support to 187 RRBs through several phases of recapitalisation upto January 2000.	No recapitalisation exercise was undertaken during 2000-01 and 2001-02. Further the Government has not made any budgetary allocation in this regard for the year 2002-03.
Co-operative Banks		Rs. 100 crore proposed in the Central Government Budget 2002-03. The provision is for grants through NABARD for providing incentives to states and co-operative institutions to adopt reform measures for strengthening co-operative credit structure.

1.117 In order to enable Indian Bank to improve its CRAR to the prescribed level, the Central Government released capital assistance of Rs.1,300 crore on March 30, 2002 on the basis of a commitment for implementing monitorable reform measures. The Government and the RBI are closely monitoring the performance of the bank and achievement of set milestones before deciding on any further recapitalisation. Concomitantly, Indian Bank reported a net profit of Rs.33 crore and CRAR at 1.70 per cent as on March 31, 2002.

1.118 The significant improvement recorded by banks in the last three years could be attributed to the sustained efforts to recover NPAs, improve incomes and efficiency and reduction of costs including staff expenses through adoption of voluntary retirement schemes (VRS) as well as close monitoring of the progress under restructuring plans.

(b) Effecting Structural Changes in the System

1.119 Although prudential norms are important to ensure systemic stability, it is imperative to effect structural changes to ensure long-run viability and sustainability of the system as a whole.

Box I.9: Alternative Forms of Support to Banks

Asset rehabilitation involves swapping impaired assets for cash or bonds. These will be at market prices. Even so, these swaps will improve capital adequacy, liquidity and the ability to make loans and can reduce funding costs. Risk-weighted capital ratios improve because the swap, generally, replaces risky loans with low-risk investments, such as Government bonds or cash.

Loss sharing arrangements can assume various forms. They might be proportional, or the bank could take the first hit upto a certain amount, with the Government covering subsequent losses according to a sliding scale. Loss sharing could also be for a limited period. The loans to be covered under loss sharing could be based on an (aggregate) assessment of the distribution of expected loan losses under different economic scenarios by sector. For example, commercial real-estate loans may have more favourable loss-sharing arrangements than home loans.

Equity purchases by Government, sub-ordinated debt or bonds (negotiable or non-negotiable) will also immediately increase net worth, improve capital ratios, liquidity and potential profitability. If asset values and corporate earnings are temporarily low, but expected to recover as the economy strengthens, support through capital injections is often a preferred choice. Where Governments provide support through purchase of preferred stock, they might forgo dividends for some time to boost banks' income. Sub-ordinated debt convertible into equity if not repurchased by the bank within a specified time can be used to protect the Government from banks' inability to service the debt (by allowing Government to intervene). Such contingent clauses can also be a powerful incentive for owners and management to rehabilitate the bank as quickly and effectively as they can.

Granting Government loans or placing deposits will also improve bank liquidity and provide an opportunity for the bank to buy impaired assets. This does not immediately increase capital, however, nor does it improve capital ratios, because assets and liabilities increase by the same amount.

References:

Claessens, A (1999), 'Experiences of Resolution of Banking Crises', *In Strengthening the Banking System in China: Issues and Experience,* BIS Policy Paper No.7, Basel. Hawkins, J and P.Turner (1999), 'Bank Restructuring in Practice: An Overview', In *Bank Restructuring in Practice,* BIS Policy Paper No.6, Basel.

E-banking

1.120 On the technology front, there is the issue of e-banking or the use of electronic delivery channels for banking products and services through automated teller machines (ATM), internet banking and tele-banking. E-banking leads to greater competition among banks, both domestic and foreign, as well as competition from the non-banking segment. Competition results in lowering of transactions cost, enables penetration into new markets and expansion of geographical reach. It also compels banks to offer a broad range of deposit, credit and investment products through diverse distribution channels.

1.121 In India, e-banking, however, has not been able to make significant inroads as an independent mode of banking due to psychological, technological and socio-economic factors. There are the additional hurdles relating to infrastructural and legal constraints. This channel of distribution, though promising, is unlikely to threaten traditional distribution channels in the immediate future.

1.122 Areas where innovations in IT and telecommunications have made significant transformation in banking services relate to new product development, speed of transaction processing and reduction in transaction costs. The major issue about new IT is its impact on the processing of information, which lies at the very core of banking business. Inspite of its advantages, reliance on such technology often exacerbates traditional risks: operational risk (since it requires changes in procedures), reputational risk (if the bank fails to deliver secure, accurate and timely services) and legal risk (uncertainty about which legislation applies to e-banking transactions), besides the emergence of other risks (business and credit risks). Another source of concern related to e-banking is the emergence of the 'digital divide' in the access to banking services. Since e-banking and other IT-led innovations in the financial sector are knowledge intensive, it often tends to favour more educated participants, that too at the cost of ignoring the relatively less privileged sections.

Transparency

1.123 Issues related to transparency in banking operation have gained prominence in recent years. The requirements of transparency are dynamic: growing with the changing character and complexities of banking business on the one hand and the economy itself, on the other. Unlike capital adequacy or asset quality, however, there is no way to quantify transparency and, therefore, the quest for transparency has to be continual and persistent.

1.124 In India, as part of the ongoing efforts towards transparency, banks have been asked to disclose certain financial and operational parameters in their balance sheet. These disclosures have gradually been expanded over the last few years. More recently, from the year ended March 2002, banks have started making additional disclosures relating to movement in provisions held towards NPAs and those held towards depreciation of investments as part of regulatory requirements of RBI.

Deposit Insurance

1.125 The issue of guarantees presents a major dilemma for Governments. On the one hand, the chances of a financial crisis can be increased by Government guarantees as the perception of sovereign protection leads market participants to take more risky positions. On the other hand, guarantees can serve to maintain confidence in the system and keep problems in one sector from spilling over into others. This is illustrated by the pros and cons of depositor protection schemes (Box I.10).

Box I.10: Deposit Protection Schemes-Cross Country Practices

Deposit insurance is designed to protect small depositors who cannot be expected to monitor the soundness of the bank's asset portfolio. Apart from promoting fair competition, the scheme would encourage savings and the use of large-scale payments systems rather than less efficient media like cash. It can also help timely bank restructuring by defusing political pressure or legal challenges leading to delays in closing banks. In the absence of deposit insurance schemes, depositors may try to avoid smaller financial entities in favour of state-owned banks (which enjoy implicit protection), large banks (which may be considered 'too-big-to-fail') or foreign banks (which may be able to rely on financial backing in their home countries).

Studies have shown that deposit insurance has its own pros and cons. On the flip side, chances of a financial crisis can be increased by Government guarantees, because the perception of official protection often leads market participants to assume more risky positions. Safety nets, however, can serve to maintain confidence in the system and keep problems in one sector from spilling over into others. While one study reveals that countries with explicit deposit insurance scheme are more likely to have systemic banking crisis (Demirguc-Kunt and Detragiache, 2000), another study finds that the adoption of an explicit deposit insurance scheme undermines market discipline exercised by creditors and depositors on banks (Demirguc-Kunt and Huizinga, 1999).

In recent years, the attention has, however, shifted from the establishment of an explicit deposit insurance scheme to institutional details such as coverage, membership, funding and administration. In this context, few studies demonstrate that the coverage and funding of deposit insurance schemes have significant impact on the probability with which a country suffers a banking crisis, while others show that the coverage and funding are important determinants of the degree of market discipline exercised by depositors *vis-à-vis* banks. The importance of the design of deposit insurance schemes thus increases the need to study institutional details of individual schemes.

In India, the Working Group on Reforms in Deposit Insurance in India (Chairman: Shri Jagdish Capoor), submitted its Report in October 1999. Based on the recommendations of the Group, a new draft law was prepared in supercession of the existing law. Subsequently, the Central Government Budget 2002-03 announced the conversion of the Deposit Insurance Credit and Guarantee Corporation (DICGC) into the Bank Deposits Insurance Corporation (BDIC). Appropriate legislative changes are to be proposed for this purpose. The proposed BDIC is expected to be an effective instrument for dealing with depositors' risks and for dealing with distressed banks. In order to evolve a suitable system for India, a joint team of officials from the Government, RBI and DICGC studied the Federal Deposit Insurance Corporation (FDIC) model and other regulatory and supervisory agencies in the US.

A comparison of the characteristics of the deposit insurance scheme as prevalent in India *vis-*

à-vis those prevailing elsewhere are given in the table. As may be seen therefrom, several features of the deposit insurance scheme in India are comparable to those existing in other economies such as its explicit nature, compulsory membership and joint funding. The major differences, however, pertain to lack of co-insurance feature and absence of risk-adjusted premiums. It may be mentioned that most countries with risk-adjusted premiums are those where the deposit insurance schemes were enacted/revised in the 1990s.

References:

Beck, T. (2000), 'Deposit Insurance as Private Club: Is Germany a Model ?', (www.worldbank.org).

Demirguc-Kunt, A and E.Detragiache (2000), 'Does Deposit Insurance Increase Banking System Stability?', *IMF Working Paper* No.3.

Demirguc-Kunt, A and H.Huizinga (1999), 'Market Discipline and Financial Safety Net Design', *World Bank Policy Research Working Paper* No. 2183.

Demirguc-Kunt, A and T.Sobaci (2001), 'Deposit Insurance Around the World', *World Bank Economic Review*, 15, 481-490.

RBI (1999), *Report on Reforms in Deposit Insurance in India* (Chairman: Shri Jagdish Capoor), RBI: Mumbai.

Table: Characteristics of Deposit Insurance Scheme

Feature of the Scheme	India	European Union	US	World Average
Explicit	Yes	Yes	Yes	68 countries
Coverage Limit	US $ 2,355	Euro 20,000	US $ 1,00,000	Three times per capita GDP
Co-insurance	No	10 per cent	No	17 out of 68 countries have co-insurance
Coverage of Foreign Currency Deposits	Yes	Can be excluded	Yes	Covered in 48 out of 68 countries
Coverage of Inter-bank Deposits	No	No	Yes	Covered in 18 out of 68 countries
Source of Funding*	Joint (public plus private)	Not regulated	Joint	Private: 15 Joint: 51 Public: 1
Administration	Public	Not regulated	Public	Private: 11 Joint: 24 Public: 33
Membership	Compulsory	Compulsory	Compulsory	Compulsory in 55 out of 68 countries
Risk-adjusted Premium	No	Not regulated	Yes	21 out of 68 countries have risk-adjusted premiums

* Not available for one country.

Source: Beck (2000) and Demirguc-Kunt and Sobaci (2001).

Internal Controls

1.126 A set of effective mechanisms for an internal control system in banks is one of the fundamental conditions of their healthy functioning. As observed by the Basel Committee on Banking Supervision (BCBS), an internal control system refers to the ongoing process by which an institution meets three key sets of objectives: operational, informational and compliance. These comprise five inter-related elements: management oversight, risk assessment, control activities, information and communication and monitoring activities. In the Indian context, it is important for banks to strengthen their internal control mechanisms through simplification of documentation procedures and building efficient inter-office communication channels. This would necessitate revisions in audit procedures, operational manuals and above all, a commitment by the senior management to take responsibility for implementing strategies approved by Boards as also to monitor their efficacy. Above all, this would need to be supplemented by internal audit procedures to ensure that the introduced control mechanisms function properly.

(c) Redefining the Regulatory and Supervisory Focus of RBI

1.127 In keeping with the changing latitudes of the banking industry, it is important that the regulatory and supervisory focus of the RBI is geared to tackle contingencies. Accordingly, the focus of regulation and supervision are fine-tuned to keep pace with the changing financial landscape.

Regulation and Supervision

1.128 Financial markets are different from product markets and, therefore, greater liberalisation needs to go along with deeper supervision and higher degree of regulation. This is because financial institutions are more leveraged and there is more scope for speculative activities in such assets, given their inherent volatility. Moreover, there are negative externalities that can destabilise financial markets and instability in financial markets can adversely affect the real economy. Keeping the above aspects in mind, the RBI has instituted a three-pronged supervisory strategy comprising of on-site inspection, off-site surveillance and external auditing towards monitoring the health profile of individual institutions. The inspection for domestic banks is conducted in a more objective manner under the CAMELS (Capital Adequacy, Asset Quality, Management, Earnings, Liquidity and Systems) methodology and a comprehensive rating system has also been put in place. The banks have been advised about the procedure followed in the rating exercise in the interest of transparency and to help them in their efforts to improve their rating in the subsequent period.

1.129 With the passage of time, financial sector supervision is expected to become increasingly risk oriented and concerned more with validation of systems. There is a growing acceptance that risk-based supervision (RBS) approach would be more efficient than the traditional transaction-based approach (Box I.11).

Box I.11: Risk-based Supervision

The RBS process entails monitoring of banks by allocating supervisory resources and focusing supervisory attention according to the risk profile of each institution. The

instruments of RBS are off-site monitoring and on-site examination supplemented by market intelligence mechanism. Internationally, off-site surveillance, however, gained primacy in recent times, given the ease and promptness of monitoring.

The objective of the RBS entails the allocation of scarce supervisory resources and paying supervisory attention in accordance with the risk profile of the concerned institution. This approach is expected to optimise utilisation of supervisory resources and minimise the impact of crisis situation in the financial system. The RBS process essentially involves continuous monitoring and evaluation of the risk profiles of the supervised institutions in relation to their business strategy and exposure. Apart from strengthening the risk modeling capabilities based on off-site data and associated research for 'predictive supervision', it would rationalise the overall compliance burden.

The major elements of RBS approach comprise of: (a) risk profiling of banks, (b) supervisory cycle, (c) supervisory programme, (d) inspection process, (e) review, evaluation and follow-up, (f) monitorable action plan, (g) supervisory organisation, (h) enforcement process and incentive framework, (i) role of external auditors, and (j) change management implications.

The central plank for RBS would be the risk profiling of banks, which, in essence, would document the various financial and non-financial risks confronting the bank. The risk profile of each bank, in turn, would entail drawing up of a supervisory programme for the concerned institution, which would be flexible enough to permit amendments warranted by subsequent major developments. The supervisory follow-up process will seek to ensure that banks take timely corrective action to remedy or mitigate any significant risks that have been identified in course of supervision. This would be implemented through the Monitorable Action Plan (MAP) that would not only outline remedial actions, but also link these to the areas of high risk identified in the risk profiling and supervisory process. In order to make the framework incentive compatible, banks with better compliance record and good risk management and control system could be subject to a longer supervisory cycle and less supervisory intervention. In case banks fail to show improvements in response to the MAP, there would be a disincentive package comprising of more frequent supervisory examination and higher supervisory intervention such as directions, sanctions and penalties, including the mandatory and discretionary actions as enshrined in the Prompt Corrective Action (PCA) framework. The process would be supplanted by leveraging the use of external auditors by widening the range of tasks and activities performed by them. Since the success of the entire process would hinge critically upon the pro-active response of banks, it is essential that banks have well-defined standards of corporate governance and documented policies and practices in place so as to clearly demarcate the lines of responsibility and accountability.

RBS offers several advantages. First, it enables supervisors to gain a better understanding of the quality of management, characteristics of the business and the risk a bank faces. It also enables supervisory authorities to display more consistency in carrying out supervisory responsibilities and establish best practices in the supervision of banks. Second, the explicit linking of tools of supervision to areas of risk or concern means that banks' management is better able to appreciate why a supervisor has used a particular supervisory tool. Third, in view of the high transactions costs involved in on-site supervision process, RBS will be better placed to decide the intensity of the future supervision, having obtained a better understanding of the bank's risk profile. The intensity of supervision and the amount and focus of supervisory action will increase in line with the perceived risk profile of the bank.

In India, in order to develop an overall plan for moving towards RBS, international consultants were appointed with the assistance of the Department for International Development of the United Kingdom. They have completed Phase-I of the project by conducting a review and evaluation of the current supervisory and regulatory framework, policies, guidelines, instructions, tools, techniques, systems, available IT infrastructure and external linkages. The thrust of Phase-I recommendations is on enhancement to the regulation and supervision framework leading to the increased effectiveness of overall supervision through greater focus on risk as well as realignment of the inspection process to fall in line with a more risk-based approach. The recommendations cover areas such as data management, supervisory process, inspection, feedback to banks, external audit, etc. During Phase-II of the project, the Consultants are expected to work out the practical and operational aspects of the above recommendations and suggest a new RBS framework including the sequencing of different stages and a time frame for implementation. A dedicated Group has been set up within the RBI for project implementation and to drive the change management implication. To meet the requirements of RBS, banks would be required to take immediate measures to improve the reliability and robustness of their risk management, management information and supervisory reporting systems. The compilation of supervision manual for the use of supervisors is in progress and the RBS approach is scheduled to be operationalised during 2003.

References:

Financial Services Authority (1998), *Risk Based Approach to Supervision of Banks*, FSA, London.

RBI (2001), *Statement on Monetary and Credit Policy for the Year 2001-2002*, RBI, Mumbai.

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Co-operative Banking

1.130 Credit institutions are linked to each other through a complex chain of inter-bank relationships, which, in adversity might become potential vehicles for spread of the contagion effect. Signs of financial mismanagement in an institution or a group of institutions, regardless of the reasons, is liable to trigger similar problems in other institutions and generate serious risks in the financial system. Being an integral part of the banking system, co-operative banks are no exception to this rule. There is a need to refashion management in co-operative banks by picking up threads of good corporate governance.

1.131 An important issue that has engaged much attention in the recent past is the dual/triple regulatory and supervisory control over cooperative banks. In view of the local interest involved in the co-operatives, there seems to be limited consensus in favour of removing supervisory and regulatory responsibilities at various levels and to entrust it exclusively to one body. In view of this, supervision of UCBs often proves to be a challenging proposition for the RBI, so that it might prove worthwhile integrating the supervision of co-operative banks under one umbrella. There is also an urgent need for clarity in defining the roles of various control institutions by streamlining processes, procedures, etc. and for removing overlapping of controls over cooperative banks presently vested with State Governments,

RBI and NABARD, as the case may be. In this context, the creation of a separate apex supervisory authority has been emphasised, which can take over the entire inspection/supervisory functions in relation to scheduled and non-scheduled UCBs. Subsequently, RBI has submitted a draft Bill which is under consideration of the Government.

Financial Soundness Indicators

1.132 Recent episodes of financial turmoil in international financial markets have underscored the need for better monitoring of financial risks and vulnerabilities. The magnitude and mobility of international capital flows have made it increasingly important to strengthen the foundations of domestic financial systems as a way to build up resilience to volatility in capital flows. As a consequence, increased attention is being paid to monitoring the health and efficiency of financial institutions and markets, and also the macroeconomic and institutional developments that pose potential risks to financial stability.

1.133 The Financial Sector Assessment Programme (FSAP), launched jointly by the IMF and The World Bank in May 1999, has sought to focus, among others, on early detection and identification of financial sector vulnerabilities, assess observance and implementation of standards and codes, and develop appropriate policy responses to weaknesses in financial systems. Towards this end, attention has come to be focused on financial soundness indicators (FSIs), complementing the macroprudential indicators (MPIs) (Box I.12).

Box I.12: Macroprudential Indicators: Salient Findings

The Mid-term Review of Monetary and Credit Policy of October 2000 had indicated that a half-yearly financial stability review using macroprudential indicators (MPIs) would be prepared. In this regard, an inter-departmental Group was constituted and a pilot review of MPIs was prepared for the half-year ended March 2000 followed by regular half-yearly reviews from September 2000 onwards. The salient findings of the review for the second half of 2001-02 are given below.

Capital Adequacy (CRAR)

The CRAR of the banking system improved over the period ending March 2001 to March 2002. This improvement in CRAR reflected the impact of higher growth in capital than the growth in risk-weighted assets. The faster growth in capital was made possible because of the surge in profits of the banking system as a whole and the mobilisation of equity capital by a couple of banks.

Non-Performing Assets (NPAs)

The gross NPAs (to gross advances) as well as net NPA (to net advances) position of the banking system witnessed an improvement by end-March 2002 *vis-à-vis* its position in end-March 2001. The containment in NPAs in the current year, viewed in the context of slowdown in industrial activity, seems significant owing to the substantial reductions effected.

Profitability-Return on Assets and Return on Equity

The profitability indicators of the banking system showed major improvement, with both return on asset and return on equity rising considerably in relation to the previous year. The improvement in profitability for PSBs, in particular, stemmed from reduction in staff

expenses. This was also made possible by significant profits on securities trading, which has witnessed a marked increase in 2001-02. Return on equity also turned out to be the highest in the last few years.

Liquidity

An assessment of the liquidity position of the banking system suggests that their short-term assets were in excess of short-term liabilities and hence, maturity mismatch is unlikely to exert any major pressure on the liquidity-adjustment-induced changes in the interest rate.

Interest Spread

The trend in interest spread (net interest income to total assets), which has witnessed a declining trend over the past few years, continued during 2001-02. This trend reflects the possible impact of greater competition among banks. In this context, the share of interest income to non-interest income assumes importance. If non-interest income can meet operating expenses, then the constraint imposed by higher operating cost on reducing the spread can be mitigated.

Investments in non-SLR Securities

Investments in non-SLR securities include investments in CPs, bonds and debentures, debt-oriented mutual funds, Central Government recapitalisation bonds, etc. Investments in non-SLR securities exhibited a higher growth during 2001-02 as against that registered in the previous year. This was largely on account of capital injection to one PSB and the merger in the new private bank segment. Excluding the latter, the growth in non-SLR securities was less as compared to the previous year.

Credit Concentration

For the banking system as a whole, the degree of credit concentration (in terms of credit extended to top 20 corporates as percentage to total credit) appeared to be significant. In respect of foreign banks, the degree of concentration was large, which appears to be a source of vulnerability in their local operations and also a cause for relatively high NPA ratios of the smaller foreign banks. Exposure of the banking system to sensitive sectors, particularly to capital market and real estate, continued to remain modest.

1.134 In contrast to the MPIs which seek to provide an assessment and monitoring of the strengths and weaknesses of the financial system, FSIs are aimed at monitoring the health and soundness of financial institutions and markets and of their corporate and household counterparts. Two sets of FSIs have been proposed, a ‘core’ set, which is broadly comparable across countries, and an ‘encouraged’ set, which is more country-specific in nature. The FSI dataset, therefore, are aimed at serving two purposes: first, it seeks to develop a set of indicators that are broadly comparable across countries (the ‘core’ set), which is possible if countries adhere to internationally agreed prudential and accounting standards, and second, it allows for internalisation of country-specific vulnerabilities by promoting the development of an ‘encouraged’ set of indicators. Unlike the MPIs, therefore, FSIs seeks to eschew the ‘one-size-fits-all’ approach and provide flexibility in the selection of indicators.

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1. DSB returns were so called because at the time of introduction of these returns, the department of RBI seeking these returns was known as **D**epartment of **S**upervision, and these returns were called for by the **B**anking wing of the

[2] As per cent to total investment, i.e., HFT, AFS and HTM categories.