Chapter I - Overview

Developments during 2002-03

1.1 The year 2002-03 was marked by a revival in industrial growth with a buoyant services sector. Nevertheless, the drought situation inhibited the farm sector, and the overall GDP growth for 2002-03 was moderate. In line with the resurgence of industrial growth, there was some pick-up in scheduled commercial banks' (SCBs) non-food credit, particularly in the second half of 2002-03. Portfolios of SCBs, on the asset side, showed some shift in favour of advances. Owing to the holding of Government securities by SCBs, far in excess of stipulated requirements and a fall in interst rates, their income profile continued to be driven by treasury operations. There has been a reduction in the ratio of non-performing assets (NPAs) to advances with various initiatives, such as, improved risk management practices and greater recovery efforts, driven, *inter alia*, by the recently enacted Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002.

1.2 Co-operative banks recorded moderate growth with less than satisfactory profitability. There was also some scaling down of activities of the development financial institutions. The performance of the non-banking financial companies during 2001-02 was less satisfactory. A number of regulatory measures by the Reserve Bank, such as, alignment of interest rates in this sector with the rates prevalent in the rest of the economy, tightening of prudential norms, standardisation of operating procedures and harmonisation of supervisory directions carried the financial sector reforms further.

Macro Environment

1.3 Overall GDP growth for 2002-03 at 4.3 per cent was lower than the 5.6 per cent growth in 2001-02, mainly because of a fall in agricultural GDP by over 3 per cent caused by the most severe drought in 14 years. Industrial production, on the other hand, witnessed broad-based upward expansion. Growth in the services sector was also higher, mainly on account of higher growth in construction, domestic trade and transport sectors, financing, insurance, real estate, and business services. The annual rate of inflation (WPI, point-to-point) remained low up to mid-January 2003, but edged up thereafter up to end-March 2003 owing to a hardening of prices of non-food articles and mineral oil. For the year 2002-03 as a whole, inflation (in terms of WPI), measured on an average basis, was, however, a shade lower at 3.4 per cent than that at 3.6 per cent in 2001-02.

1.4 Notwithstanding the lacklustre and uncertain global environment, robust growth in merchandise exports, higher services exports such as software, and buoyant inward remittances resulted in a surplus of US $ 4.1 billion (0.8 per cent of GDP) in the current account of balance of payments during 2002-03. Net capital flows were high at US $ 12.1 billion. With improvement in the capital account, India's foreign exchange reserves increased significantly from US $ 54.1 billion as at end-March 2002 to US $ 75.4 billion as at end-March 2003.

1.5 In the domestic economy, liquidity conditions remained comfortable during the year. Broad money (M_3) growth, net of the impact of the merger, increased by 13.2 per cent on top of a 14.1

per cent growth a year ago; this was in line with the projected level of 14.0 per cent during 2002-03. Among its components, aggregate deposits of scheduled commercial banks in 2002-03 were somewhat lower (adjusted for mergers). Reflecting the acceleration in industrial production, there was a sustained increase in credit flow to the commercial sector. During 2002-03, growth in both non-food credit (adjusted for mergers), as well as, investment in Government securities was much higher. There was also a larger flow of resources from non-banks, including issuance of Global and American Depository Receipts, Foreign Currency Convertible Bonds, and Commercial Papers (CPs).

1.6 Against this backdrop, while continuing the preference for soft interest rates, along with a vigil on movements in the price level, the overall stance of the Reserve Bank's monetary policy during 2002-03 continued to focus on the provision of adequate liquidity to meet credit growth and support investment demand in the economy. In line with the aforesaid objectives, the Cash Reserve Ratio (CRR) was reduced from 5.5 per cent to 5.0 per cent in June 2002 and further to 4.75 per cent in November 2002, cumulatively augmenting the lendable resources of banks by about Rs.10,000 crore. The Bank Rate and repo rate have emerged as important tools for the Reserve Bank to signal its policy intentions. In October 2002, the Bank Rate was lowered to 6.25 per cent. The repo rate was also reduced to 5.75 per cent in June 2002 and further cuts were effected in two stages, reducing it to 5 per cent by March 2003.

Scheduled Commercial Banks

1.7 The year 2002-03 was characterised by strong earnings for Indian commercial banks with all major income categories showing significant improvements. Return on assets (*i.e.*, the ratio of net profit to total assets), witnessed a marked improvement for SCBs to 1.0 per cent in 2002-03 - the highest over the last six years. Record low interest rates continued to drive the retail and housing segments, boosting both lending and fee-based income of banks.

1.8 Given the buoyant Government securities market resulting from declining yields arising from excess liquidity in the market, and soft interst rate conditions, the banking industry witnessed significant activity in trading in Government securities during the major part of the year. Notwithstanding some dampening of sentiments during the last quarter of 2002-03, the banking industry as a whole witnessed a sharp improvement in performance during 2002-03, driven largely by containment in interest expense (Table I.1).

Table I.1: Select Financial Sector Indicators: 2001-02 *Vis-À-Vis* 2002-03

	Financial Entity		Indicator	2001-02	2002-03
	1		2	3	4
I	Scheduled Commercial Banks	a)	Growth in Major Aggregates (Per cent)		
			Aggregate Deposits	14.6	13.4 *
			Non-food Credit	13.6	18.6 *
			Investment in Government Securities	20.9	27.3
		b)	Financial Indicators (as percentage of total assets)		
			Operating Profits	1.9	2.4
			Net Profits	0.8	1.0
			Spread	2.6	2.8
		c)	Non-Performing Assets (as percentage of advances)		
			Gross NPA	10.4	8.8

		Net NPA	5.5	4.4
II Urban Co-Operative Banks	a)	Growth in Major Aggregates (Per cent)		
		Deposits	15.1	9.1
		Credit	14.1	4.5
	b)	Financial Indicators (as percentage of total assets) @		
		Operating Profits	1.5	1.3
		Net Profits	-0.9	-1.1
		Spread	2.2	2.1
	c)	Non-Performing Assets (as percentage of advances)		
		Gross NPA	21.9	21.0
III All-India Financial Institutions	a)	Growth in Major Aggregates (Per cent)[1]		
		Sanctions	-39.9	-31.3
		Disbursements	-18.5	-30.5
	b)	Financial Indicators (as percentage of total assets) 2		
		Operating Profits	1.6	1.4
		Net Profits	0.7	0.9
		Spread	0.6	0.7
	c)	Non-Performing Assets (as percentage of advances) 2		
		Net NPA	8.8	10.6
IV Non-banking Financial Companies	a)	Growth in Major Aggregates (Per cent)		
		Public Deposits	4.1	—
	b)	Financial Indicators (as percentage of total assets)		
		Net Profits	-0.5	—
	c)	Non-Performing Assets (as percentage of advances)[3]		
		Net NPA	3.9	4.3 #

*Adjusted for merger. @ Relates to scheduled urban co-operative banks.

Figure pertains to September 2002.

1. Comprise IDBI, IFCI, IIBI, IDFC, SIDBI, IVCF, ICICI Venture, TFCI, LIC, UTI, and GIC.
2. Comprise following nine FIs, viz., IDBI, IFCI, IIBI, IDFC, Exim Bank, TFCI, SIDBI, NABARD and NHB.
3. For reporting companies with variations in coverage.

1.9 The significant improvement in the performance of SCBs masks the wide variation in performance across bank groups. For example, increase in income was the lowest for old private banks, owing to a modest increase in interest income. Foreign banks, on the other hand, experienced a decline in both income and expenses, with the decline in the latter outpacing that in the former, arising largely from containment in interest expenses. Taking advantage of the easy liquidity conditions, public sector banks (PSBs) contained their interest expenses within reasonable levels. Declining rates also allowed banks to realise gains on the sale of appreciated securities. Provisions and contingencies increased for most bank groups reflecting a greater appreciation on their part to improve the credit portfolio; an exception being the foreign banks for whom provisions in fact declined reflecting improvements in their asset portfolio.

1.10 Capital levels of the banking sector improved markedly during the year with the overall capital adequacy of SCBs rising from 10.4 per cent as at end-March 1997 to 12.6 per cent as at end-March 2003, owing to ploughing back of profits into reserves. All public sector banks had capital well above the stipulated minimum. At the aggregate level, out of the 93 SCBs (excluding RRBs), only two could not satisfy the stipulated 9.0 per cent capital adequacy ratio.

1.11 A marked improvement in credit risk management of banks was also evident. The overall non-performing assets (NPAs) of the banking sector declined by over Rs.2,000 crore to 8.8 per cent of gross advances as at end-March 2003. This was driven by the twin-track measures of improved risk management practices and greater recovery efforts. The recently enacted SARFAESI Act, which enabled banks to recover around Rs.500 crore till end-June 2003, had a salutary effect in this regard. Notwithstanding the improvement in asset quality, banks have been making pro-active efforts towards increasing their provisioning levels. This is reflected in the fact that the cumulative provisioning against gross NPAs of PSBs increased from 42.5 per cent in 2001-02 to 47.2 per cent in 2002-03. With increased provisioning, the net NPA to net advances of PSBs witnessed a distinct decline from 5.8 per cent in 2001-02 to 4.5 per cent in 2002-03.

1.12 Competitive pressures are increasingly making their presence felt in the Indian banking system. The interest margin for SCBs, defined as the excess of interest income over interest expense, normalised by total assets, has exhibited a declining trend from 3.1 per cent in 1995-96 to 2.8 per cent in 2002-03. This has been effected in a soft interest rate scenario. Further, there were expenditure curtailment and manpower rationalisation, as evidenced in their reduction in operating expenses, while harnessing the beneficial influence of technology.

Co-operative Banks

1.13 Co-operative banks recorded moderate growth during the year under review after the strong expansion in the latter half of the 1990s. The profitability of co-operative banking continues to be less than satisfactory. This largely reflects a narrowing of spreads – especially as co-operative banks typically do not trade in the Government securities market, and are, thus, not able to exploit lowered interest rates to their advantage. At the same time, there was some improvement in asset quality in case of urban co-operative banks with their gross non-performing assets (NPAs), as proportion of advances, recording a marginal decline during 2002-03.

1.14 The performance of rural co-operatives was also in line with the long-term trends. Profitability of the state co-operative banks continued to be strong during 2002-03. The NPAs of rural co-operatives continued to be high – with the asset quality of the lower tier being relatively worse than that of the upper tier.

Financial Institutions

1.15 The sharp declining trend in financial assistance by all-India Financial Institutions (FIs)[1] , noticed in the recent period, continued during 2002-03. When the financial assistance of the FIs is adjusted for the gross flow for repayments, flow of resources from some development financial institutions to corporates is found to be negative. While the merger of ICICI with ICICI Bank and the shrinkage in the size of balance sheets of some FIs explain, to a great extent, this decline in financial assistance, the subdued performance of the FIs is consistent with the increasing role of banks in financing of Indian industries. Besides, a sluggish capital market, lack of demand for new projects and increase in industrial production through utilisation of unused capacities all may have contributed to lower demand for long-term financial assistance.

1.16 The balance sheet of select FIs, as a group, showed a growth of 5.7 per cent over the previous year. The pattern of liabilities and assets, however, remained broadly similar. On the liability side, bonds and debentures constituted a major share in the total, as they provide more flexibility of structuring with call and put options as also the tradable facility in the secondary market by way of listing on the stock market. Total sources and deployment of funds of FIs (excluding ICICI) declined by 2.1 per cent during 2002-03 as against an increase of 19.8 per cent in the previous year. The performance of select FIs in respect of maintenance of a minimum capital to risk weighted assets ratio (CRAR) reveals that, except IFCI and IIBI, all FIs had a CRAR much above the norm of 9 per cent during 2002-03. There was, however, an increase in net non-performing loans (NPLs) of some FIs during 2002-03.

1.17 Resource mobilisation by mutual funds declined sharply during 2002-03 mainly due to the substantial net outflow of funds from UTI, which was restructured during the year. Private sector mutual funds also recorded a decline in mobilisation of funds while public sector funds (other than UTI) recorded a modest increase.

Non-Banking Financial Companies

1.18 The licensing process of the deposit-accepting non-banking financial companies (NBFCs) was completed during 2002-03. The number of non-banking financial companies, however, fell during the year, reflecting a combination of several factors, such as, mergers, closures and cancellation of licenses. The number of public-deposit-accepting companies also came down because of conversion to non-public-deposit accepting activities. At the same time, balance sheets of the NBFCs have been strengthening in recent years in response to prudential norms. In terms of capital adequacy, most of the reporting NBFCs registered a CRAR of at least the stipulated minimum of 12 per cent, with almost three-fourth reporting a CRAR of above 30 per cent. Besides, non-performing assets, in both gross and net terms, as a percentage of credit exposure, have also been declining.

1.19 The financial performance of NBFCs was, however, less satisfactory. In fact, the sector as a whole, recorded losses for the second year in succession during 2001-02. There was a decline in both fund-based and fee-based incomes. The reduction in expenditure was much more moderate as operating expenditures and tax provisions have tended to be sticky. Performance indicators for 2002-03 for the NBFCs are yet to be out. Nevertheless, leading information from the quarterly data on broad liquidity (L3), encompassing the monetary and liquid liabilities of the banking sector, post office banks, FIs and NBFCs, reveal that public deposits of NBFCs recorded a marginal growth during 2002-03.

1.20 The SARFAESI Act provides for sale of financial assets by banks and FIs to securitisation companies (SCs) or reconstruction companies (RCs). Recently IDBI, ICICI Bank, SBI and a few other banks jointly promoted the Asset Reconstruction Company (India) Limited (ARCIL) with an initial authorised capital of Rs.20 crore and paid-up capital of Rs.10 crore. ARCIL has been given license by the Reserve Bank to commence operations.

Developments during 2003-04

1.21 The Indian economy is poised to record strong growth during 2003-04. During the first quarter (April-June 2003), the growth in GDP accelerated to 5.7 per cent over the corresponding quarter of the previous year. There is likely to be a recovery in agricultural production, following normal monsoons after a year of drought. Besides, industrial growth continues to be strong. The increase in the index of industrial production accelerated to 5.6 per cent during 2003-04 (April-August) from 5.2 per cent during the corresponding period of the previous year, driven by an improved performance in the manufacturing sector. There are indications of sustained growth in the production of basic goods, capital goods and consumer goods. Consequent to all these factors, the overall growth in GDP during 2003-04 is expected to be around 6.5 - 7.0 per cent, with an upward bias. The surge in capital flows continued during 2003-04 (up to October), reinforced by the revival of FII investment. As a result, the Reserve Bank's foreign exchange reserves climbed to US $ 92.6 billion by end-October 2003. The exchange rate of the rupee which was Rs.47.50 per US dollar at end-March 2003 appreciated by 4.8 per cent to Rs.45.32 per US dollar by end-October 2003 but depreciated by 2.3 per cent against Euro, 2.5 per cent against Pound Sterling and 4.2 per cent against Japanese Yen during the period. During April-September 2003, while growth in exports was lower, that of imports was higher than those in the corresponding period of the previous year.

1.22 Liquidity conditions continued to be comfortable, driven by strong capital flows. Broad money (M_3) growth, at 7.4 per cent during this year so far (up to October 17, 2003) was somewhat lower than that of 8.1 per cent experienced during the corresponding period of 2002-03, after adjusting for mergers. Overall, remained within the projections the growth in M3 of the Monetary and Credit Policy of April 2003. SCBs' non-food credit offtake at 5.7 per cent (up to October 17, 2003) was somewhat lower as compared with 7.4 per cent, adjusted for merger effects, during the comparable period of the previous year. Nevertheless, some new trends in the credit market, such as, growth of retail credit, particularly to the housing sector, are noteworthy. The annual rate of WPI inflation, on a point-to-point basis, remained high in the range of 6.3 – 6.9 per cent during the first two months of 2003-04; thereafter it declined to 5.0 per cent by October 18, 2003.

1.23 Reflecting easy liquidity conditions as well as reductions in the repo rate by the Reserve Bank, interest rates continued to soften further in the financial markets. Another positive feature during the year was the revival of capital markets, with the BSE Sensex gaining by as much as 61 per cent during 2003-04 (up to end-October).

1.24 The performance of the commercial banking system during the quarter ended June 2003, as revealed from the supervisory returns of SCBs, indicate a significant improvement in their performance over the corresponding quarter of the previous year. The net profits to total assets of SCBs for the quarter ended June 2003 stood at 0.32 per cent as compared with 0.24 per cent during the comparable period of the previous year. The improvement in net profits was driven by containment of expenses, in general, and interest expended, in particular, and was achieved despite a sharp rise in provisions and contingencies across bank groups. Operating expenditures, by and large, remained at the same level as at end-June 2002; an exception being the new private banks for whom these expenses increased marginally. Reflecting the industrial recovery, financial assistance by FIs increased during April-September 2003.

---

* As the Report pertains to 2002-03, the primary focus of the Chapter is confined to the year 2002-03.

[1] Comprising IDBI, IFCI, IDFC, IIBI, SIDBI, ICICI (till 2001-02), IVCF, ICICI Venture, TFCI, LIC, UTI and GIC.