Chapter III - Developments in Commercial Banking

1. Introduction

3.1 The revival of industrial activity induced a distinct shift in the operating macroeconomic environment for commercial banks in 2002-03. Along with continued strong capital flows, there was a revival of non-food credit offtake during the year. Commercial banks were able to fund this increased demand from industry without impinging on liquidity conditions by unwinding positions - in both domestic and foreign investments - built up during the previous years of poor credit off-take. Their performance during the year, thus, reflected the mix of a falling interest rate regime and a revival of credit demand. Easy liquidity conditions continued though the first half of 2003-04, driven by strong capital flows.

3.2 The net profits of scheduled commercial banks (SCBs), excluding Regional Rural Banks (RRBs) continued to record substantial growth during 2002-03 over and above the strong performance last year. The return on assets witnessed a marked improvement driven by increases in all major income categories. The spurt in the retail and housing segments boosted both lending and fee incomes. Trading income continued to be strong in consonance with a sustained rally in the Government securities markets, reflecting the softening of the interest rate regime. Interest expenses decelerated sharply with the reduction in deposit rates (Table III.1).

Table III.1: Changes in the Income Expenditure Profile of Scheduled Commercial Banks

(Amount in Rs. crore)

Indicator	2001-02		2002-03	
	Absolute	Per cent	Absolute	Per cent
1	2	3	4	5
1. Income (a+b)	**18,956**	**14.3**	**21,342**	**14.1**
a) Interest Income	11,867	10.3	13,760	10.8
b) Other Income	7,089	41.7	7,582	31.5
2. Expenses (a+b+c)	**13,783**	**11.0**	**15,841**	**11.4**
a) Interest Expenses	9,375	12.0	6,091	7.0
b) Operating Expenses	-499	-1.5	4,406	13.1
c) Provisions and Contingencies	4,907	36.7	5,344	29.3
3. Operating Profits	**10,080**	**51.0**	**10,845**	**36.3**
4. Net Profits	**5,173**	**80.8**	**5,501**	**47.5**

3.3 Banks have been taking pro-active steps to align their risk management processes in line with international best practices. In tandem with the changing face of competition, banks have also undertaken significant initiatives to strengthen their business practices. This included greater product sophistication with increasing leveraging of information technology to deliver value-added services to customers. Besides, there was a greater emphasis on integrated risk management systems to monitor credit, market and operational risks, sharper focus on recovery management including setting up of specialised asset recovery management branches, and on corporate governance practices.

2. Assets and Liabilities of Scheduled Commercial Banks[1]

3.4 The size of the balance sheet of SCBs recorded slower growth during 2002-03 as compared with that of the previous year, adjusted for merger effects. However, all bank groups, except foreign and new private banks, witnessed double-digit asset growth (Table III.2).

Table III.2: Consolidated Balance Sheet of Scheduled Commercial Banks

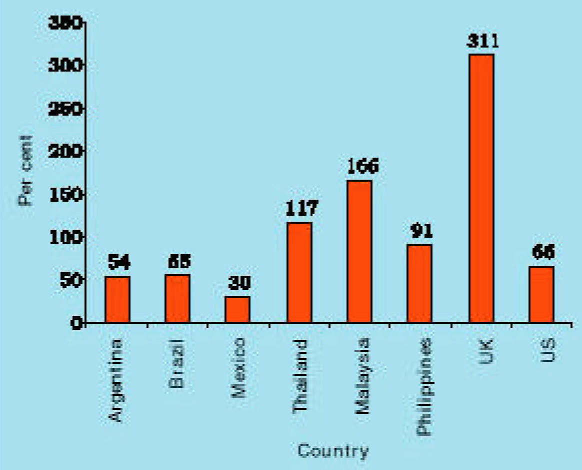
(Amount in Rs.crore)

Item	As at end-March 2002		As at end-March 2003	
	Amount	per cent to total	Amount	per cent to total
1	2	3	4	5
Total Liabilities	**15,36,425**	**100.0**	**16,98,916**	**100.0**
1. Capital	21,472	1.4	21,594	1.3
2. Reserves & Surplus	62,684	4.1	76,288	4.5
3. Deposits	12,05,930	78.5	13,55,880	79.8
3.1 Demand Deposits	1,52,929	10.0	1,64,590	9.7
3.2 Savings Bank Deposits	2,55,598	16.6	3,02,303	17.8
3.3 Term Deposits	7,97,403	51.9	8,88,987	52.3
4. Borrowings	1,02,226	6.6	87,476	5.1
5. Other Liabilities and Provisions	1,44,113	9.4	1,57,678	9.3
Total Assets	**15,36,425**	**100.0**	**16,98,916**	**100.0**
1. Cash and balances with RBI	86,761	5.7	86,118	5.1
2. Balances with banks and money at call and short notice	1,18,576	7.7	74,554	4.4
3. Investments	5,87,253	38.2	6,93,791	40.8
3.1 In Government securities (a+b)	4,31,796	28.1	5,36,381	31.6
a. In India	4,28,418	27.9	5,33,143	31.4
b. Outside India	3,378	0.2	3,238	0.2
3.2 In other approved securities	21,753	1.4	19,276	1.1
3.3 In non-approved securities	1,33,704	8.7	1,38,134	8.1
4. Loans and Advances	6,45,438	42.0	7,40,473	43.6
4.1 Bills purchased & discounted	53,094	3.5	58,783	3.5
4.2 Cash Credit, Overdrafts, *etc.*	3,22,199	21.0	3,51,519	20.7
4.3 Term Loans	2,70,145	17.6	3,30,171	19.4
5. Fixed Assets	20,091	1.3	20,278	1.2
6. Other Assets	78,306	5.1	83,702	4.9

Source: Balance sheets of respective banks.

3.5 The size of bank assets of an economy is a measure of financial maturity. The size of bank assets in relation to GDP has important implications for financial development of any economy. The ratio of bank assets to GDP at market prices, at about 70 per cent for India, compares favourably with those of developing countries in Asia and Latin America (Chart III.1).

Chart III.1: Bank Assets to GDP in Select Countries



Source: Barth, J., G. Caprio and R. Levine (2001), "The Regulation and Supervision of Banks Around the World", The World Bank, Washington DC.

3.6 The changes in the composition of the balance sheet of SCBs, by and large, reflected the changing macroeconomic environment. Deposits continued to account for about four-fifth of the liabilities. The share of Government paper in total assets continued to climb in response to the rally in the Government securities markets. At the same time, the share of bank credit in total assets also recorded an increase with the revival of industrial activity. This was funded by an unwinding of positions in the call/term money markets, and a drawdown of *nostro* balances abroad in respect of all bank groups [Appendix Table III.1(A) to III.1(C)]. The increase in profitability in recent years raised the share of reserves and surpluses with banks well above the average recorded during the past five years.

Bank-group wise Position

3.7 The broad overall trends held, more or less, for all bank groups during 2002-03. Reflecting the improving investment climate, the advances portfolio of the public sector banks (PSBs) witnessed a turnaround after several years. A similar phenomenon was evidenced for old private banks as well. New private banks did witness an increase in term deposits, with an accompanying increase in term loans. Foreign banks continued to be active in the Government securities market, although their share in total assets was lower than that of PSBs.

Intra-year Variations[2]

3.8 The dynamics of the balance sheet flows indicate a stronger growth of credit and investments during 2002-03 (Table III.3). During 2003-04 so far, deposit growth remained on the moderate side and bank credit off-take was subdued.

Table III.3: Select Banking Indicators

(Amount in Rs. crore)

Indicator	Outstanding as on March	Financial Year Flows (per cent)

		21, 2003	2001-02	2002-03
1		2	3	4
1.	Aggregate Deposits (a+b)	12,80,853	14.6	16.1 (13.4)
	a) Demand Deposits	1,70,289	7.4	11.3
	b) Time Deposits	11,10,564	15.9	16.9 (13.7)
2.	Bank Credit (a+b)	7,29,215	15.3	23.7
	a) Food Credit	49,479	35.0	-8.3
	b) Non-food Credit	6,79,736	13.6	26.9
3.	Investments in Government Securities	5,23,417	20.9	27.3

Note :Figures in brackets exclude the impact of mergers since May 3, 2002.

Source: Section 42 (2) returns of commercial banks.

Deposits

3.9 Deposit mobilisation (net of impact of mergers) by SCBs during 2002-03 was, more or less, in line with the projection of deposit growth, at 14.0 per cent, envisaged in the Monetary and Credit Policy Statement of April 2003 (Appendix Table III.2). The lower deposit growth during 2002-03 partly reflected the deceleration in the monetary base. Time deposits (net of mergers) decelerated reflecting a number of factors, such as, lower accrual of interest in view of the recent softening of deposit rates, and a shift to current accounts in consonance with higher industrial activity. Consequently, demand deposits registered a healthy growth, reflecting the higher non-food credit off-take, fuelled by the revival of industrial production. Deposit expansion remained subdued in 2003-04 so far, primarily reflecting the deceleration in time deposits in response to lower interest rates and impact of the last year's drought. Demand deposits, on the other hand, have remained buoyant during the current year.

Certificates of Deposit (CDs)

3.10 CDs issued by SCBs continued to decline during 2002-03 with the prevalence of easy liquidity conditions - although there was a mild revival in 2003-04 so far (Appendix Table III.3). The discount rates on CDs also continued to soften. The main issuers, as in the past, were mainly banks with a relatively modest retail base, such as, UTI Bank, ICICI Bank, IndusInd Bank, Centurion Bank and Karnataka Bank during 2002-03, and ICICI Bank, UTI Bank, IndusInd Bank, Canara Bank and CitiBank N.A. during 2003-04 so far.

Standing Liquidity Facilities

3.11 The Reserve Bank has been in the process of phasing out sector-specific refinance facilities. The Collateralised Lending Facility (CLF), hitherto available to scheduled commercial banks against the collateral of excess holdings of Government of India dated securities/ Treasury bills (over their investments as part of Statutory Liquidity Ratio (SLR) required to be maintained), has been withdrawn in a phased manner, completely, effective from October 5, 2002. The Export Credit Refinance (ECR) Facility, provided on the basis of banks' eligible outstanding Rupee export credit, both at the pre-shipment and post-shipment stages, remains the only standing facility.

3.12 The apportionment of the standing facilities into normal and back-stop facilities was altered from the initial ratio of two-third to one-third (*i.e.*, 67:33) to one half (*i.e.*, 50:50) each, effective from November 16, 2002. While the normal facility continues to be provided at the Bank Rate, in view of the need to rationalise the multiplicity of rates at which liquidity is injected, effective from April 30, 2003, the following measures were taken in order to increase the efficacy of Liquidity Adjustment Facility (LAF) operations:

- The 'back-stop' interest rate is placed at the reverse repo cut-off rate at which funds were injected earlier during the day in the regular LAF auctions,

- Where no reverse repo bid is accepted as part of LAF auctions, the 'back-stop' interest rate would generally be 2.0 percentage points over the repo cut-off rate of the day under the LAF.

- On the days when no bids for repo or reverse repo auctions are received/ accepted, the 'back-stop' interest rate would be decided by the Reserve Bank on an *adhoc* basis.

3.13 With effect from April 1, 2002, scheduled banks are provided export credit refinance to the extent of 15.0 per cent of the outstanding export credit eligible for refinance as at the end of the second preceding fortnight. In response to suggestions received from the exporting community (after deregulation of interest rates on post-shipment Rupee export credit beyond 90 days and up to 180 days), with effect from May 1, 2003, the Reserve Bank announced that the refinance facility would continue to be extended to eligible export credit remaining outstanding under post-shipment Rupee credit beyond 90 days and up to 180 days.

3.14 There was a substantial increase in aggregate export credit, consistent with high export growth during 2002-03. The export credit refinance limit, however, declined steadily during 2002-03 (and 2003-04 so far) as a large part of the drawals were in the form of pre-shipment credit in foreign currency and export bills rediscounted which are not eligible for refinance (Appendix Table III.4). The average daily utilisation of the export credit refinance facility picked up in May 2002 (48 per cent of the limit as on May 17, 2002) on account of a temporary hardening of interest rates arising out of border tensions but thereafter declined to negligible levels with the return of easy liquidity conditions. The average daily utilisation of liquidity support under the CLF provided to SCBs ranged between Rs.30 crore and Rs.175 crore during April-May 2002 and was virtually vacated when it was withdrawn completely on October 5, 2002.

Bank Credit

3.15 Bank credit (net of impact of mergers) increased during 2002-03. There was, however, a change in the composition of the credit off-take. Food credit recorded a drop on account of lower procurement operations during the year. Non-food credit, on the other hand, registered a pick-up, reflecting a turnaround in the industrial climate, especially during the latter half of the year. Besides, there was a sharp increase in foreign currency credit demand reflecting relatively lower cost of funds to the borrower *vis-à-vis* Rupee loans. During 2003-04 so far, bank credit growth remained moderate. Food credit contracted owing to lower procurement and higher off-take.

Non-food credit off-take remained relatively subdued amidst buoyancy in industry reflecting, *inter alia*, increased recourse by corporates to internal sources of financing as well as external commercial borrowings. More recently, *i.e.*, since September 2003, some signs of a pick-up in non-food credit are clearly discernible.

Other Investments

3.16 Besides conventional credit, banks have been investing significantly in non-SLR investments in the form of commercial paper, shares, bonds, and debentures issued by the private corporate sector and public sector undertakings (PSUs) (Table III.4). The sharp increase in such investments during 2002-03 reflects partly the impact of merger effects. In particular, there was a substantial drop in investments in CP, reflecting a decline in issuances during the latter half of the year. Non- SLR investments showed some decline in 2003-04 primarily on account of a fall in the holdings of bonds and debentures of the private corporate sector.

Table III.4: Scheduled Commercial Banks' Select Non-Slr Investments

(Rs. crore)

Instrument	March 22, 2002	March 21, 2003
1	**2**	**3**
1. Commercial Paper	8,497	4,007
	(10.5)	(4.3)
2. Investment in shares issued by (a+b)	5,914	9,019
	(7.3)	(9.7)
a) Public sector undertakings	1,587	1,430
	(2.0)	(1.5)
b) Private corporate sector	4,327	7,589
	(5.3)	(8.2)
3. Investments in bonds/debentures issued by (a+b)	66,589	79,828
	(82.2)	(86.0)
a) Public sector undertakings	39,520	46,854
	(48.8)	(50.5)
b) Private corporate sector	27,069	32,973
	(33.4)	(35.5)
Total (1+2+3)	**81,000**	**92,854**
	(100.0)	**(100.0)**

Note: Data are based on statutory Section 42 (2) returns submitted by scheduled commercial banks.
Figures in brackets are percentages to the total. Constituents, may not add to total due to rounding off of figures.

Commercial Paper (CP)

3.17 Banks' investments in CPs issued by the corporates declined during 2002-03, especially during the second half of the year. This reflected, in part, a fall in primary issuances by manufacturing companies having access to sub-PLR lending *etc.* The principal investors of CP included the following banks, *viz.*, State Bank of India, HDFC Bank, Union Bank of India, Punjab National Bank and Central Bank of India. The top five issuers of CP were EXIM Bank, IDBI, Indian Petroleum Corporation Ltd. (IPCL), the erstwhile ICICI Ltd. and HDFC. The discount rate on CP invested by SCB's declined steadily from 7.4-10.3 per cent in March 2002 to 6.0-7.8 per cent by March 2003, and further to 4.7-6.5 per cent by September 2003. The spread of the weighted average discount rate (WADR) between the prime-rated and medium-rated companies widened to 156 basis points by end-November 2002 from 89 basis points in mid-April 2002, but narrowed to 59 basis points by end-March 2003 and thereafter to 65 basis points as at end-September 2003.

Commercial Bills

3.18 The market for bills rediscounting recorded a general decline in activity during 2002-03. However, during 2003-04 so far, it showed a marked increase from an average of Rs.281 crore during the first quarter of 2003-04 to Rs. 567 crore during the following quarter. The share of SIDBI, at 78.2 per cent of the total transactions during 2002-03 and 84.5 per cent of total transactions during the first half of 2003-04, continued to be substantial.

Forward Rate Agreements (FRAs) / Interest Rate Swaps (IRS)

3.19 There was a sharp increase in volume in the markets for futures products, such as, FRAs and IRS during 2002-03. While there was a spurt in both the number of contracts and the outstanding notional principal amount, participation in the market continues to remain restricted mainly to select foreign and private sector banks and a primary dealer. In a majority of these contracts, the NSE-Mumbai Inter-Bank Offered Rate (MIBOR) and Mumbai Inter-Bank Forward Offered Rate (MIFOR) were used as the benchmark rates. The other benchmark rates used include the 1-year Government of India security secondary market yield and primary cut-off yield on 364-day Treasury Bills. FRA/ IRS transactions continued to increase sharply to 12,951 contracts at Rs.3,33,736 crore as on September 19, 2003.

Sectoral Deployment of Gross Bank Credit

3.20 The gross bank credit of select SCBs (covering major banks accounting for 85-90 per cent of bank credit of all SCBs) recorded marginally higher growth during 2002-03 as compared with the previous year (Table III.5 and Appendix Table III.5). There was a sharp acceleration in non-food credit, driven mainly by an acceleration in advances to industry (medium and large) and housing.

3.21 Fiscal 2002-03 witnessed a sharp pickup in housing loans, which witnessed a quantum rise to 6.1 per cent of non-food gross bank credit as at end-March 2003, up from 4.6 per cent as at end-March 2002, reflecting several policy initiatives in this regard. In fact, banks have consistently exceeded the targets prescribed for providing housing loans during 2001-02 and 2002-03 (Table III.6).[3]

Changing Pattern of Export Financing

3.22 The share of export credit in net bank credit remained at a level of 8.0 per cent as in the previous year, notwithstanding higher export growth during the year (Chart III.2). This might be due to the changes in the financing pattern of exports brought about by the liberalised policy regime, softening of domestic and global interest rates and availability of alternative sources of finance at competitive rates.

Chart III.2: Indian Exports and Export Credit

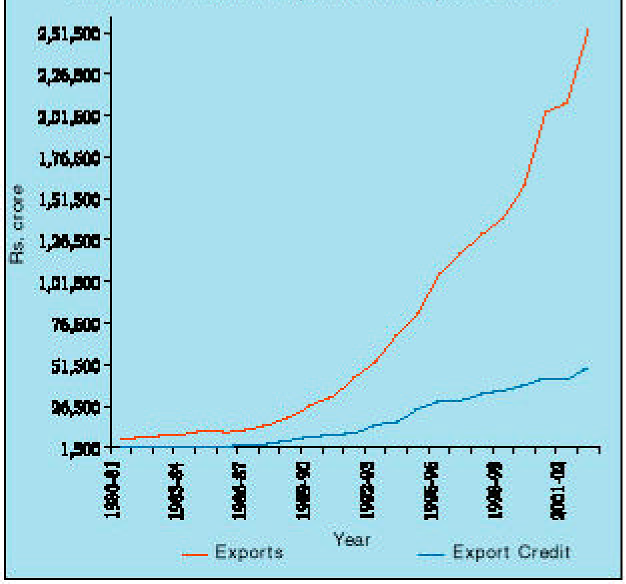


Table III.6: Housing Finance by Scheduled Commercial Banks

(Amount in Rs. crore)

Item	April-March	
	2001-02	2002-03
1	2	3
Minimum Prescribed	5,046	8,574
Allocation	(31.1)	(69.9)
Disbursements	14,746	33,841
	(51.9)	(129.5)

Notes : 1. Data are provisional.
2. Figures in brackets indicate percentage changes over the previous year.

Industry-wise Deployment of Credit

3.23 The increase in industrial credit was, by and large, spread across all sectors (Chart III.3 and Appendix Table III.6). Industry-wise, significant credit growth was observed in electricity, cotton textiles, infrastructure and iron and steel. However, four out of 26 industries, *i.e.*, coal, engineering, tobacco and tobacco products and sugar recorded a decline in credit during 2002-03.

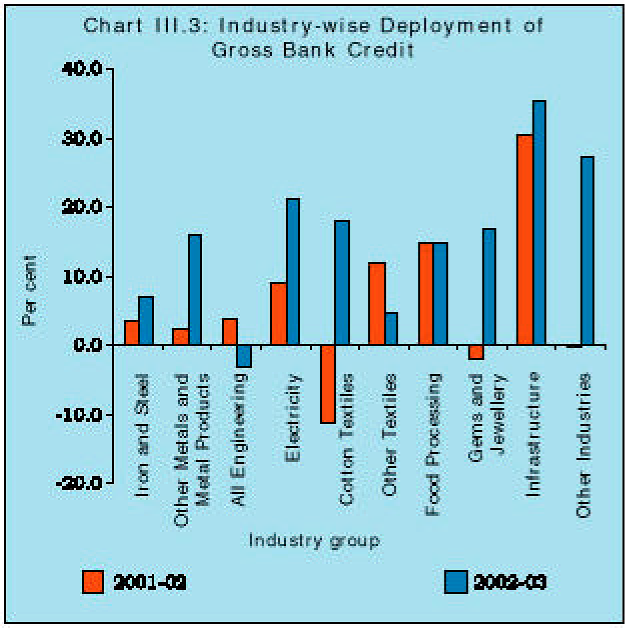


Table III.5: Sectoral Deployment of Gross Bank Credit: Flows

(Variations over the year)

(Amount in Rs. crore)

Sector	2001-02		2002-03	
	Absolute	Per cent	Absolute	Per cent
1	2	3	4	5
1. Priority sector	20,845	13.5	28,540	16.3
2. Industry (Medium and Large)	9,487	5.8	28,011	16.3
3. Housing	6,203	38.4	12,308	55.1
4. Non-banking financial companies	1,843	23.6	4,399	45.6
5. Wholesale trade (other than food procurement)	2,614	14.6	1,939	9.5
6. Other sectors	12,595	18.0	9,481	11.5
7. Total (1 to 6)	**53,587**	**12.5**	**84,678**	**17.5**
of which:				
Export Credit	-343	-0.8	6,424	14.9

Note : Data are provisional and relate to select scheduled commercial banks which account for 85-90 per cent of bank Credit of all scheduled commercial banks.

Bank Credit to Sick/Weak Industries

3.24 There has been a decline in the number of sick-SSI and non-SSI (sick / weak) industrial units financed by SCBs in recent years (Appendix Table III.7). The quantum of bank loans locked up in sick/weak industries increased marginally to Rs.26,065 crore as at end-March 2002.

Lending to Sensitive Sectors

3.25 The overall exposure of SCBs to sensitive sectors comprising capital market, real estate and commodities, underwent a compositional shift during 2002-03 (Table III.7 and Appendix Table III.8). There was a jump in housing finance - so much so that the overall exposure to sensitive sectors of most bank groups has gone up. PSBs continued to account for about two-thirds of the total exposure of SCBs to sensitive sectors.

Table III.7: Lending to Sensitive Sectors by Scheduled Commercial Banks

(Amount in Rs. crore)

Advances to	Outstanding as at end-March		Per cent to total	
	2002	2003	2002	2003
1	2	3	4	5
1. Capital market	3,082	2,504	14.8	10.5
2. Real estate	9,012	12,464	43.3	52.0
3. Commodities	8,727	8,979	41.9	37.5
Total (1+2+3)	**20,821**	**23,947**	**100.0**	**100.0**

3.26 Most bank groups, excluding the foreign bank category, unwound their exposure to the capital market during 2002-03, partly on account of the subdued performance of the capital market with limited activity being witnessed during 2002-03 and partly on account of the new growth driver: housing finance. Most commercial banks are engaged in offering retail credit for housing on highly competitive prices and customer-friendly terms, supported by strong marketing efforts to enhance their customer appeal. Consequently, real estate lending by most bank groups experienced moderate to significant increases, a decline being evidenced only in case of old private banks who, in fact, experienced a cutback in their overall lending to sensitive sectors. Exposure to commodities was on the lower side for most bank groups, with declines being evident for the State Bank group, foreign banks and old private banks.

Credit-Deposit Ratio

3.27 According to the data available from the Basic Statistical Returns (BSR), the credit-deposit (C-D) ratio of SCBs as at end-March 2002 (as per utilisation) was 58.4 per cent (Appendix Table III.9) The total flow of resources, as reflected in the credit *plus* investment to deposit (IC-D) ratio showed an increase (as per utilisation) over the last few years. The same trend has been observed in all the regions, except the western region. The western region showed a decline as at end-March 2002 as compared with end-March 2001 mainly due to a decline in the IC-D ratio of Maharashtra, which may be partly attributed to the impact of the merger.

Credit to Government

3.28 Commercial banks continued to invest heavily in Government paper, as the sustained softening of interest rates continued to fuel a rally in gilt prices. As a result, commercial bank SLR investments further increased to 38.5 per cent of their net demand and time liabilities (NDTL) as at end-March 2003 from 36.0 per cent as at end-March 2002, much above the stipulated minimum norm of 25.0 per cent. This climbed to over 40 per cent of NDTL by end-September 2003, amidst surplus liquidity in financial markets.

Role of Banks as Authorised Dealers (ADs)

3.29 A distinctive feature of the 1990s has been the growing influence of capital flows on the operations of the monetary and banking system (Box III.1). Not only has the liberalisation of the external sector significantly enhanced the quantum of funds channeled between residents and nonresidents manifold, but increasingly, the relaxation of balance sheet restrictions in respect of foreign exchange operations has transformed banks into active participants in the foreign exchange markets. Switches in capital flows, therefore, now directly affect bank liquidity. Second, the resultant impact on interest rates has been impacting bank profitability. Third, given the differential between domestic and international interest rates, the allocation between domestic and foreign assets also influences bank profitability, especially in view of the increasing liberalisation of banks' foreign exchange operations. The turnover in the foreign exchange business of banks increased by an annual average of about 4 per cent, in US dollar terms, between 1997-98 and 2002-03. While inter-bank transactions still continue to account for around 80 per cent of the total turnover, the merchant banking business of the ADs has grown much faster in recent years (Table III.8).

Table III.8: Composition of Foreign Exchange Turnover of Authorised Dealers

(Amount in US $ million, ratios in per cent)

Year	Merchant		Inter-Bank		Total	
	Purchase	Sale	Purchase	Sale	Purchase	Sale
1	2	3	4	5	6	7
1997-98	97,937	1,11,989	5,58,019	5,38,103	6,55,956	6,50,091
	(14.9)	(17.2)	(85.1)	(82.8)	(100.0)	(100.0)
1998-99	1,18,097	1,34,587	5,40,752	5,34,294	6,58,849	6,68,881
	(17.9)	(20.1)	(82.1)	(79.9)	(100.0)	(100.0)
1999-2000	1,23,747	1,28,294	4,66,042	4,65,844	5,89,789	5,94,139
	(21.0)	(21.6)	(79.0)	(78.4)	(100.0)	(100.0)
2000-01	1,33,214	1,48,018	5,90,638	5,62,379	7,23,852	7,10,397
	(18.4)	(20.8)	(81.6)	(79.2)	(100.0)	(100.0)
2001-02	1,34,966	1,37,420	6,04,678	6,10,295	7,39,644	7,47,715
	(18.2)	(18.4)	(81.8)	(81.6)	(100.0)	(100.0)
2002-03	1,65,544	1,63,664	6,24,151	6,31,380	7,89,695	7,95,044
	(21.0)	(20.6)	(79.0)	(79.4)	(100.0)	(100.0)

Note: Figures in brackets are shares in total turnover.

Box III.1: Banks as Authorised Dealers

The Reserve Bank designates specific banks as authorised dealers (ADs) for undertaking various foreign exchange transactions. There are currently 92 banks (inclusive of 35 foreign banks) functioning as ADs through 27,762 branches. The Reserve Bank also authorises companies to transact in foreign exchanges through two other channels, *viz.*, full-fledged money-changers (FFMCs), who are allowed to buy and sell foreign exchange against Indian Rupees, and restricted money changers (RMCs), who can only buy foreign exchange against Indian Rupees. The Reserve Bank also permits ADs and FFMCs to enter into agency/franchising agreements with entities for the purposes of carrying on RMC business subject to certain conditions. In addition, the Reserve Bank authorises certain development finance institutions to undertake specific types of foreign exchange transactions incidental to their main business.

The Foreign Exchange Management Act (FEMA), 1999, allows an AD in India or a branch outside India of an Indian bank to lend in foreign currency subject to certain conditions. An AD is allowed to grant loans to its constituents in India, wholly-owned subsidiaries abroad, joint ventures abroad of Indian entities and another AD in India. An AD in India may borrow in foreign currency subject to certain conditions, including its head office or branch or correspondent outside India up to 25 per cent of its unimpaired Tier I capital, or US $ 10 million, whichever is higher.

ADs play a crucial role in the development of India's foreign exchange market. In view of the gradual approach to external liberalisation, ADs have been given powers to buy and sell foreign exchange on behalf of their clients by ensuring proper documentation without the intervention of the Reserve Bank, subject to limits deemed sufficient to cover the underlying authorised transactions. For foreign exchange transactions beyond the limits set for specific purposes, however, the permission of the Reserve Bank is required for the release of foreign exchange. For specified current account transactions relating to purposes like education, medical treatment, employment, emigration, family maintenance and private travel, only self-certification is needed.

In view of the substantial autonomy in conducting foreign exchange business, ADs have emerged as main agencies responsible for implementation of the FEMA and the notifications under the Act. The Reserve Bank has decided not to specify the documents to be verified by ADs while transacting in foreign exchange. Both ADs and their customers desiring to carry out foreign exchange transactions have the responsibility to ensure that all applicable regulatory requirements and guidelines are being followed in course of their business.

The Reserve Bank would mainly focus on the effective monitoring of the operations of ADs, under the liberalised regime. As a result, the inspection approach of the Reserve Bank has shifted from transaction-specific inspection to systems-supervision. ADs are required to report their turnover to the Reserve Bank on a daily basis. The Reserve Bank scrutinises returns submitted by the ADs to ensure effective implementation of the FEMA regulations/ notifications.

International Banking Statistics

3.30 Monitoring of the cross-border flow of funds has assumed critical importance in view of the growing liberalisation of the external sector. The Reserve Bank now compiles and disseminates international banking statistics (IBS) on the lines of the reporting system devised by the Bank for International Settlements (BIS). Such statistics provide an understanding of the total magnitude of international assets and liabilities of the banking system and their composition, mainly in terms of maturity, currency composition and country of residence. International assets / liabilities cover claims / liabilities of reporting banks with / toward nonresidents in any currency and residents only in foreign currency.

3.31 The locational banking statistics (LBS) provide the gross position of international assets and international liabilities of all banking offices located in India. They report exclusively banks' international transactions including the transactions with any of their own branches / subsidiaries /joint ventures located outside India.

3.32 International liabilities of banks recorded a sharp increase during both 2001-02 and 2002-03 partly driven by the accretion to non-resident deposits and their large-scale foreign currency borrowings (Table III.9). International liabilities were predominantly denominated in either US dollars or Indian Rupees, given the large size of Rupee non-resident deposits.

Table III.9: International Liabilities of Banks Classified According to Type

(Rs. crore)

Liability type	Amount outstanding as at end-March		
	2001	**2002**	**2003**
1	**2**	**3**	**4**
1. Deposits and Loans	1,04,148	1,20,604	1,45,930
of which:			
Foreign Currency Non-Resident Bank [FCNR(B)] Scheme	37,991	39,636	43,989
Foreign Currency Borrowings*	1,222	5,514	18,411
Non-resident External Rupee (NRE) Accounts	29,413	33,233	53,124
Non-Resident Non-Repatriable (NRNR) Rupee Deposits	25,867	27,181	15,207
2. Own Issues of Securities Bonds (including IMDs/RIBs)	43,652	43,582	44,087
3. Other Liabilities	4,580	7,150	10,475
ADRs / GDRs	850	1,862	3,833
Equities of banks held by non-residents	382	547	556
Capital/remittable profits of foreign banks in India and other unclassified International liabilities	3,348	4,741	6,086
Total International Liabilities	**1,52,380**	**1,71,336**	**2,00,493**

* Inter-bank borrowing in India and from abroad, external Commercial borrowings of banks.

3.33 Banks' international assets, as at end-March 2003, on the other hand, remained roughly the same as at end-March 2002 (Table III.10). There was, however, a dramatic change in the composition of banks' international assets, with a large scale substitution of *nostro* balances, including term deposits with non-resident banks, with foreign currency loans to residents, reflecting higher domestic demand for relatively cheaper foreign currency loans. The bulk of the international assets continued to be held in US dollars, although the share of Euro persisted to record a steady rise.

Table III.10: International Assets of Banks Classified According to Type

(Rs. crore)

Asset type	Amount outstanding as at end-March		
	2001	**2002**	**2003**

1	2	3	4
	80,389	95,794	97,657
1. Loans and Deposits			
of which:			
Loans to non-residents*	4,397	5,218	4,634
Foreign Currency Loans to Residents**	13,446	19,561	36,859
Outstanding export bills Drawn on non-residents by Residents	11,119	15,190	19,242
Nostro balances@	51,287	55,642	36,708
2. Holdings of debt securities	607	952	1,027
3. Other assets@@	2,237	4,629	5,890
Total International Assets	**83,233**	**1,01,375**	**1,04,574**

* Includes Rupee loans and Foreign Currency (FC) loans out of non-resident deposits.

** Includes loans out of FCNR (B) deposits, PCFCs, FC lending To and FC Deposits with banks in India, *etc.*

@ Including balances in term deposits with non-resident banks (including FCNR funds held abroad).

@@ Capital supplied to and receivable profits from foreign branches/subsidiaries of Indian banks and other unclassified International assets.

3.34 The consolidated banking statistics (CBS) provide comprehensive and consistent quarterly data on banks' financial claims on other countries, both on immediate borrower basis for providing a measure of country transfer risk, and on ultimate risk basis for assessing country credit risk exposures of the domestic banking system. The immediate country risk refers to the country where the original risk lies and the ultimate country risk relates to the country where the final risk lies. The consolidated claims of banks, based on immediate country risk, as at end-March 2003 were mainly concentrated on the US, Hong Kong and the UK (Table III.11).

Table III.11: Consolidated International Claims of Banks on Countries Other Than India: Amount Outstanding

(based on CBS statement)

(Rs. crore)

Country	**Ultimate country risk basis**			**Immediate country risk basis**		
	March 2001	**September 2001**	**March 2002**	**June 2002**	**September 2002**	**March 2003**
1	**2**	**3**	**4**	**5**	**6**	**7**
France	1,638	2,445	2,230	2,582	2,599	2,461
	(2.2)	(2.9)	(2.4)	(2.7)	(2.7)	(2.7)
Germany	4,542	4,567	4,078	3,689	3,463	3,281
	(6.1)	(5.4)	(4.4)	(3.9)	(3.6)	(3.6)
Hong Kong	2,025	2,869	3,107	14,317	14,115	13,416
	(2.7)	(3.4)	(3.3)	(15.1)	(14.7)	(14.7)
Italy	2,666	4,623	3,706	3,362	3,362	2,832
	(3.6)	(5.5)	(4.0)	(3.6)	(3.5)	(3.1)
Singapore	1,936	3,239	4,118	6,080	5,976	5,776
	(2.6)	(3.8)	(4.4)	(6.4)	(6.2)	(6.3)
United Kingdom@	7,900	8,599	11,351	12,140	13,500	12,779
	(10.6)	(10.2)	(12.2)	(12.8)	(14.0)	(14.0)
United States of America	30,037	31,704	35,473	20,940	21,607	20,446

	(40.4)	(37.5)	(38.2)	(22.1)	(22.5)	(22.5)
All Other Countries	23,621	26,446	28,762	31,534	31,609	30,070
	(31.8)	(31.3)	(31.0)	(33.3)	(32.8)	(33.0)
Total Consolidated International Claims	**74,365**	**84,492**	**92,825**	**94,644**	**96,231**	**91,061**
(including claims on India)	**(100.0)**	**(100.0)**	**(100.0)**	**(100.0)**	**(100.0)**	**(100.0)**

@ excluding Guernsey, Isle of Man and Jersey.

Notes: 1. Figures in brackets are percentages to total.

2. The country-wise CBS has been compiled based on country of ultimate risk till March 2002. The data from the quarter ended June 2002 onwards, adopt country of immediate risk-based classification. Hence, the data for March 2003 are not strictly comparable with those of earlier years/quarters.

3.35 The distribution of consolidated international claims of banks on various countries, other than India, according to residual maturity reveals that banks continue to prefer to invest/lend for short-term purposes although there was a slight shift to longer-term maturities during the year (Table III.12).

Table III.12: Maturity (Residual) Classification of Consolidated International Claims of Banks: Amount Outstanding

(based on CBS statement)

(Rs. crore)

Country	**Ultimate country risk basis**			**Immediate country risk basis**		
	March 2001	**September 2001**	**March 2002**	**June 2002**	**September 2002**	**March 2003**
1	**2**	**3**	**4**	**5**	**6**	**7**
Up to 6 months	35,679	52,572	70,879	61,842	63,285	59,831
	(48.0)	(62.2)	(76.4)	(65.3)	(65.8)	(65.7)
6 months - 1 year	2,105	3,830	4,401	10,502	7,245	6,412
	(2.8)	(4.5)	(4.7)	(11.1)	(7.5)	(7.0)
1 year - 2 years	971	2,213	3,674	3,916	4,887	4,247
	(1.3)	(2.6)	(4.0)	(4.1)	(5.1)	(4.7)
Over 2 years	7,683	8,213	9,224	14,197	18,895	18,861
	(10.3)	(9.7)	(9.9)	(15.0)	(19.6)	(20.7)
Unallocated	27,927	17,664	4,647	4,185	1,919	1,710
	(37.6)	(20.9)	(5.0)	(4.4)	(2.0)	(1.9)
Total	**74,365**	**84,492**	**92,825**	**94,644**	**96,231**	**91,061**
	(100.0)	**(100.0)**	**(100.0)**	**(100.0)**	**(100.0)**	**(100.0)**

Notes: 1. Unallocated residual maturity comprises maturity not applicable (*e.g.*, equities) and maturity information not available from reporting bank branches.

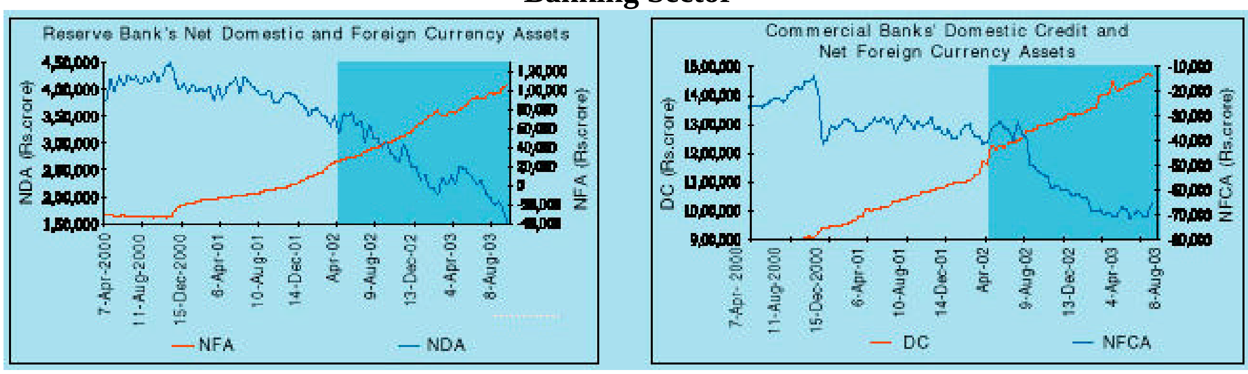
2. Figures in brackets are percentages to total.

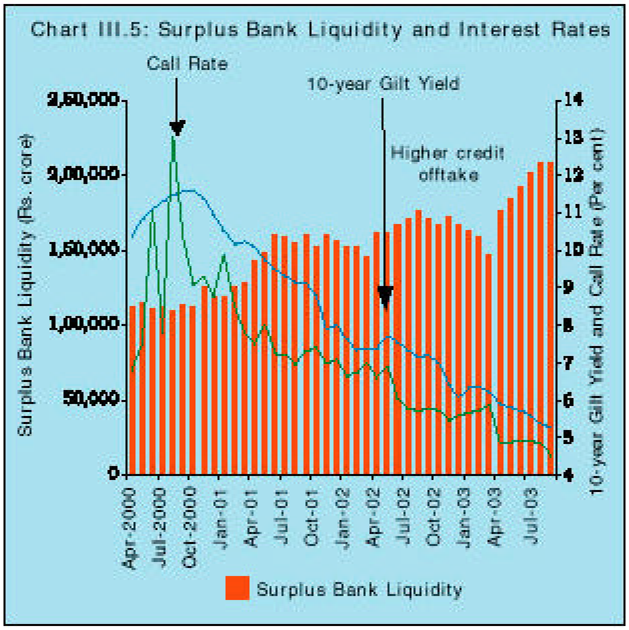
3. The country-wise CBS has been compiled based on country of ultimate risk till March 2002. The data from the quarter ended June 2002 onwards, adopt country of immediate risk-based classification. Hence, the data for March 2003 are not strictly comparable with those of earlier years/quarters.

3.36 The contours of the management of liquidity by commercial banks during 2002-03 were different from that of 2001-02, essentially because of a revival of credit demand with a turnaround in industrial activity. The analysis of banks' liquidity management is facilitated by the compilation of the Commercial Bank Survey following the recommendations of the Working Group on Money Supply: Analytics and Methodology of Compilation (Chairman: Dr. Y. V. Reddy) (Box III.2, Table III.13 and Appendix Table III.10).

3.37 Portfolio management by banks, reinforced by the Reserve Bank's simultaneous operations in the foreign exchange and Government securities markets, allowed a smooth reallocation of domestic and foreign asset flows during 2002-03 (Chart III.4). Besides, the announcement of indicative calendars for the auctions of the Central Government dated securities as well as Treasury bills during 2002-03 provided greater manoeuvrability to banks to plan their investments and manage their liquidity[4]. The availability of surplus liquidity with the banking system ensured the continuation of a regime of softening interest rates, even while funding the higher demand for credit (Chart III.5). The higher credit off-take during 2002-03 was, by and large, funded by a redeployment of assets - essentially a liquidation of both domestic and foreign investments built up in the previous phase of easy liquidity so that there was no need for banks to either canvass for deposits or cut down their exposures in gilts - without putting immediate pressure on interest rates. The share of deposit mobilisation in the sources of funds declined to 91.7 per cent, net of merger effects, during 2002-03 from 96.6 per cent during the previous year. The resultant gap was funded by a mix of higher call/term funding from financial institutions, overseas foreign currency borrowings and drawdown of foreign currency assets. In contrast to 2001-02, when banks parked a sizeable portion of the liquidity emanating from foreign currency flows in foreign assets because of a lack of domestic demand, they preferred, during 2002-03, to liquidate such investments to advance loans in foreign currency to domestic corporates.

Chart III.4: Movements in Net Demestic Assets and Net Foreign Currency Assets of the Banking Sector





Box III.2: Commercial Bank Survey

The Reserve Bank publishes an analytical Commercial Bank Survey of commercial banks' assets and liabilities, following the recommendations of the Working Group on Money Supply: Analytics and Methodology of Compilation (Chairman: Dr. Y. V. Reddy). The Commercial Bank Survey draws not only on the Form A submitted by banks under Section 42(2) of the Reserve Bank of India Act, 1934, which has been the traditional source of fortnightly data on commercial banks, but also on the Memorandum and Annexures A and B appended to Form A on the recommendations of the Reddy Working Group. This allows it to capture three critical changes taking place in the bank balance sheets in the light of financial sector reforms:

- Broadening of the concept of bank credit from the conventional credit (in the form of loans, cash credit, overdrafts and bills purchased and discounted) to include investments in non-SLR money market and capital market instruments.

- Composition of net foreign assets of commercial banks, comprising their holdings of foreign currency assets, netted for non-resident repatriable foreign currency fixed deposits. Consequently, bank deposits are adjusted for these non-resident deposits to arrive at deposits of residents.

- Introduction of a capital account, comprising capital and reserves.

The gradual firming up of the reporting system for commercial banks set up on the basis of the Reddy Working Group report increasingly provides a comprehensive view of the intra-year flow of funds within the financial system. The enhanced coverage in the CBS has narrowed down the gap between identified liabilities and assets in commercial bank data to about Rs.6,000 crore (0.5 per cent of deposits) from about Rs.84,000 crore (6.6 per cent of deposits) in Form A as at end-March 2003.

References:

Reserve Bank of India (1998), *Report of the Working Group on Money Supply: Analytics and Methodology of Compilation*
(Chairman: Dr. Y. V. Reddy), Mumbai.
Reserve Bank of India (2000), "New Monetary Aggregates",
Reserve Bank of India Bulletin, Mumbai.
Reserve Bank of India (2003), *Annual Report*, Mumbai.

Table III.13: Operations of Scheduled Commercial Banks

(Rs. crore)

Variable	Outstanding as on March 21, 2003	2002-03 Q4	2002-03 Q3	2002-03 Q2	2002-03 Q1	2001-02 Q4	2001-02 Q3	2001-02 Q2	2001-02 Q1
1	2	3	4	5	6	7	8	9	10
I. Components									
Aggregate Deposits of Residents	**11,58,942**	**24,073**	**37,484**	**32,201**	**52,675**	**32,122**	**29,675**	**20,856**	**53,337**
Demand Deposits	1,70,289	5,405	11,654	-4,535	4,717	4,412	10,074	-9,382	5,392
Time Deposits of Residents	9,88,653	18,668	25,829	36,735	47,958	27,710	19,601	30,237	47,945
Call/Term Funding from Financial Institutions	**12,638**	**2,142**	**227**	**792**	**6,448**	**-1,471**	**409**	**1,865**	**-341**
II. Sources									
Credit to the Government	**5,23,417**	**23,798**	**22,680**	**18,716**	**47,047**	**12,049**	**13,791**	**21,088**	**24,213**
Credit to the Commercial Sector	**8,46,494**	**27,881**	**39,481**	**20,322**	**22,825**	**33,676**	**31,320**	**11,217**	**9,349**
Food Credit	49,479	-2,468	-1,415	-7,645	7,030	1,702	4,015	-2,079	10,349
Non-food Credit	6,35,192	39,439	32,541	19,945	7,522	28,347	25,673	12,649	-2,367
Net Credit to Primary Dealers	4,093	-5,886	959	5,817	2,874	526	115	-401	221
Investments in Other Approved Securities	24,129	-306	-965	-459	-1,233	-644	-1,452	62	-997
Other Investments (in non-SLR Securities)	1,33,601	-2,898	8,361	2,664	6,633	3,745	2,970	986	2,143
Net Foreign Currency Assets of Commercial Banks	**-68,366**	**-8,820**	**-9,027**	**-15,136**	**2,748**	**-2,670**	**-3,544**	**-941**	**4,952**
Foreign Currency Assets	31,082	-5,345	-7,955	-14,412	4,718	-3,483	-1,996	2,023	5,886
Non-resident Foreign Currency Repatriable Fixed Deposits	92,240	-703	-230	669	1,655	475	1,425	2,018	835
Overseas Foreign Currency Borrowings	7,208	4,178	1,302	55	315	-1,288	123	946	99
Net Bank Reserves	**65,823**	**-5,700**	**-1,619**	**11,055**	**-2,943**	**-3,929**	**-1,277**	**-7,373**	**16,304**
Capital Account	**86,541**	**1,625**	**-1,815**	**-742**	**15,152**	**1,150**	**958**	**2,297**	**4,403**
Memo:									
Release of resources through changes in CRR	—	0	3,500	0	6,500	0	8,000	0	4,500
Net open market sales to commercial banks	—	7,338	12,803	13,228	3,131	0	1,904	9,614	4,106

Notes: 1. Q1 refers to the quarter ending June, and so on.
2. Deposits have been adjusted for the full impact of the mergers while credit has been adjusted for the initial impact of the same since May 3, 2002.

3.38 The portfolio allocation of banks' foreign currencies has several macro and monetary implications. If banks choose to park balances abroad, the entire transaction set is money -and output-neutral. If banks advance loans in foreign currency to residents, the transaction set is money-neutral because funds are still deployed abroad but there is an output effect arising out of the funds received by domestic industry. If banks convert their foreign currencies with the Reserve Bank in Rupees and advance loans to domestic corporates, there is a monetary as well as an output effect. If domestic corporates convert their foreign currency loans to meet domestic expenditure, the monetary impact depends on whether the banking system is able to meet this demand through a substitution within its existing portfolio or whether it accesses the Reserve Bank for Rupee resources. Since such exchange rate risk is borne by the domestic corporates, the Mid-term Review of the Monetary and Credit Policy of November 2003, requires banks to extend foreign currency loans above US $ 10 million only on the basis of a well-laid out policy by each bank to ensure hedging, except in case of exports receivables and for meeting foreign exchange expenditures.

3.39 Fiscal 2002-03 commenced with the usual ample liquidity conditions during April, thereby unwinding the end-of-the-year tightening in the market for funds. This was counter-balanced by the commencement of the market borrowing programme of the Central Government, reinforced by the Reserve Bank's open market (including repo) purchases. Liquidity conditions, in fact, tightened in the first half of May, as the Government's market borrowing programme progressed and with a substantial pick up in food credit. This led to a withdrawal of banks from LAF auctions and a drawdown of their balances with the Reserve Bank. Furthermore, border tensions created market uncertainty, necessitating a series of private placements of the Government securities with the Reserve Bank during the second half of May. The reduction of CRR by 50 basis points, reinforced by Government bond redemptions, augmented liquidity conditions in June, facilitating banks' subscriptions in the auctions of Government securities and advance tax outflows. The repo rate reduction of 25 basis points on June 27 restored sentiments and regenerated interest in the Government securities market.

3.40 There was a sharp increase in non-food credit off-take during the remaining part of the year, engendered by the turnaround in industrial activity. Besides the liquidity injected by a CRR cut of 25 basis points in November, this was, by and large, funded by a deployment of assets through the following means, *viz.,* (a) a decline in food credit, as a result of drought conditions, (b) a drawdown of *nostro* balances (especially to meet foreign currency credit demand), (c) reduced subscriptions in the LAF repo auctions, and (d) liquidation of non-SLR investments. As a result, ample liquidity conditions continued to prevail, notwithstanding a few stray episodes of temporary tightness, *viz.*, around mid-November (gilt auction outflows before transiting to a higher average daily CRR maintenance), in mid-January (sizeable open market sales) and the latter part of February (on-tap sales of State Governments loans). The impact of capital flows on bank liquidity was neutralised as the Reserve Bank continued to counterbalance its purchases of foreign currency with open market sales of Government securities even as the tempo of Government's market borrowing moderated. The ample liquidity facilitated a smooth phasing out of the collateralised lending support facility to banks by the Reserve Bank effective from the fortnight beginning October 5, 2002. The year 2003-04 so far was also characterised by easy liquidity emanating predominantly from a continued upsurge in capital inflows which more than counterbalanced the deceleration in commercial banks' domestic deposit mobilisation and relatively moderate credit demand. A reduction in the CRR by 25 basis points to 4.5 per cent of NDTL in June 2003 also released additional funds to the banking system. Mirroring easy liquidity conditions, the repo rate was cut by 50 basis points to 4.5 per cent in August 2003. As a consequence, commercial banks' investments in the Government securities remained strong through primary auctions and open market (including repo) operations.

3.41 The turnover in the call money markets declined since the latter half of 2002-03 on account of substantial improvement in liquidity during this period for which the need to borrow came down markedly for borrowers. Also, some earlier chronic borrowers turned into occasional lenders now in this market. Further, with repo rates under LAF ruling consistently higher than call rates during April-mid October 2003, lenders have a tendency to place larger funds into

Reserve Bank's LAF, thereby depressing the turnover in the call/notice segment.

Maturity Profile of Assets and Liabilities of Banks

3.42 The maturity profile of commercial banks' liabilities continues to be relatively short, with the bulk of the deposits in the one- to three-year maturity bucket (Table III.14). In case of assets, a large part of the investment portfolio is long-term in nature, with a maturity of over five years. The portfolio of loans and advances remains relatively in line with the deposit portfolio with a sizeable part in the less than three-year maturity bucket.

Table III.14: Bank Group-Wise Maturity Profile of Select Liabilities/Assets

(per cent)

Asset/Liability	Public Sector Banks		Old Private Sector Banks		New Private Sector Banks		Foreign Banks	
	2002	2003	2002	2003	2002	2003	2002	2003
1	2	3	4	5	6	7	8	9
I. Deposits	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
a) Up to 1 year	29.4	34.2	50.5	49.4	58.5	53.4	54.5	53.4
b) Over 1 year to 3 years	52.2	44.7	40.5	39.2	37.3	41.9	23.6	42.6
c) Over 3 years to 5 years	9.7	9.4	4.0	5.3	2.2	1.9	10.8	3.9
d) Over 5 years	8.7	11.7	5.0	6.1	2.0	2.8	11.1	0.1
II. Borrowings	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
a) Up to 1 year	60.9	74.9	92.1	82.9	52.9	45.7	77.4	87.4
b) Over 1 year to 3 years	15.9	14.9	4.1	13.2	31.3	39.2	4.7	12.4
c) Over 3 years to 5 years	11.9	5.5	2.4	2.1	9.5	6.6	16.2	0.0
d) Over 5 years	11.3	4.7	1.4	1.8	6.3	8.5	1.7	0.2
III. Loans and Advances	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
a) Up to 1 year	41.6	39.3	41.3	43.5	35.8	36.1	65.6	64.7
b) Over 1 year to 3 years	33.2	35.2	37.5	36.1	28.5	29.6	20.3	22.1
c) Over 3 years to 5 years	11.4	11.7	10.4	8.8	13.9	12.9	6.2	5.9
d) Over 5 years	13.8	13.8	10.8	11.6	21.8	21.4	7.8	7.3
IV. Investments (at book value)	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
a) Up to 1 year	11.6	12.3	14.2	18.9	40.0	44.9	45.7	46.6
b) Over 1 year to 3 years	15.9	13.7	16.5	14.6	22.0	29.0	23.2	24.8
c) Over 3 years to 5 years	15.6	15.8	9.4	9.6	12.6	6.3	16.2	12.4
d) Over 5 years	56.9	58.2	59.9	56.9	25.4	19.8	14.9	16.2

Source: Balance sheets of respective banks.

Bank Stock Prices

3.43 Bank scrips, as indicated by both the recently introduced BANKEX at the BSE as well as the S&P CNX Bank Index at the NSE recorded impressive gains throughout 2002-03, notwithstanding sluggish conditions in the capital markets (Chart III.6). The market preference for bank scrips was also reflected in a sharp increase in the trading volumes of bank scrips, especially PSB scrips (Table III.15). In the capital market segment of the NSE, of the 16 listed PSBs, 9 yielded a positive daily mean return and of the 19 private banks, 14 yielded positive daily mean returns (Table III.16). While market expectations of take-overs and mergers in case of certain private sector banks and disinvestments in case of PSBs added to the sharp increase in bank stock prices, it primarily reflected the positive impact of the following two factors:

Chart III.6: Movements in Indices Bank Stocks

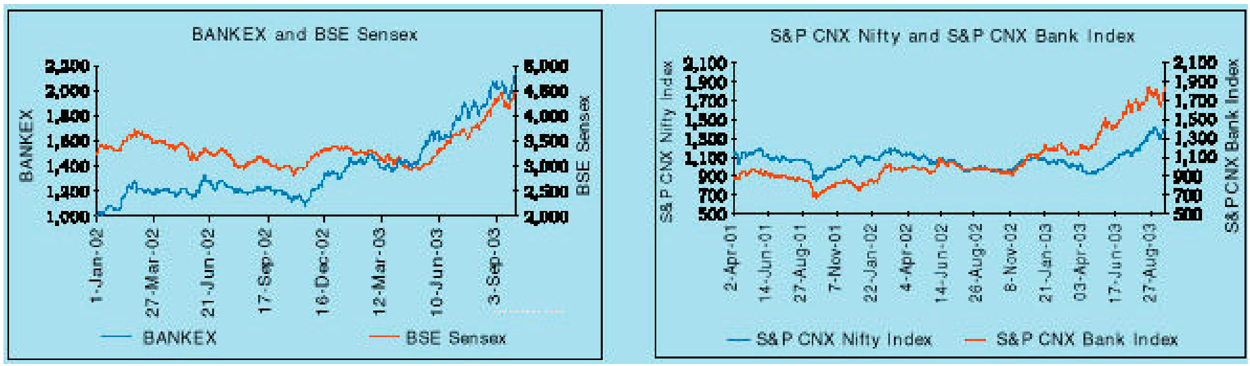


Table III.15: Turnover Details of Bank Shares at The NSE

Category	2001-02		2002-03	
	Value (Rs.lakh)	Per cent to total Turnover	Value (Rs.lakh)	Per cent to total turnover
1	2	3	4	5
Public Sector Banks	4,33,567	0.8	16, 40,648	2.7
Private Banks	2,19,800	0.4	4,26,216	0.7
Total	6,53,367	1.2	20,66,864	3.3
Total Turnover	**5,13,16,740**		**6,17,98,860**	

- An increase in bank profitability, especially as a result of trading profits in a regime of southward-bound interest rates, which seemed to have enhanced the sensitivity of bank stock prices to monetary policy measures during the year, such as reductions in policy rates.

- Progress of banking sector reforms, including the relaxation of foreign direct investment (FDI) norms for private sector banks.

3.44 The major gainers, in terms of average daily prices, included the Bank of Baroda, Indian Overseas Bank, Vijaya Bank, Dena Bank and the Oriental Bank of Commerce (Table III.16). The most active scrips, in terms of average daily turnover, worked out to be the State Bank of India, Syndicate Bank, ICICI Bank, Bank of Baroda and Bank of India.

Table III.16: Share Prices of Banks at the NSE

Name of the Bank	Average Daily Closing Price (Rs.)	
	2001-02	2002-03
1	2	3
Public Sector Banks		
Allahabad Bank	—	13.5 *
Andhra Bank	8.5	17.0
Bank of Baroda	45.9	59.3
Bank of India	16.2	31.2
Canara Bank	—	61.5 +
Corporation Bank	130.4	120.9
Dena Bank	6.9	10.8
Indian Overseas Bank	8.1	12.9
Oriental Bank of Commerce	35.6	46.7
Punjab National Bank	—	56.1 @
Syndicate Bank	9.4	14.6

Union Bank of India	—	20.0 #
Vijaya Bank	7.5	12.4
State Bank of India	208.0	250.7
State Bank of Bikaner and Jaipur	286.2 **	—
State Bank of Travancore	263.1 **	—
Private Sector Banks		
Bank of Rajasthan Ltd.	10.5	15.3
City Union Bank Ltd.	21.3	30.9
Federal Bank Ltd.	50.2	87.1
Jammu and Kashmir Bank Ltd.	48.8	95.2
Karnataka Bank Ltd.	33.8	61.2
Karur Vysya Bank Ltd.	127.8	194.7
Laxmi Vilas Bank Ltd.	45.9	65.9
Nedungadi Bank Ltd.	41.5	34.9 ++
South Indian Bank Ltd.	29.1	36.5
United Western Bank	22.8	22.8
Vysya Bank Ltd.	132.6	258.3
Bank of Punjab Ltd.	12.9	13.9
Centurion Bank Ltd.	9.3	8.7
Global Trust Bank Ltd.	22.4	18.9
HDFC Bank Ltd.	227.0	217.6
ICICI Bank Ltd.	117.0	137.4
IDBI Bank Ltd.	19.5	18.9
IndusInd Bank Ltd.	12.5	15.9
UTI Bank Ltd.	30.3	38.9

* From November 29, 2002;
+ From December 23, 2002;
** Up to December 27, 2001;
++ Up to September 30, 2002;
@ From April 26, 2002;
# From September 24, 2002.
Note : Averages are calculated using daily closing prices.
Source: National Stock Exchange.

3. Financial Performance of Scheduled Commercial Banks

3.45 During 2002-03, there was a significant increase in the profitability of the scheduled commercial banking system. The rise in profits was primarily driven by two factors. First, there was a significant rise in trading incomes consequent upon the easy liquidity conditions prevailing in the market which boosted 'other income' of the banking sector. Secondly, as a result of the reduction in deposit rates, the interest expended in general, and, the interest outgo on deposits, in particular, was largely contained (Table III.17).

Table III.17: Important Financial Indicators of Scheduled Commercial Banks

(Amount in Rs. crore)

Year	2000-01		2001-02		2002-03	
	Amount	Per cent to Total Assets	Amount	Per cent to Total Assets	Amount	Per cent to Total Assets
1	2	3	4	5	6	7
1. Income (a+b)	1,32,076	10.2	1,51,032	9.8	1,72,374	10.1
a) Interest Income	1,15,091	8.9	1,26,958	8.3	1,40,718	8.3
b) Other Income	16,985	1.3	24,074	1.6	31,656*	1.9

2.	Expenditure (a+b+c)	1,25,672	9.7	1,39,456	9.1	1,55,297	9.1
	a) Interest Expended	78,141	6.0	87,516	5.7	93,607	5.5
	b) Operating Expenses	34,178	2.6	33,679	2.2	38,085	2.2
	of which:						
	Wage bill	23,218	1.8	21,785	1.4	23,613	1.4
	c) Provisions and Contingencies	13,353	1.0	18,261	1.2	23,605	1.4
3.	Operating Profit	19,757	1.5	29,837	1.9	40,682	2.4
4.	Net Profit	6,403	0.5	11,576	0.8	17,077	1.0
5.	Spread (1a-2a)	36,950	2.9	39,441	2.6	47,111	2.8

Note: The number of scheduled commercial banks in 2000-01, 2001-02 and 2002-03 were 100, 97 and 93 respectively.

* Includes profit on shares of ICICI Bank Ltd. Held by erstwhile ICICI Ltd.

Income

3.46 The total income of SCBs increased by 14.1 per cent in 2002-03, which was higher than the average growth rate of 12.1 per cent recorded over the period 1997-2002. Among bank groups, the increase in income was the highest for the new private bank group. Total income, in fact, declined for foreign banks due largely to a rationalisation in the number of foreign banks operating in India. The high growth in income in the new private bank category meant that the ratio of income to total assets of SCBs increased from 9.8 per cent in 2001-02 to 10.2 per cent in 2002-03. However, except for new private banks, all other bank groups registered declines in this ratio (Appendix Table III.11). The bottomline of certain PSBs also improved owing to the fact that the Reserve Bank allowed banks to recognise income on accrual basis in respect of some categories of projects under implementation which had a time overrun [Appendix Table III.12(A) to (G)].

Interest Income

3.47 Interest income comprises the major income of most bank groups. For PSBs, for instance, interest income typically comprises over 80 per cent of their total income. The two major sources of interest income are income on advances and income on investments. On account of high-interest loans contracted in the past, income on advances still comprised a major portion of interest income, accounting for around 46 per cent of interest income of PSBs in 2002-03, as compared with 50 per cent in 1997-98. Besides, there also was the impact of the larger credit off-take during the year. The other major income component for banks is income on investments. The fall in the share of interest income has been compensated, to a large extent, by the rise in income on investments. The share of this income for PSBs, which was 43 per cent in 1997-98 jumped to 47 per cent in 2002-03. Typically, the ratio of interest income to total assets of SCBs has hovered around 8.3 per cent during the last five years.

3.48 The composition of commercial bank assets has been changing in recent years in response to the prevalence of easy liquidity conditions, driven by strong capital flows on the supply side and weak credit off-take on the demand side as well as the tightening of prudential norms. As a result, the rate of accretion to investments was higher than that of earning advances (*i.e.*, advances, net of NPAs) during 1997 to 2003. The composition of income has also been changing in response to the changes in asset patterns and the underlying macroeconomic conditions. The share of interest on advances in total income has been declining, reflecting both the slower expansion of credit as well as the softening of interest rates. The share of interest income from investments in total income, on the other hand, increased because of the larger pool of investments, partly offset by the decline in yields.

Other Income

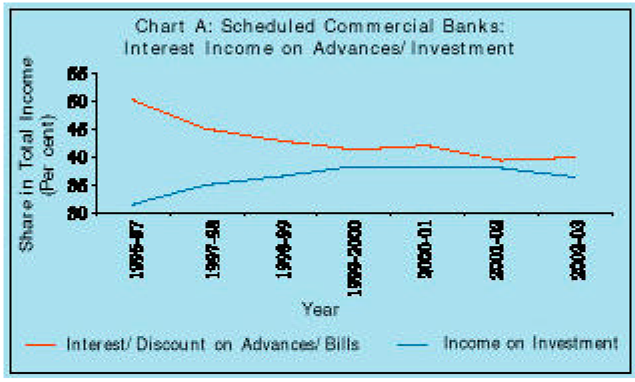
3.49 The other major component of income is income generated from fee-based activities such as those from commission and brokerage, profit on sale of land, building as well as net income arising out of exchange transactions. Of these, commission, exchange and brokerage typically comprise the major part of other incomes. Recent years have, however, witnessed significant gains to banks, primarily PSBs and to a lesser extent, private banks, owing to their sharp rise in trading incomes. The deepening of Government securities markets coupled with the sustained decline in yields resulted in a sharp increase in profits from sale of investments. The issue has, therefore, arisen as to whether the treasury is the major source of bank income (Box III.3). In fact, in 2002-03, trading incomes of PSBs increased by nearly 65 per cent over the previous year, reflecting the gains made on this account by almost all banks, with a virtual quadrupling of trading income in case of certain banks. Forex income, on the other hand, has traditionally been high in case of the foreign bank group, reflecting their high off-balance sheet activities, primarily forward exchange contracts. Public sector banks have also recorded substantial forex income over the last two years.

Box III.3: Is Treasury Income a Major Source of Bank Income?

An analysis of the sources of income of the commercial banks indicates a change in the pattern of their income in the recent years. Interest/discount earned on advances/bills, which is the core income of banks, has fallen below 40 per cent of their total income. Interest income on investments accounted for 36 per cent of the total income in 2002-03.

The above change in the pattern of income is in tandem with the changing pattern of assets in banks' balance sheet. While investments recorded a compounded annual growth rate of 20.7 per cent during 1997 to 2003, earning advances (*i.e.*, advances netted for non-performing assets) increased at a lower rate of 18.6 per cent during the same period.

Due to the change in the asset pattern, income from investments registered a higher compound annual growth rate of 17.4 per cent during the period 1996-97 to 2002-03 as compared with the interest on advances at 10.2 per cent, narrowing down the gap between their shares in total income. The steep decline in lending rates also contributed to the changing pattern of income (Chart A).



Profits from the sale of investments (securities trading) for SCBs went up by 39 per cent to Rs.13,245 crore from Rs.9,541 crore in the previous year. Fifty-one banks recorded increase in trading profits during 2002-03. On the other hand, nine banks reported net loss on sale of investments. Trading profits accounted for about 7.7 per cent of the total income of banks and about 33 per cent of their operating profits during 2002-03.

During 1996-97 to 2000-01, the ratio of trading profits in operating profits was much lower varying between 3.5 and 16.1 per cent, it went up sharply thereafter to 32 per cent in 2001-02 and increased further to 32.6 per cent in 2002-03 (Chart B).

The share of profits from securities trading varied across bank groups. Old private sector banks depended heavily on securities trading which contributed over 50 per cent of their operating profits both in 2001-02 and 2002-03. Foreign banks, which booked profits over Rs.1,000 crore from securities trading in 2001-02, registered a decline in trading profits to Rs.504 crore, which contributed only 13.5 per cent of their operating profits. The SBI group booked higher profits of Rs.2,675 crore from securities trading during the year as compared with Rs.1,034 crore in 2001-02. However, its share in operating profits was below 25 per cent, lower than the system average of 32.6 per cent.

At the bank level, while 27 banks (accounting for about 14 per cent of total assets of the banking system) earned more than 50 per cent of their profits from securities trading, 16 banks (mostly small foreign banks whose combined share in total assets is less than 0.5 per cent) had not made any profits from securities trading. For another 10 banks, trading profits were below 15 per cent of their operating profits. Thirty-eight banks earned more than Rs.100 crore each from securities trading in 2002-03.

Trading profits thus, at the system level, appeared to have a significant share in the profitability of banks during 2002-03. At bank level, while it was the major source of profits for some banks, some other banks did not earn any profits from securities trading.

Expenditure

3.50 The expenditure of SCBs clocked a growth of 11.4 per cent in 2002-03, lower than the average annual growth of 11.7 per cent witnessed over the period 1997-2002. Among bank groups, foreign banks witnessed a sharp containment in their expenses arising from the three factors: (a) significant reduction in their interest expenses,

(b) containment of their wage costs, and (c) lowering of provisions and contingencies; all these led to a lowering of the overall expenditure to asset ratio to 8.8 per cent from 10.1 per cent a year earlier. Other bank groups also experienced a significant reduction in overall expenses arising from the containment of interest expenses and operating expenses. An exception was, however, the new private banks whose expenses increased markedly, reflecting partly the rise in interest expenses (interest on notes and bonds issued, effected in the earlier year) and partly on account of a rise in operating expenses.

Interest Expenditure

3.51 Interest on deposits comprises the major component of interest expense. For PSBs, this accounted for around 65 per cent of total expenditure and over 90 per cent of interest expense over the last five years. For foreign banks, interest on deposits, both as percentage of total expenses, as well as interest expenses, is much lower than their counterparts in the public and private sectors. Over the last few years, in tandem with the fall in interest rates across the board and the introduction of floating rate deposits by the Reserve Bank, there have been significant declines in interest expenses across all categories of banks. This is reflected in the fact that the share of interest expense has witnessed a noticeable decline for most bank groups. Illustratively, for PSBs, the share of interest expenses in total expenses, which was over 65 per cent in 1997-98 has come down to about 60 per cent in 2002-03. Similar declines were evidenced for most other bank groups as well.

Operating Expenses

3.52 Operating expenses comprise, among others, wage expenses and non-wage expenses such as rent, taxes and lighting, advertisement, directors' fees and allowance and legal charges. For most bank groups, operating expenses registered marginal increases, especially in case of PSBs on account of higher depreciation, audit fees and expenses on account of repairs and maintenance. Additionally, the charging of retirement benefit relating to leave encashment led to a rise in wage expenses in several PSBs. Foreign banks, on the other hand, witnessed a reduction in operating expenses indicating a containment in their wage bill, which is generally low among bank groups. Given the gradual lowering of operating expenses across bank groups, for SCBs as a whole, operating expenses to total assets witnessed a declining trend over the last few years.

Wage Bill

3.53 Payments to and provision for employees is a major item of operating expenses, especially for PSBs and comprised around 20 per cent of their total expenses over the last few years. The share of the wage bill increased in 2000-01, wherein the voluntary retirement scheme (VRS) introduced in PSBs sharply increased their wage bill and consequently, their operating expenses as well. The enlargement in the wage bill over the period 1997-2001 for PSBs was 12.5 per cent, and inclusive of 2001-02, was 8.6 per cent. The rationalisation of manpower following the VRS has sharply curtailed the wage bill of PSBs and brought down its share in total expenses to around 17 per cent. The share, however, continues to remain high on account of higher contributions to provident funds, gratuity fund and provision for leave encashment facility. The share of the wage bill in total expenses for most other bank groups is markedly lower, ranging from around 13 per cent in old private banks to less than 5 per cent in new private banks in 2002-03. In fact, the more technology-intensive new private and foreign banks tend to have a much lower proportion of the wage bill in total expenses as compared with their old private and public sector counterparts.

Provisions and Contingencies

3.54 The major items on provisions and contingencies consist of provisions for loan losses, provisions for depreciation in value of investments and provisions for taxes. Provisions typically constitute around 10-12 per cent of total expenses of SCBs, but there is a marked variation across bank groups. Owing to their higher non-performing assets reflecting the past legacy, PSBs generally have higher loan loss provisions in absolute terms than foreign banks, for whom it is generally on the lower side, due to the their better overall asset quality. All bank groups and PSBs, in particular, witnessed sharp increases in provisions, and especially in loan loss provisions, both in percentage terms and also as ratio to total expenses. Apart from the *ad hoc* general provisions made for the impending 90-day delinquency norms, the provision on standard assets on global portfolio basis, introduced effective end-March 2000, has raised overall provisioning levels. The international experience with regard to provisioning is generally supportive of the fact that loan loss provisions tend to be counter-cyclical (Box III.4).

Box III.4: Cyclicality of Loan Loss Provisions

It is widely perceived that risk-based minimum capital requirements tend to have a counter-cyclical effect on the economy. After all, during an economic downturn, the quality of the bank loan portfolio deteriorates, which leads to an increase in capital requirements for provisioning of such loans.

Empirical tests of the hypothesis of income smoothing for loan-loss provisioning have arrived at different results. Based on data on individual US banks, a positive relation between loan loss provisions and bank earnings was observed (Greenwalt and Sinkey, 1988). More recently, for Spanish banks, a fairly robust and significant relationship between loan loss provisions and the business cycle was evidenced for the period 1986-2000 (Fernandez *et al.*, 2002).

Recent internal empirical research looked into trends in loan loss provisioning by Indian banks (Charts A and B). Annual loan-loss provisioning for 75 Indian banks (27 PSBs, 8 new private, 20 old private and 20 foreign banks) for the period 1997-2003[5], indicated that loan loss provisions tend to display a downward movement during the period when GDP growth is high. Probing the question further, it is hypothesised that banks tend to show imprudent loan loss behaviour and are susceptible to have pro-cyclical effect on their capital, if one of the following three conditions are met:

1. Loan loss provisions are negatively associated with banks' earnings (*i.e.*, if a bank is prudent in smoothing income, it should keep aside higher provisions during periods of better earnings).

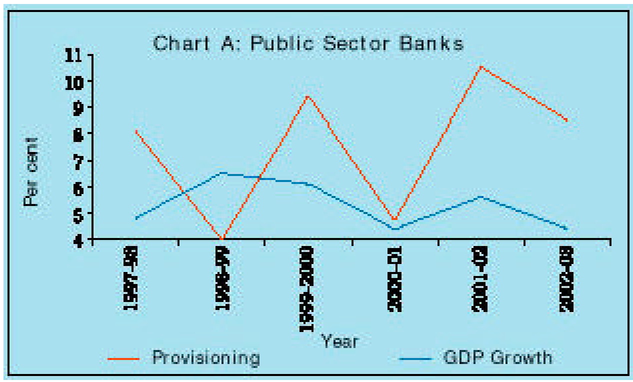
2. Loan loss provisions are negatively related to real loan growth (*i.e.*, rapid growth of bank lending is associated with a deterioration in the quality of the loan portfolio).

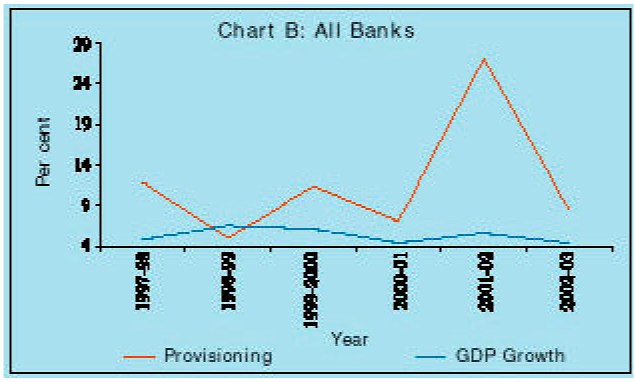
3. Loan loss provisions are negatively related to real GDP growth, to address its relationship with the economic cycle.

Accordingly, the behaviour of loan loss provisions (as percentage of bank assets) was sought to be explained in terms of the following factors, *viz.*, operating profits (normalised by total assets), loan growth and GDP growth. In addition, year control dummies were introduced to catch time-specific effects, such as trends in the regulatory stance. The results suggest that there is a negative and significant relationship between the ratio of loan loss provisions and bank earnings signifying the fact that on an average, banks have not followed an income-smoothing pattern. The real loan growth rate, on the contrary, has a positive coefficient. This indicates that banks have been prudent during periods of rapid credit growth. The observed negative relationship between GDP growth and loan loss provisions suggests that banks in India do not make sufficient provisions before economic recessions.

Furthermore, an attempt was made to ascertain the diversity of behaviour of loan-loss provisioning across banks (through inclusion of bank-group wise dummy variable). It was found that loan loss provisions are lower for new and old private banks *vis-à-vis* the foreign bank category.

There are several policy implications for such observed behaviour of Indian banks. First, there is a policy incentive to encourage banks to make sufficient provisioning to take care of exigencies. Keeping this in mind, the Union Budget 2002-03 raised the allowance for deduction by banks against provisions made for bad and doubtful debts from 5 per cent of their total income to 7.5 per cent. Second, though a minimum requirement for standard loans (which amounts to a *de facto* general provision) can be considered a minimum requirement of a forward-looking system, *ceteris paribus*, it might be desirable to set aside more resources during periods of economic growth than during downturns. This pattern of general provisions is labelled 'dynamic provisioning'. The fundamental principle underpinning such provisioning is that provisions are set against loans outstanding in each accounting time period in line with an estimate of expected long-run loss.





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Operating Profits

3.55 As on March 31, 2003, the operating profits of SCBs exhibited a growth of 36 per cent over the previous year, far higher than the annual average growth rate of 16 per cent recorded over the last six years. In fact, the operating profits of SCBs witnessed their highest growth in 2002-03, leaving aside the new private banks, for whom the growth was the highest owing to the inclusion of a new private bank and the lead effect of a merger in the earlier year. As a result, the operating profit to total assets of PSBs, which generally has been in the range of 1.4-1.8 per cent, jumped to 2.3 per cent in 2002-03. The ratio also witnessed a sharp rise in the case of new private banks and a marginal rise in case of foreign banks. For old private banks, the ratio has stayed roughly at the same level as in the earlier year, although it is much higher than those in the preceding three years.

Net Profit

3.56 Net profits of SCBs increased by nearly 50 per cent in 2002-03, on top of a rise of 81 per cent in the previous year. Among bank groups, the increase in net profit was the highest for new private banks, although most other bank groups also registered substantial increases (Chart III.7). Within the PSB group, the increase was much higher in case of nationalised banks as compared with the State Bank group. This was due largely to the large non-interest incomes generated from treasury operations. In recent times, treasury operations have emerged as a major profit centre for Indian banks, with a significant increase in 2002-03 as compared with 2001-02. Forex incomes, although not as large as treasury income, have also been contributing significantly to bank's operating profits in recent years, despite the pressure on margins and the thinning of inter-bank spreads (Table III.18 and Appendix Table III.13).

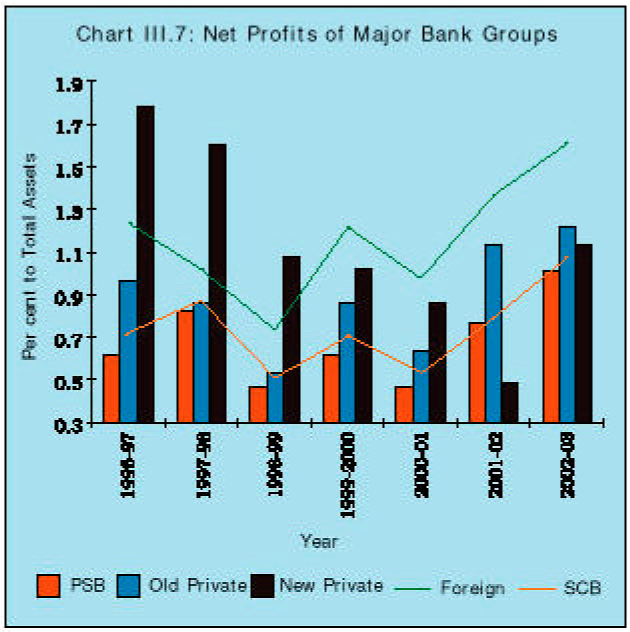

Chart III.7: Net Profits of Major Bank Groups

Table III.18: Bank Group-Wise Break-Up of Major Income

(Rs. crore)

Bank Group	Trading Income		Forex Income		Operating Profit	
	2001-02	2002-03	2001-02	2002-03	2001-02	2002-03
1	2	3	4	5	6	7
Scheduled Commercial Banks	**9,541**	**13,245**	**2,464**	**2,813**	**29,837**	**40,682**
Public Sector Banks	5,999	9,924	1,547	1,672	21,677	29,715
Nationalised Banks	4,965	7,249	998	1,035	12,957	18,486
State Bank Group	1,034	2,675	549	638	8,720	11,229
Old Private Sector Banks	1,408	1,466	113	123	2,516	2,804
New Private Sector Banks	1,109	1,351	135	129	2,131	4,434
Foreign Banks	1,024	504	668	888	3,514	3,728

Notes : 1. Trading Income - Net Profit on Sale of Investment.
2. Forex Income - Net Profit on Exchange Transaction.

Trends during the First Quarter of 2003-04

3.57 The performance of the commercial banking system during the quarter ended June 2003 has been analysed based on off-site returns of domestic transactions of SCBs. The data reveals a significant improvement in performance of SCBs over the corresponding period of June 2002.

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 for the quarter ended June 2002. The improvement in net profits was driven by a containment in expenses in general, and interest expended, in particular, despite a sharp rise in provisions and contingencies across bank groups. Operating expenditures, by and large, remained at the same level for the quarter ended June 2002; an exception being the new private banks for whom these expenses increased owing to a rise in the wage bill.

3.58 The international experience suggests that bank profitability was low in 2002, but generally remained adequate given the poor economic backdrop. There are, however, diverse developments across countries (Table III.19).

Table III.19: Profitability of Major Banks

(As per cent of total assets)

Country	Pre-tax profits		Provisioning expenses		Net interest Margin		Operating costs	
	2001	2002	2001	2002	2001	2002	2001	2002
1	2	3	4	5	6	7	8	9
United States (10)	1.49	1.66	0.71	0.72	3.10	3.11	4.06	3.46
Japan (12)	-0.93	0.04	1.36	0.28	1.14	0.81	1.20	0.82
Germany (4)	0.14	0.05	0.24	0.39	0.90	0.80	1.62	1.50
United Kingdom (4)	1.27	1.11	0.31	0.36	2.07	2.02	2.48	2.40
France (4)	0.74	0.58	0.22	0.20	0.94	1.03	1.87	1.81
Italy (6)	0.81	0.48	0.55	0.67	2.04	2.16	2.39	2.61
Spain (4)	1.20	0.93	0.44	0.49	2.86	2.66	2.60	2.37
Canada (6)	0.92	0.51	0.41	0.59	1.95	2.06	2.84	2.76
Sweden (4)	0.82	0.70	0.10	0.09	1.49	1.48	1.51	1.44
Memo:								
India*	0.49	0.75	1.03	1.19	2.85	2.57	2.64	2.19

* Pertain to 100 scheduled commercial banks in 2001 and 97 for 2002. Financial year is April-March. The profit figure refers to net profits.

Note: 1. Figures are a percentage to total assets.
2. Figures in brackets indicate number of major banks included.

Source: BIS Annual Report (2003).

3.59 The focus of the reform process in India has been on improving the productivity, efficiency and profitability of the banking system. In fact, raising the efficiency levels through greater manpower productivity and increased deployment of technology in order to reduce transactions cost has been at the core of the banking sector reform process. Attempts have, therefore, been underway to consolidate the gains of earlier reform measures. In this context, the issue has arisen whether there have been the efficiency gains consequent upon the reform measures in the financial sector (Box III.5).

Box III.5: Efficiency in Indian Banking

Banking sector reforms in India were introduced in order to improve efficiency in the process of financial intermediation. It was expected that banks would take advantage of the changing operational environment and improve their performance. Towards this end, the Reserve Bank initiated a host of measures for the creation of a competitive environment. Deregulation of interest rates on both the deposit and lending sides imparted freedom to banks to appropriately price their products and services. To compete effectively with non-banking entities, banks were permitted to undertake newer activities like investment banking, securities trading and insurance business. This was facilitated through amendments in the relevant Acts which permitted PSBs to raise equity from the market up to a threshold limit (49 per cent) and also by enabling the entry of new private and foreign banks. This changing face of banking led to an erosion of margins on traditional banking business, promoting banks to search for newer activities to augment their fee incomes. At the same time, banks also needed to devote focused attention to operational efficiency in order to contain their transactions costs. Simultaneously with the deregulation measures, prudential norms were instituted to strengthen the safety and soundness of the banking system.

In the international context, it has been found that, overall, depository financial institutions/banks experience annual average efficiency of around 77 per cent, keeping enough room of augmenting outputs from the same level of inputs. Inefficiencies emanate from either of the two components, *viz.*, technical and allocative. Due to the former, there is likely to be sizeable under-utilisation or wastage of resources. On the other hand, due to higher allocative inefficiency banks might not be able chose correct input combinations in terms of their price. Inefficiency at financial institutions has generally been found to consume a considerable portion of costs and that it is a much greater source of performance problems than either scale or product mix inefficiencies, and has a strong empirical association with higher probabilities of failure.

Recent internal empirical research found that over the period 1992-2003, there has been a discernible improvement in the efficiency of Indian banks. The increasing trend in efficiency has been fairly uniform, irrespective of the ownership pattern. The rate of such improvement has, however, not been sufficiently high. The analysis also reveals that PSBs and private sector banks in India did not differ significantly in terms of their efficiency measures. Foreign banks, on the other hand, recorded higher efficiency as compared with their Indian counterparts.

The pattern of efficiency improvement is broadly in consonance with what is expected from an industry undergoing deregulation and transformation. Clearly, all the bank groups registered efficiency gains, even in the face of increasing competition in the financial marketplace. However, while sustaining the current trends in efficiency, there remains scope for banks to expand their asset base relative to their input usage by adapting innovations in production technology.

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Off-Balance Sheet Activities

3.60 Off-balance sheet activities of SCBs, comprising forward exchange contracts, guarantees, acceptances and endorsements, rose sharply in 2002-03 (Appendix Table III.14). Accordingly, the share of off-balance sheet operations in terms of total liabilities increased to nearly 69 per cent in 2002-03. Out of this, nearly three-fourths were forward exchange contracts, mostly related to exports and imports.

3.61 Foreign banks were particularly active in off-balance sheet activities with the result that the ratio of their off-balance sheet activity to total liabilities rose from 394 per cent in 2001-02 to 483 per cent in 2002-03.

Cost of Funds

3.62 Prudent resource management within a sound asset-liability management framework has lowered the cost of funds across bank groups (Table III.20). Falling interest rates have meant that both the return on advances and investments have come down across bank groups. For new private sector banks, the interest paid on both deposits and borrowings have been higher reflecting, *inter alia*, the lagged effect of the inclusion of a new private bank with high borrowings, as also the inclusion of a new scheduled bank operational since March 2003. These factors, consequently, led to a rise in the cost of funds for this bank group.

Table III.20: Bank Group-Wise Cost of Funds and Returns

(per cent)

Variable/ Bank Group	Public Sector Banks		Old Private Sector Banks		New Private Sector Banks		Foreign Banks	
	2001-02	2002-03	2001-02	2002-03	2001-02	2002-03	2001-02	2002-03
1	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**
Cost of Funds	6.8	6.1	7.6	6.6	3.8	4.4	6.2	5.3
Return on Advances	9.6	9.0	10.9	9.7	4.7	10.3	11.0	10.3
Return on Investments	10.2	9.2	10.5	9.2	5.8	8.2	10.5	7.7

Notes : 1. Cost of funds = (Interest Paid on Deposits+Interest Paid on Borrowings)/(Deposits+Borrowings).
2. Return on Advances = Interest Earned on Advances / Advances.
3. Return on Investments = Income on Investment / Investment.

Spread

3.63 The spread of SCBs increased by 19.5 per cent in 2002-03. Most bank groups, recorded a double-digit increase in spread arising largely from the containment in interest expenditure in a softer interest regime. Spreads of foreign banks are typically higher than their public sector and private counterparts, owing to their lower interest costs on deposits. The substantial increase in spreads meant that the spread to total assets ratio increased significantly for most bank groups. However, the ratio of spread to total assets has continually been shrinking for most bank groups as yields on assets have declined more than proportionately *vis-à-vis* the cost of liabilities[6].

Investment Fluctuation Reserve

3.64 Banks were advised to build up the Investment Fluctuation Reserve (IFR) of a minimum of five per cent of the investment held in the 'Available for Sale' (AFS) and 'Held for Trading' (HFT) categories of the investment portfolio within a period of five years commencing from the year ended March 31, 2002. The bank group-wise position reveals that, as at end-March 2003, while SCBs had built up an IFR ratio (defined as IFR as percent of investments under AFS and HFT categories, taken together) of 1.8 per cent, the IFR ratios of certain bank groups have been higher than this figure (Table III.21 and Appendix Table III.18). New private sector banks were observed to be lagging behind in respect of their IFR position. The bank-wise position in respect of PSBs reveals that several of them have made substantial progress and built up a comfortable IFR ratio since the Reserve Bank advised banks on this issue in January 2002. While banks are required to build up an IFR portfolio of a minimum of five per cent of their investments within a period of five years, it is observed that 17 PSBs had already built up IFR ratio of 2.0 per cent or more.

Table III.21: Bank Group-Wise Investment Fluctuation Reserves (IFR)

(As at end-March 2003)

(Amount in Rs. crore)

Bank Group	**Available for Sale (AFS)**	**Held for Trading (HFT)**	**IFR**	**IFR/ (AFS+HFT) (per cent)**
1	**2**	**3**	**4**	**5=4/(3+2)**
Scheduled Commercial Banks	**5,13,190**	**28,637**	**9,635**	**1.8**
Public Sector Banks	4,09,268	13,782	7,697	1.8
Nationalised Banks	2,35,003	3,210	4,334	1.8
State Bank Group	1,74,265	10,572	3,363	1.8
Old Private Sector Banks	31,078	1,964	694	2.1
New Private Sector Banks	45,702	4,161	559	1.1
Foreign Banks	27,142	8,730	685	1.9

3.65 The large policy-induced changes in the interest rate environment have brought forth the issue of interest rate sensitivity of banks' balance sheet. The impact on the bottomline of banks, under such circumstances, is likely to depend on whether the future interest rate movement is in tandem with the banks' respective interest rate expectations. Building up an adequate cushion, as entailed in the IFR, in a benign interest rate environment, is likely to mitigate the adverse effects of interest rate movement (Box III.6).

Box III.6: Effect of Interest Rate Changes on Banks' Income

The changes in interest rates affect bank earnings through the net interest income and the level of other interest-sensitive income and operating expenses. This impacts the underlying value of the bank's assets, liabilities and off-balance sheet instruments because the present value of future cash flows (and in some cases, the cash flows themselves) change when interest rates change. Interest rate risk arises out of the exposure of a bank to adverse movements in interest rates. While accepting this risk is a normal part of banking and can be an important source of profitability and shareholder value, excessive interest rate risk-taking can pose a significant threat to a bank's earnings and capital base. The primary form of the interest rate risk arises from timing differences in the maturity (for fixed rate) and repricing (for floating rate) of bank assets, liabilities and off-balance-sheet (OBS) positions. Thus, effective risk management to maintain interest rate risk within prudent levels is essential to the safety and soundness of banks.

A number of techniques are available for measuring the interest rate risk exposure of both earnings and economic value. Their complexity ranges from simple calculations to static simulations using current holdings to highly sophisticated dynamic modelling techniques that reflect potential future business and business decisions. The gap method for measuring a bank's interest rate risk exposure generates simple indicators of the interest rate risk sensitivity of both earnings and economic value to changing interest rates. This essentially measures the gap between interest-sensitive assets and liabilities (including OBS positions) in the specific time bands in which these interest sensitive assets and liabilities are located. The gap is positive (negative) when maturing/re-pricing assets are more (less) than the liabilities. After calculating the net gap by adding the gaps within each time band, adjusted for hedging, the impact on earnings is estimated by computing the likely losses or gains in the event of a change in the interest rate, in terms of the net interest income (NII) earned by the banks. The net interest income takes into account both the interest earned as well as interest paid on interest bearing liabilities and risk arising out of interest rate movement would directly affect the NII earned by the banks (BIS, 2003).

A preliminary internal exercise within the Reserve Bank using the gap method to calculate the impact of interest rate changes on banks' net interest income carried out with reference to banks' asset-liability profile as on March 31, 2003 as reported through their offsite statement, suggests the following:

- The banking system as a whole is likely to have a positive impact of 4.9 per cent on net interest income in the event of a rise in interest rates by 200 basis points.

- Among the bank groups, the positive impact of a rise in interest rates by 200 basis points would be largest in case of public sector bank group.

- On the other hand, in the event of a fall in interest rates by 200 basis points, new private banks and old private banks would have positive impact on their net interest income.

- The foreign bank group would have the least impact on net interest income in a rising or falling interest rate regime.

It needs to be recognised that estimates of this nature are essentially indicative. For instance, the study focuses only on interest earnings and is subject to usual limitations associated with the gap method. Furthermore, banks' interest rate risk positions are dynamic in nature. The analysis does not incorporate the appreciation/depreciation of banks' securities portfolio consequent to these interest rate changes. Under current regulations, banks are required to follow a conservative accounting practice in respect of unrealised capital gains on their investment portfolio and therefore have latent reserves to serve as a cushion in the event of an interest rate shock.

Reference:
Bank for International Settlements (2003), Principles for the Management and Supervision of Interest Rate Risk, Basel.

4. Non-performing Assets[7]

3.66 Credit risk is an important factor impinging on financial entities. The solvency crisis of financial systems, such as the American Savings and Loan crisis in the 1980s, the Nordic banking crisis at the beginning of the 1990s and more recently, the banking sector problems in Japan and Turkey have, in large measure, been a consequence of accumulation of problem loans over time. In order to contain the growth in non-performing assets (NPAs), recovery management has become a keyword for the banking industry in recent years. In the Indian context, several initiatives have been taken by the Reserve Bank in conjunction with the Government to contain the NPAs of banks. As a consequence, NPAs of SCBs have witnessed a secular decline since the initiation of income recognition and asset classification (IRAC) norms. It is instructive to turn to the relevant empirical and theoretical literature revealing the factors behind the credit risk (Box III.7).

Box III.7: Determinants of Credit Risk

Credit risk has received extensive theoretical and empirical investigation. However, such research has concentrated mostly on evaluation of *ex-ante* risks of borrowers and/or of individual loan operations, and on studying the response of lenders to such evaluations. Credit spreads, collateral, loan term structures and commitments between borrowers and lenders over time (*i.e.*, relational lending) have been some of the widely investigated topics. Other relevant variables, such as *ex-post* credit losses, have been largely ignored, especially at the microlevel of financial institutions, possibly as a result of lack of reliable data on loan losses.

The majority of the studies pertaining to determinants of credit risk have dealt primarily with the US banking industry and to a lesser extent, the Latin American banking sector. These studies primarily employ macroeconomic variables to explain credit losses. Available research on this score in the Indian context have attempted to examine the regional dimension of the non-performing loan problem and more recently, the issue whether the non-performing loans are explained by poor operating efficiency or otherwise. These studies utilised microeconomic variables to explain impaired loans in Indian banks. However, it is widely believed that problem loans are caused by both macro as well as microeconomic factors.

Recent internal empirical research sought to explain problem loans in terms of GDP growth (macroeconomic) and bank-specific (microeconomic) factors. The evidence suggested that: (a) problem loans are not immediately written down and are, in fact, carried forward for several periods, (b) the GDP growth rate (current and lagged) negatively impacted the problem loan ratio. However, while the contemporary impact was observed to be strongly significant, the lagged impact was not significant at standard levels. Several microeconomic variables, such as, lagged credit growth and operating efficiency were also observed to impact problem loans significantly.

References:

Berger, Allan and Robert de Young (1997), "Problem Loans and Cost Efficiency in Commercial Banks", *Journal of Banking and Finance*, Vol. 21.

Das, Abhiman and Saibal Ghosh (2003), "Determinants of Credit Risk in Indian State-owned Banks: An Empirical Investigation", Paper presented at the Conference on Money, Risk and Investment, Nottingham Trent University, U.K.

Rajaraman, Indira and Garima Vasishtha (2002), "Non-performing Loans of PSU Banks: Some

Panel Results", *Economic and Political Weekly*, Special Issue on Money, Banking and Finance.

3.67 The decline in NPAs has also been evidenced across bank groups, except in 2000-01. In line with this declining trend, NPAs declined sharply in 2002-03, reflecting, *inter alia*, the salutary impact of earlier measures towards NPA reduction and the enactment of the SARFAESI Act ensuring prompter recovery without intervention of court or tribunal (Box III.8). The progress under this Act has been significant, as evidenced by the fact that during 2002-03, reductions outpaced addition, especially for PSBs and reflected in an overall reduction of non-performing loans to 9.4 per cent of gross advances from 14.0 per cent in 1999-2000 (Table III.22 to Table III.25). The bank-wise gross/ net NPAs as percentage to advances/assets are provided in Appendix Tables III.19 (A) to 19(F). Sector-wise NPAs of individual public and private sector banks are presented in Appendix Tables III.20(A) and 20(B).

Box III.8: Progress under the SARFAESI Act

The enactment of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act has provided a significant impetus to banks to ensure sustained recovery. The Act provides, *inter alia*, for enforcement of security interest for realisation of dues without the intervention of courts or tribunals. The Government of India has also notified the Security Interest (Enforcement) Rules, 2002 to enable secured creditors to authorise their officials to enforce the securities and recover the dues from the borrowers. Banks and financial institutions (FIs) have already initiated the process of recovery under the Act. The Government has advised the PSBs and financial institutions to take action under the SARFAESI Act and report the compliance to the Reserve Bank. The Supreme Court has stayed the operation of the Act to a limited extent so that secured assets, can be seized under the Act, but cannot be sold / leased or assigned.

Since the Act provides for sale of financial assets by banks / financial institutions to Securitisation Companies (SC) / Reconstruction Companies (RC) created thereunder, a set of guidelines has been issued to banks and All-India financial institutions so that the process of asset reconstruction proceeds on smooth and sound lines in a uniform manner. These guidelines, *inter alia*, prescribe the financial assets which can be sold to SC / RC by banks / FIs, procedure for such sales (including valuation and pricing aspects), prudential norms for the sale transactions (*viz.*, provisioning / valuation norms, capital adequacy norms and exposure norms) and related disclosures required to be made in the Notes on Accounts to their balance sheets.

Since the commencement / enforcement of the SARFAESI Act till end-June 2003, PSBs have issued 33,736 notices for an outstanding amount of Rs.12,147 crore and have recovered Rs. 499.20 crore from 9,946 cases (Table A).

Table A: Bank-wise Details of Progress under SARFAESI Act

(As at end-June 2003)

(Amount in Rs.crore)

Name of the Bank	Notices issued	Amount Outstanding	Recovered cases	Amount recovered	Per cent of amount recovered to amount outstanding
1	2	3	4	5	6
Allahabad Bank	1,579	514.8	610	21.9	4.2

Andhra Bank	401	73.9	118	9.5	12.8
Bank of Baroda	125	429.5	19	7.8	1.8
Bank of India	1,241	405.8	692	34.3	8.4
Bank of Maharashtra	332	52.7	61	2.6	4.9
Canara Bank	1,011	350.5	393	34.5	9.8
Central Bank of India	2,617	1,204.9	395	39.1	3.3
Corporation Bank	247	155.0	98	18.5	11.9
Dena Bank	348	358.6	147	22.3	6.2
Indian Bank	1,007	425.8	240	19.5	4.6
Indian Overseas Bank	1,879	509.9	747	29.4	5.8
Oriental Bank of Commerce	2,217	427.5	1,184	41.9	9.8
Punjab National Bank	3,015	711.8	1,086	39.3	5.5
Punjab and Sind Bank	1,102	499.0	509	23.0	4.6
Syndicate Bank	1,226	156.9	480	17.2	10.9
Union Bank of India	1,601	757.2	524	22.6	2.9
United Bank of India	148	14.1	54	1.8	13.0
UCO Bank	1,130	88.4	138	4.6	5.2
Vijaya Bank	1,988	239.9	638	26.4	11.0
State Bank of India	7,141	3,974.0	1,037	48.0	1.2
State Bank of Bikaner and Jaipur	606	114.5	217	3.9	3.4
State Bank of Hyderabad	827	282.5	102	9.8	3.5
State Bank of Indore	403	68.6	123	6.6	9.6
State Bank of Mysore	344	102.1	34	4.6	4.5
State Bank of Patiala	807	126.0	210	4.4	3.5
State Bank of Saurashtra	325	70.8	59	3.6	5.1
State Bank of Travancore	69	32.5	31	2.1	6.6
Total	**33,736**	**12,147.2**	**9,946**	**499.2**	**4.1**

References :

Reserve Bank of India (2003), *Annual Report*, 2002-03, Mumbai.
Reserve Bank of India (2002), *Report on Trend and Progress of Banking in India*, 2001-02, Mumbai.

Table III.22: Bank Group-Wise Gross and Net Npas of Scheduled Commercial Banks

(as at end-March)

(Amount in Rs. crore)

Bank Group/Year	Gross Advances	Gross NPAs			Net Advances	Net NPAs		
		Amount	Per cent To Gross Advances	Per cent to total Assets		Amount	Per cent To Net Advances	Per cent to total Assets
1	2	3	4	5	6	7	8	9
Scheduled Commercial Banks								
2000	4,75,113	60,408	12.7	5.5	4,44,292	30,073	6.8	2.7
2001	5,58,766	63,741	11.4	4.9	5,26,328	32,461	6.2	2.5
2002	6,80,958	70,861	10.4	4.6	6,45,859	35,554	5.5	2.3
2003	7,78,043	68,714	8.8	4.0	7,40,473	32,764	4.4	1.9
Public Sector Banks								
2000	3,79,461	53,033	14.0	6.0	3,52,714	26,187	7.4	2.9
2001	4,42,134	54,672	12.4	5.3	4,15,207	27,977	6.7	2.7
2002	5,09,368	56,473	11.1	4.9	4,80,681	27,958	5.8	2.4
2003	5,77,813	54,086	9.4	4.2	5,49,351	24,963	4.5	1.9
Old Private Sector Banks								
2000	35,404	3,815	10.8	5.2	33,879	2,393	7.1	3.3
2001	39,738	4,346	10.9	5.1	37,973	2,771	7.3	3.3
2002	44,057	4,851	11.0	5.2	42,286	3,013	7.1	3.2
2003	51,329	4,568	8.9	4.3	49,436	2,741	5.5	2.6
New Private Sector Banks								

2000	22,816	946	4.1	1.6	22,156	638	2.9	1.1
2001	31,499	1,617	5.1	2.1	30,086	929	3.1	1.2
2002	76,901	6,811	8.9	3.9	74,187	3,663	4.9	2.1
2003	94,718	7,232	7.6	3.8	89,515	4,142	4.6	2.2
Foreign Banks								
2000	37,432	2,614	7.0	3.2	35,543	855	2.4	1.0
2001	45,395	3,106	6.8	3.0	43,063	785	1.8	0.8
2002	50,631	2,726	5.4	2.4	48,705	920	1.9	0.8
2003	54,184	2,829	5.2	2.4	52,171	918	1.8	0.8

Source: 1. Balance sheets of respective banks.
2. Returns submitted by respective banks.

Movements in Provisions for Non-performing Assets

3.68 With effect from the year ended March 2002, banks were directed to submit additional returns as part of Notes on Accounts in their balance sheet relating to (a) movements in provisions for non-performing loans, and (b) movements in provisions for depreciation in investments. A major part of SCBs' total provisions was accounted for by PSBs, which accounted for 47.2 per cent of gross NPAs as at end-March 2003. For the State Bank group, provisions were lower than that in the previous year reflecting an improvement in their asset quality. Foreign banks, inspite of their improved asset quality *vis-à-vis* other banks, typically had higher provisions (Table III.26).

Table III.23: Bank Group-Wise Movements in Non-Performing Assets - 2002-03

(Amount in Rs.crore)

Particular	Scheduled Commercial Banks (93)	Public Sector Banks (27)	Old Private Banks (21)	New Private Banks (9)	Foreign Banks (36)
1	2	3	4	5	6
Gross NPAs					
As at end-March 2002	70,153	56,473	4,389	6,821	2,469
Additions during the year	21,863	16,065	1,625	2,649	1,523
Reductions during the year	23,302	18,452	1,447	2,239	1,164
As at end-March 2003	68,714	54,086	4,568	7,232	2,829
Net NPAs					
As at end-March 2002	35,256	27,958	2,775	3,663	860
As at end-March 2003	32,764	24,963	2,741	4,142	918
Memo:					
Gross Advances	7,78,043	5,77,813	51,329	94,718	54,184
Net Advances	7,40,473	5,49,351	49,436	89,515	52,171
Ratio					
Gross NPA/Gross Advances	8.8	9.4	8.9	7.6	5.2
Net NPA/Net Advances	4.4	4.5	5.5	4.6	1.8

Note : Figures in brackets indicates the number of banks in that category for the year 2002-03.
Source : Balance sheets of respective banks.

Table III.24: Classification of Loan Assets of Scheduled Commercial Banks–Bank Group-Wise

(Amount in Rs.crore)

Bank Group/ Year	Standard Assets		Sub-standard Assets		Doubtful Assets		Loss Assets		Total NPAs		Total Advances
	Amount	Per Cent	Amount	per cent	Amount	Per Cent	Amount	per cent	Amount	per cent	Amount
1	2	3	4	5	6	7	8	9	10	11	12

Scheduled Commercial Banks											
2000	4,14,917	87.2	19,594	4.1	33,688	7.1	7,558	1.6	60,840	12.8	4,75,757
2001	4,94,716	88.6	18,206	3.3	37,756	6.8	8,001	1.4	63,963	11.4	5,58,679
2002	6,09,972	89.6	21,382	3.1	41,201	6.0	8,370	1.2	70,953	10.4	6,80,925
2003	7,09,260	91.2	20,078	2.6	39,731	5.1	8,971	1.2	68,780	8.8	7,78,040
Public Sector Banks											
2000	3,26,783	86.0	16,361	4.3	30,535	8.0	6,398	1.7	53,294	14.0	3,80,077
2001	3,87,360	87.6	14,745	3.3	33,485	7.6	6,544	1.5	54,774	12.4	4,42,134
2002	4,52,862	88.9	15,788	3.1	33,658	6.6	7,061	1.4	56,507	11.1	5,09,369
2003	5,23,724	90.6	14,909	2.6	32,340	5.6	6,840	1.2	54,089	9.4	5,77,813
Old Private Sector Banks											
2000	31,447	88.8	1,577	4.5	2,061	5.8	347	1.0	3,985	11.2	35,432
2001	35,166	88.7	1,622	4.1	2,449	6.2	413	1.0	4,484	11.3	39,650
2002	39,262	89.0	1,834	4.2	2,668	6.1	348	0.8	4,850	11.0	44,112
2003	46,761	91.1	1,474	2.9	2,772	5.4	321	0.6	4,567	8.9	51,328
New Private Sector Banks											
2000	21,870	95.9	560	2.5	294	1.3	92	0.4	946	4.1	22,816
2001	29,905	94.9	963	3.1	620	2.0	11	0.0	1,594	5.1	31,499
2002	70,010	91.2	2,904	3.8	3,871	4.9	41	0.0	6,816	8.8	76,826
2003	87,487	92.4	2,700	2.9	3,675	3.9	856	0.9	7,231	7.6	94,718
Foreign Banks											
2000	34,817	93.0	1,096	2.9	798	2.1	721	1.9	2,615	7.0	37,432
2001	42,285	93.1	876	1.9	1,202	2.6	1,033	2.3	3,111	6.9	45,396
2002	47,838	94.5	856	1.7	1,004	2.0	920	1.8	2,780	5.5	50,618
2003	51,288	94.7	995	1.8	944	1.7	954	1.8	2,893	5.3	54,181

Notes : 1. The figures furnished in this table may not tally with the data in Table III.22 due to different sources of data collection.
2. Figures are provisional.
3. Constituent items may not add up to the totals due to rounding off.

Source : Returns submitted by respective banks.

Table III.25: Distribution of Scheduled Commercial Banks by Ratio of Net Npas to Net Advances

(Number of banks)

Net NPAs/ Net Advances	End-March				
	1999	2000	2001	2002	2003
1	2	3	4	5	6
Public Sector Banks	**27**	**27**	**27**	**27**	**27**
1. Up to 10 per cent	18	22	22	24	25
2. Above 10 and up to 20 per cent	8	5	5	3	2
3. Above 20 per cent	1	—	—	—	—
Old Private Sector Banks	**25**	**24**	**23**	**22**	**21**
1. Up to 10 per cent	17	18	16	17	19
2. Above 10 and upto 20 per cent	5	5	4	3	1
3. Above 20 per cent	3	1	3	2	1
New Private Sector Banks	**9**	**8**	**8**	**8**	**9**
1. Up to 10 per cent	9	8	8	8	8
2. Above 10 and upto 20 per cent	—	—	—	—	1
3. Above 20 per cent	—	—	—	—	—
Foreign Banks	**41**	**42**	**42**	**40**	**36**
1. Up to 10 per cent	27	31	31	26	28
2. Above 10 and upto 20 per cent	11	7	6	5	4
3. Above 20 per cent	3	4	5	9	4

Table III.26: Bank Group-Wise Movements in Provisions for Non-Performing Assets - 2002-03

(Amount in Rs.crore)

Particular	Scheduled Commercial Banks (93)	Public Sector Banks (27)	Old Private Banks (21)	New Private Banks (9)	Foreign Banks (36)
1	2	3	4	5	6

Provisions for NPA					
As at end-March 2002	30,749	24,807	1,432	3,097	1,414
Add : Provision made during the year	13,181	9,861	778	1,731	810
Less : Write-off, write back of excess during the year	12,049	9,131	573	1,786	559
As at end-March 2003	31,881	25,537	1,637	3,042	1,665
Memo:					
Gross NPAs	68,714	54,086	4,568	7,232	2,829
Cumulative provision to Gross NPAs (per cent)	46.4	47.2	35.8	42.1	58.9

Note : Figures in brackets indicates the number of banks in that group for the year 2002-03.
Source: Balance sheets of respective banks.

Movements in Provisions for Depreciation in Investment

3.69 PSBs increased their provisions for depreciation in investments during the year by an amount exceeding the write-back. New private banks, on the other hand, unwound their provisions reflecting possibly the greater proportion of investments in the AFS and HFT categories (Table III.27).

Incremental Non-performing Assets

3.70 The recoveries of NPAs in 2002-03 have exceeded additions implying that, incremental NPAs, both in gross and net terms, have turned negative. In absolute terms, for SCBs as a whole, gross NPAs declined by Rs.2,147 crore. There was a marginal increase in the incremental gross NPAs of nationalised banks with additions outpacing recoveries. Net NPAs, on the other hand, declined by over Rs.1,800 crore, reflecting the increased provision made by them during the year. The largest decline was effected by the State Bank group. This, in effect, served to make the incremental ratio of gross NPAs to gross advances negative for most bank groups in 2002-03. Incremental net NPAs also mirrored a similar trend (Table III.28 and Table III.29).

5. Capital Adequacy

3.71 As at end-March 2003, all the 27 PSBs had capital to risk-weighted assets ratio (CRAR) above the stipulated minimum levels of 9 per cent. Of these, 26 banks had CRAR levels in excess of 10 per cent. For PSBs as a whole, the CRAR as at end-March 2003 stood distinctly higher at 12.64 per cent than that of 11.76 per cent as at end-March 2002. Capital adequacy for top five banks (in terms of total assets) was more or less around the overall CRAR for the PSBs (Chart III.8). Perhaps, in view of the impending operationalisation of the new Capital Accord, banks, especially those with international presence, have been holding capital well above the stipulated levels.

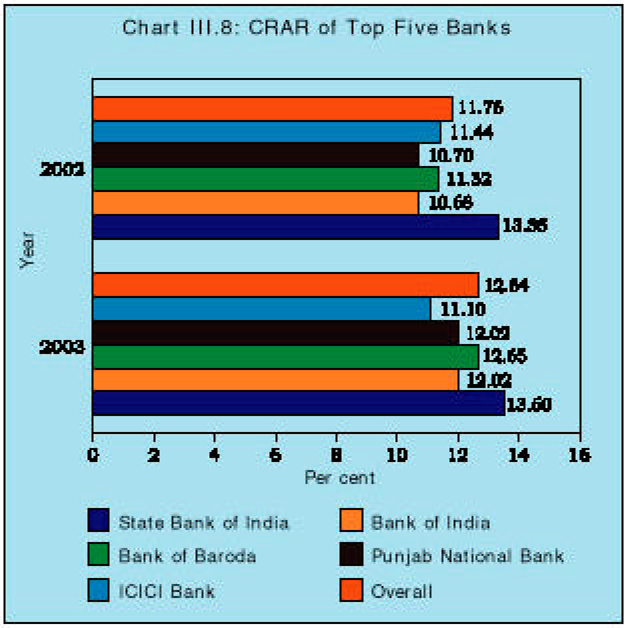

Chart III.8: CRAR of Top Five Banks

3.72 All the old private sector banks and foreign banks operating in India had CRAR above the stipulated levels. Two new private sector banks had CRAR below the prescribed minimum (Table III.30). Bank-wise details of CRAR of various bank groups are given in Appendix Table III.21 (A) to 21(C).

Table III.27: Bank Group-Wise Movements in Provisions for Depreciation on Investment - 2002-03

(Rs.crore)

Particular	**Scheduled Commercial Banks (93)**	**Public Sector Banks (27)**	**Old Private Banks (21)**	**New Private Banks (9)**	**Foreign Banks (36)**
1	**2**	**3**	**4**	**5**	**6**
Provisions for Depreciation					
As at end-March 2002	4,524	2,400	124	1,894	107
Add : Provisions made during the year	925	985	79	-191	52
Less : Write-off, write back of excess during the year	575	458	62	41	14
As at end-March 2003	4,875	2,927	141	1,662	145

Note : Figures in brackets indicates the number of banks in that group for the year 2002-03.
Source: Balance sheets of respective banks.

Table III.28: Bank Group-Wise Incremental Gross and Net Npas

(Rs.crore)

Bank Group	**Incremental Gross NPAs**		**Incremental Net NPAs**	
	2001-02	**2002-03**	**2001-02**	**2002-03**
1	**2**	**3**	**4**	**5**
Scheduled Commercial Banks	**7,120**	**-2,147**	**3,093**	**-2,790**
Public Sector Banks	1,801	-2,387	-19	-2,995
Nationalised Banks	2,681	119	468	-1,822
State Bank Group	-880	-2,506	-487	-1,173
Old Private Sector Banks	505	-283	243	-272
New Private Sector Banks	5,195	421	2,734	479

Foreign Banks	-380	103	135	-2

Source : Balance sheets of respective banks.

Equity Capital

3.73 The amendments in the State Bank of India Act, 1955 as well as the Banking Companies (Acquisition and Transfer of Undertakings) Acts, 1970/1980 have enabled

Table III.29: Bank Group-Wise Incremental Ratio of Gross and Net Npas

(Per cent)

Bank Group	**Incremental Ratio of Gross NPAs to**				**Incremental Ratio of Net NPAs to**			
	Gross Advances		**Total Assets**		**Net Advances**		**Total Assets**	
	2001-02	**2002-03**	**2001-02**	**2002-03**	**2001-02**	**2002-03**	**2001-02**	**2002-03**
1	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**
Scheduled Commercial Banks	**5.8**	**-2.2**	**3.0**	**-1.3**	**2.6**	**-2.9**	**1.3**	**-1.7**
Public Sector Banks	2.7	-3.5	1.4	-1.8	0.0	-4.4	0.0	-2.3
Nationalised Banks	5.0	0.3	3.4	0.1	0.9	-4.1	0.6	-2.1
State Bank Group	-6.4	-11.0	-1.9	-5.6	-3.5	-4.8	-1.1	-2.6
Old Private Sector Banks	11.7	-3.9	5.8	-2.4	5.6	-3.8	2.8	-2.3
New Private Sector Banks	11.4	2.1	5.4	2.4	6.2	3.1	2.9	2.7
Foreign Banks	-7.3	2.9	-3.4	3.3	2.4	-0.1	1.2	-0.1

Source: 1. Balance sheets of respective banks.
2. Returns received from respective banks.

Table III.30: Distribution of Scheduled Commercial Banks by CRAR

(No. of banks)

Bank Group	**2001-02**				**2002-03**			
	Below 4 per cent	**Between 4-9 per cent**	**Between 9-10 per Cent**	**Above 10 per cent**	**Below 4 per cent**	**Between 4-9 per cent**	**Between 9-10 per cent**	**Above 10 per cent**
1	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**
State Bank Group	—	—	—	8	—	—	—	8
Nationalised Banks	1	1	2	15	—	—	1	18
Old Private Sector Banks	—	—	2	19	—	—	2	19
New Private Sector Banks	—	1	1	6	2	—	1	6
Foreign Banks	—	—	2	33	—	—	—	36
Total	**1**	**2**	**7**	**81**	**2**	**—**	**4**	**87**

PSBs to increasingly take recourse to the capital market to shore up their capital base. Over the period 1993-2002, as many as 12 PSBs raised capital through public issues to the tune of Rs.6,501 crore.

3.74 During 2002-03, the Union Bank of India made an Initial Public Offering (IPO) in August 2002 by a public issue of 18 crore equity shares at an issue price of Rs.16 per share aggregating Rs.288 crore. The bank also returned capital of Rs.58 crore to the Government immediately prior to the issue. Consequent upon this IPO, the shareholding of the Government in the bank stands reduced to 60.9 per cent. Allahabad Bank made an IPO in October 2002 by public issue of 10 crore shares of Rs.10 each at par aggregating Rs.100 crore. Consequent upon the issue, the Government shareholding in the bank has reduced to 71.2 per cent. Canara Bank made a public issue of 11 crore equity shares at an issue price of Rs.35 aggregating Rs.385 crore. Subsequent upon this issue, the Government shareholding in the bank stands reduced to 73.2 per cent. With this, the total amount raised by PSBs through equity issues over the period 1993-2003 has aggregated Rs.7,274 crore. The Government shareholding in PSBs which have accessed the capital market, presently ranges from a low of 57.2 per cent to a high of 75 per cent.

Return of Capital

3.75 During 2002-03, three nationalised banks, *viz.*, the Union Bank of India (Rs.58 crore), Canara Bank (Rs.278 crore) and Andhra Bank (Rs.50 crore) returned capital to the Government. With this, the total capital returned by nationalised banks to Government till end-March 2003 aggregated Rs.1,253 crore.

Writing off Losses against Paid-up Capital

3.76 With the approval of the Central Government, the Central Bank of India and UCO Bank wrote off losses of Rs. 681 crore during the year 2001-02 and Rs.1,665 crore during 2002-03, respectively, from its paid-up capital.

Indian Banks' Operations Abroad

3.77 Several Indian banks have been operating in other countries across the world. As at end-September 2003, the number of Indian banks having overseas operations remained at nine, of which eight banks were in public sector and one in the private sector. With the closure of State Bank of India's Flushing, New York branch in the USA, and the foreign currency banking unit of Indian Overseas Bank in Colombo, the total number of overseas branches of the nine Indian banks has been reduced to 92.

3.78 The number of representative offices of Indian banks abroad increased from 15 to 18 with the opening of representative offices in London and New York by ICICI Bank Limited, in Dubai by HDFC Bank Limited, in Shenzhen (China) and Ho Chi Minh City (Vietnam) by Bank of India, and in London by Punjab National Bank. The State Bank of India had earlier closed down its Representative offices in Ho Chi Minh City (Vietnam), Sao Paulo (Brazil) and Jakarta (Indonesia).

3.79 The number of joint ventures and subsidiaries abroad of Indian banks stood at 5 and 15, respectively.

Foreign Banks' Operations in India

3.80 Foreign banks have been permitted more liberal entry into the Indian financial market since the inception of reforms. As at end-September 2003, the number of foreign banks in India were 35 with 207 branches. However, the number of their Representative Offices remained unchanged at 26.

3.81 Under a Scheme of Amalgamation and in terms of Section 44A of the Banking Regulation Act, 1949, the Indian branches of Standard Chartered Grindlays Bank Limited (SCGB) were merged with the Indian branches of Standard Chartered Bank (SCB). Accordingly, SCGB was de-scheduled in August 2002 in terms of Clause (b) of sub-section (6) of section 42 of the Reserve Bank of India Act, 1934.

3.82 The Development Bank of Singapore Limited, incorporated in Singapore with one branch in Mumbai, changed its name to 'DBS Bank Limited' with effect from July 21, 2003 in terms of clause (c) of sub-section (6) of Section 42 of the Reserve Bank of India Act, 1934 (2 of 1934).

3.83 Five banks, *viz.*, Commerzbank, Dresdner Bank AG, KBC Bank, the Siam Commercial Bank P.C.L., and the Toronto Dominion Bank have wound up their banking operations in India. The Overseas Chinese Banking Corporation Limited is in the process of closing their operations in India.

6. Regional Spread of Banking

3.84 The total number of branches of SCBs as at end-June 2003 stood at 66,514. Branch expansion of commercial banks has recorded an average annual growth of nearly one per cent over the last five years. The share of rural branches declined marginally to 48.7 per cent as at end-June 2003 from 49.0 per cent as at end-June 2002 reflecting the branch rationalisation policy wherein loss-making rural branches at centres served by two commercial bank branches (excluding that of regional rural banks) may be closed by mutual consultation. There was a marginal rise in the share of urban branches, whereas the proportion of metropolitan branches stayed at the same level as earlier (Appendix Table III.22).

3.85 The state-wise distribution of branches reveals that all regions witnessed a rise in the number of branches over the period July 2002 to June 2003, although in absolute terms, the additions to bank branches have been declining over the last few years. In line with the regional distribution of the national income, the Southern and Central regions accounted for the highest percentage of bank branches. In fact, the Southern region experienced the opening of the maximum number of branches during the year, particularly in the States of Andhra Pradesh and Karnataka. The Northern region also experienced a significant increase in the number of branches opened during the year, particularly in Punjab (31) and Delhi (26) (Appendix Table III.23).

3.86 While questions have been raised about the usefulness of 'social banking' in India on efficiency grounds, recent evidence on Indian rural branch expansion programme between 1997 and 1990 suggests that the programme made a significant dent on rural poverty and increased non-agricultural output (Box III.9).

7. Interest Rates of Scheduled Commercial Banks

3.87 Fiscal 2002-03 continued to see a softening of interest rates in most markets (Table III.31). In the credit markets, commercial bank deposit rates continued to fall reflecting the ample liquidity in the banking system. Lending rates remained relatively sticky, reflecting the impact of structural factors as well as the revival of credit demand during the latter half of the year. As a result, the spread between long-term deposit rates and lending rates widened during the year

(Chart III.9).

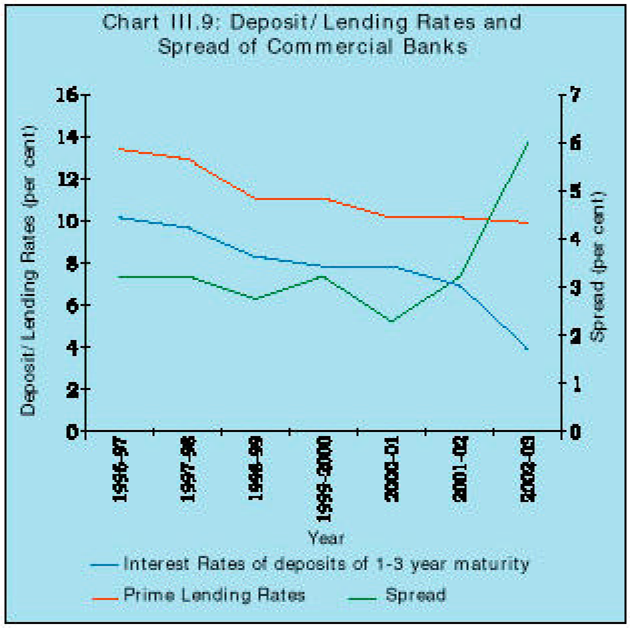

Chart III.9: Deposit/ Lending Rates and Spread of Commercial Banks

Domestic Deposit Rates

3.88 The deposit rates, in general have come down during 2002-03, following moderation in inflation expectations (Table III.32). Maturity-wise, longer term deposit rates of commercial banks showed a larger decline than the short-term rates.

3.89 The Reserve Bank has been encouraging banks to adopt floating rate deposit schemes, notwithstanding the poor response from the depositors as these were in the long-term interest of banks as well as depositors. In order to improve flexibility in the interest rate, banks were given freedom to decide the period of reset on variable rate deposits. In this context, a Working Group (Chairman: Shri H.N. Sinor), with members from major banks and the Reserve Bank to examine various issues concerning the deposit rates and procedure, submitted its Report in May 2003.

Box III.9: Branch Banking and Indian Banks

Access to finance has been considered to be a critical factor in enabling people to transform their production and employment activities and come out of poverty. Financial development, in this context, may enable the poor to obtain access to credit and consequently, improve their economic performance. Accordingly, in many emerging and developing countries, where a significant proportion of the poor remains cut-off from access to credit, Government intervention in the banking sector is perceived to channelise credit to the needy sectors of the society. The evidence on the success of such interventions in reducing poverty has, however, been limited.

There is some recent evidence that the branch expansion programme in India undertaken since the nationalisation had a positive impact on poverty and non-agricultural output. Using data on sixteen major Indian States over the period 1961-2000, the following has been observed:

- branch licensing rule succeeded in encouraging commercial banks in opening branches in backward rural locations,
- rural banks managed to reach the rural poor, and
- commercial banks offered opportunities for households to save. The saving accounts provided households with means of accumulating capital which could be used to invest in various productive activities.

It, thus, seems that social banking programmes as employed by the Government served to redistribute resources to the rural poor. This would suggest that expanding access of finance to poor, rural setting can generate significant social returns.

Reference:

Burgess, R. and R. Pande (2003), "Do Rural Banks Matter? Evidence from the Indian Social Banking Experiment",
STICERD Discussion Paper, No.40, London School of Economics (August).

Table III.31: Structure of Interest Rates

(Per cent)

Interest Rate	March 2002	March 2003	September 2003
1	2	3	4
I. Credit Markets			
1.Deposit Rate			
Public Sector Banks	4.25-8.75	4.00-7.00	3.75-6.25
Foreign Banks	4.25-10.00	3.00-8.50	3.00-8.00
Private Banks	5.00-10.00	3.50-8.00	3.00-8.00
2.Lending Rate			
Public Sector Banks	10.00-12.50	9.00-12.25	9.00-12.25
Foreign Banks	9.00-17.50	6.75-17.50	5.05-17.50
Private Banks	10.00-15.50	7.00-15.50	8.00-15.50
II. Money Markets			
3.Call Borrowing (Average)	6.97	5.86	4.50
4.Commercial Paper			
WADR (61-90 days)	7.78	6.53	5.26
WADR (91-180 days)	8.00	6.21	4.89
Range	7.41-10.25	6.00-7.75	4.74-6.50
5.Certificates of Deposit			
Range	5.00-10.03	5.00-7.10	4.25-6.00
Typical Rate			
3 months	7.38	-	5.00
12 months	10.00	5.25	5.31
6.Treasury Bills			
91 days	6.13	5.89	4.57
364 days	6.16	5.89	4.59
III.Debt Markets			
7.Government Securities Market			
5-year	6.75	5.92	4.79
10-year	7.30	6.13	5.13
8.AAA rated Corporate Bonds			

1-year	8.05	6.21	5.05
5-year	8.40	6.79	5.54

8. Regional Rural Banks

Mobilisation and Deployment of Funds

3.90 Regional Rural Banks (RRBs) continue to be important in rural institutional financing in terms of geographical coverage, clientele outreach, business volume and contribution to the development of the rural economy. In line with macroeconomic trends, deposit mobilisation by RRBs has been slowing down in recent years.

Table III.32: Movements in Deposit and Lending Interest Rates

(per cent)

Interest Rate	March 2002	March 2003	September 2003
1	2	3	4
I. Domestic Deposit Rates			
Public Sector Banks			
a) Up to 1 year	4.25 - 7.50	4.00 - 6.00	3.75-5.50
b) 1 year up to 3 years	7.25 - 8.50	5.25 - 6.75	4.75-6.00
c) Over 3 years	8.00 - 8.75	5.50 - 7.00	5.25-6.25
Private Sector Banks			
a) Up to 1 year	5.00 - 9.00	3.50 - 7.50	3.00-7.00
b) 1 year up to 3 years	8.00 - 9.50	6.00 - 8.00	5.50-7.50
c) Over 3 years	8.25 - 10.00	6.00 - 8.00	5.75-8.00
Foreign Banks			
a) Up to 1 year	4.25 - 9.75	3.00 - 7.75	3.00-7.75
b) 1 year up to 3 years	6.25 - 10.00	4.15 - 8.00	3.50-8.00
c) Over 3 years	6.25 - 10.00	5.00 - 9.00	3.75-8.00
II. Prime Lending Rates			
Public Sector Banks	10.00 - 12.50	9.00 - 12.25	9.00-12.25
Private Sector Banks	10.00 - 15.50	7.00 - 15.50	8.00-15.50
Foreign Banks	9.00 - 17.50	6.75 - 17.50	5.05-17.50

At the same time, there was a recovery in credit off-take. The Monetary and Credit Policy Statement of April 2002 announced that RRBs should maintain their entire SLR holdings in the form of Government and other approved securities by converting existing deposits with sponsor banks into approved securities by March 2003. However, SLR deposits maturing beyond March 31, 2003 have been allowed to be retained with sponsor banks till they mature, and upon maturity, these deposits are to be converted into Government securities. As a result, there was a sharp accretion in investments in Government securities, largely funded by a drawdown of inter-bank assets (Table III.33).

Financial Performance of RRBs

3.91 The data in respect of 196 RRBs for 2001-02 and 2002-03 indicate that there has been an overall decline in the number of profit-making RRBs in 2002-03. The performance of the loss-making RRBs witnessed a sharp downturn during 2002-03. On the expenditure front, both the interest expenses as well as operating expenses of the loss-making RRBs witnessed a sharp rise, the latter owing largely to the rise in the wage bill. The increase in operating profits of the profit-making RRBs in 2002-03 was largely offset by the significant losses of the loss-making RRBs. As a consequence, the loss-making RRBs, in terms of their net profit to total assets, fared poorly than in the previous year leading to a decline in the ratio for RRBs as a whole (Table III.34).

Purpose-wise Outstanding Loans and Advances

3.92 The composition of credit extended by RRBs continued to be broadly the same. While the shares of agricultural and non-agricultural loans are broadly equal, there has been a marginal bias in favour of the latter in recent years (Table III.35).

9. Priority Sector Lending

Public Sector Banks

3.93 The outstanding priority sector advances of PSBs increased by 18.6 per cent during 2002-03. At this level, priority sector advances formed 42.5 per cent of net bank credit (NBC). While 'other priority sector advances' registered the largest rise, direct and indirect advances to agriculture, taken together, also registered an increase. Advances to agriculture constituted 15.3 per cent of NBC as on the last reporting Friday of March 2003 (Appendix Table III.24). The bank-wise details of advances to agriculture and weaker sections as well as NPAs arising out of advances to weaker sections are furnished in Appendix Tables III.25 (A) and 25(B).

Private Sector Banks

3.94 Total priority sector advances extended by private sector banks rose as a proportion of NBC. The share of other priority sector category was the highest at 21.3 per cent of NBC, followed by advances to agriculture and small-scale industries (Appendix Table III.26). Bank-wise details of advances to priority sector, agriculture and weaker sections as well as NPAs arising out of advances to weaker sections are furnished in Appendix Table III.27 (A) and 27(B).

Foreign Banks

3.95 Foreign banks operating in India are required to achieve the target of 32.0 per cent of NBC for the priority sector with sub-targets of 10.0 per cent of NBC for small-scale industries and 12.0 per cent of NBC for exports. Lending to the priority sector by foreign banks constituted 33.9 per cent of NBC as on the last reporting Friday of March 2003, of which the share of export credit, as percentage to NBC was 18.7 per cent (Appendix Table III.28).

Table III.33: Important Banking Indicators of Regional Rural Banks

(Outstanding on)

(Amount in Rs.crore)

Item	March 30, 2001	March, 29 2002	March 28, 2003	Variations 2001-02	2002-03
1	**2**	**3**	**4**	**5**	**6**
				(3-2)	(4-3)

1 Liabilities to the Banking System	**177**	**188**	**179**	**11**	**-9**
				(6.2)	**(-4.8)**
2 Liabilities to Others	**38,696**	**44,873**	**50,190**	**6,177**	**5,317**
				(16.0)	**(11.8)**
2.1 Aggregate Deposits (a+b)	37,027	43,220	48,346	6,193	5,126
				(16.7)	(11.9)
a) Demand Deposits	6,499	7,716	8,802	1,217	1,086
				(18.7)	(14.1)
b) Time Deposits	30,528	35,504	39,544	4,976	4,040
				(16.3)	(11.4)
2.2 Borrowings	24	12	131	-12	119
				(-50.0)	(991.7)
2.3 Other Demand and Time Liabilities*	1,645	1,641	1,713	-4	72
				(-0.2)	(4.4)
3 Assets with the Banking System	**16,973**	**18,509**	**15,091**	**1,536**	**-3,418**
				(9.0)	**(-18.5)**
4 Bank Credit	**15,579**	**18,373**	**21,773**	**2,794**	**3,400**
				(17.9)	**(18.5)**
5 Investments (a+b)	**7,546**	**6,772**	**12,524**	**-774**	**5,752**
				(-10.3)	**(84.9)**
a) Government Securities	1,588	1,915	8,311	327	6,396
				(20.6)	(334.0)
b) Other Approved Securities	5,958	4,857	4,213	-1,101	-644
				(-18.5)	(-13.3)
6 Cash Balances	**441**	**472**	**515**	**31**	**43**
				(7.0)	**(9.1)**
Memo:					
a. Cash Balance-Deposit Ratio	1.2	1.1	1.1		
b. Credit-Deposit Ratio	42.1	42.5	45.0		
c. Investment/Deposit Ratio	20.4	15.7	25.9		
d. Investment+Credit/Deposit Ratio	62.5	58.2	70.9		

* includes Participation Certificates issued to others.
Note: Figures in brackets are percentage variations.

Differential Rate of Interest (DRI) Scheme

3.96 The differential rate of interest (DRI) Scheme, introduced in 1972, is being implemented by all SCBs throughout the country. Under the scheme, bank finance is provided at a concessional rate of interest of 4.0 per cent per annum to the weaker sections for engaging in productive and gainful activities, thereby enabling an improvement in their economic conditions. Banks are required to lend at least one per cent of their aggregate advances as at the end of the previous year under the scheme. Moreover, two-thirds of the total DRI advances must be routed through the bank's rural and semi-urban branches. The annual income ceiling for eligibility is Rs.7,200 per family in urban or semi-urban areas and Rs.6,400 per family in rural areas. The outstanding advances of PSBs under the DRI Scheme as at end-March 2003 amounted to Rs. 300 crore in 3.70 lakh borrowal accounts. The DRI advances of the banks as at the end of March 2003 formed 0.08 per cent of the total advances outstanding as at the end of the previous year, *i.e.*, March 2002 which is lower than the relative target of one per cent.

Table III.34: Financial Performance of Regional Rural Banks

(Amount in Rs. crore)

Particular	2001-02	2002-03	Variation

	Loss Making [29]	Profit Making [167]	RRBs [196]	Loss Making [40]	Profit Making [156]	RRBs [196]	during 2002-03
1	**2**	**3**	**4**	**5**	**6**	**7**	**8 = (7)-(4)**
A. Income (i+ii)	**484**	**5,080**	**5,564**	**774**	**5,157**	**5,931**	**367 (6.6)**
i) Interest income	449	4,743	5,191	727	4,775	5,501	310 (6.0)
ii) Other income	36	337	373	48	383	430	57 (15.4)
B. Expenditure (i+ii+iii)	**576**	**4,380**	**4,956**	**989**	**4,418**	**5,407**	**451 (9.1)**
i) Interest expended	361	2,968	3,329	567	2,946	3,513	184 (5.5)
ii) Provisions and contingencies	28	138	166	66	124	190	24 (14.5)
iii) Operating expenses	187	1,274	1,461	356	1,348	1,703	243 (16.6)
of which : Wage Bill	158	1,107	1,264	321	1,159	1,480	216 (17.1)
C. Profit							
i) Operating Profit/Loss	-64	838	774	-149	863	714	-59 (-7.7)
ii) Net Profit/Loss	-92	700	608	-215	739	524	-83 (-13.7)
D. Total Assets	**6,169**	**50,635**	**56,804**	**10,282**	**53,332**	**63,614**	**6,811 (12.0)**
E. Financial Ratios (as percentage of total assets)							
i) Operating Profit	-1.0	1.7	1.4	-1.4	1.6	1.1	
ii) Net Profit	-1.5	1.4	1.1	-2.1	1.4	0.8	
iii) Income	7.9	10.0	9.8	7.5	9.7	9.3	
iv) Interest income	7.3	9.4	9.1	7.1	9.0	8.6	
v) Other Income	0.6	0.7	0.7	0.5	0.7	0.7	
vi) Expenditure	9.3	8.6	8.7	9.6	8.3	8.5	
vii) Interest expended	5.9	5.9	5.9	5.5	5.5	5.5	
viii) Operating expenses	3.0	2.5	2.6	3.5	2.5	2.7	
ix) Wage Bill	2.6	2.2	2.2	3.1	2.2	2.3	
x) Provisions and Contingencies	0.5	0.3	0.3	0.6	0.2	0.3	
xi) Spread (Net Interest Income)	1.4	3.5	3.3	1.5	3.4	3.1	

Source: NABARD.

Special Agricultural Credit Plans (SACP)

3.97 In order to enable achievement of the targeted agricultural lending, PSBs were advised to formulate Special Agricultural Credit Plans (SACP) since 1994-95, and fix self-set targets for achievement during the year (April - March). Since the introduction of the SACP, there has been a substantial increase in the flow of credit to agriculture from Rs.8,255 crore in 1994-95 to Rs.33,921 crore in 2002-03 against the target of Rs.36,838 crore for the year 2002-03.

Government - sponsored Schemes

3.98 The total number of Swarozgaris assisted under the Swarnajayanti Gram Swarozgar Yojana (SGSY) during the year 2002-03 (up to February 2003) was 5,35,133. Bank credit to the tune of Rs. 781 crore and Government subsidy amounting to Rs. 404.88 crore were disbursed under this Scheme. Of the Swarozgaris assisted, 1,60,638 (30.0 per cent) belonged to the Scheduled Castes and 78,157 (14.6 per cent) to the Scheduled Tribes, while 2,57,664 (48.2 per cent) were women and 4,166 (0.8 per cent) were physically handicapped.

Table III.35: Purpose-Wise Break-Up of Outstanding Advances

(Amount in Rs.crore)

Purpose	**2001**	**2002**
1	**2**	**3**
1. Short-term Loans (crop loans)	3,095	3,812
2. Term Loans (for agriculture and allied activities)	871	782
3. Indirect Advances	N.A.	N.A.
I. Total (Agriculture) (1 to 3)	**3,966 (44.9)**	**4,594 (43.5)**
4. Rural Artisans, etc.	181	198
5. Other Industries	70	107
6. Retail Trade, etc.	1,123	1,279
7. Other Purposes	3,483	4,393
II. Total (Non-agriculture) (4 to 7)	**4,857 (55.1)**	**5,977 (56.5)**
Total (I+II)	**8,823 (100.0)**	**10,571 (100.0)**

N.A. Not Available.

Note: Figures in brackets are percentages to the total.

Source: NABARD.

3.99 The total number of applications sanctioned under the Scheme of Liberation and Rehabilitation of Scavengers (SLRS) during 2002-03 were 12,310. Out of this, disbursements added up to Rs. 20 crore in 11,091 cases as on March 31, 2003.

3.100 As for the Prime Minister's *Rozgar Yojana* (PMRY), as per provisional figures, the number of applications sanctioned under the Scheme during the year 2002-03 numbered 2,22,996 involving an aggregate sanctioned amount of Rs.1,449 crore.

Kisan Credit Cards (KCC)

3.101 The *Kisan* Credit Card is a successful financial innovation which was introduced pursuant to the announcement made in the Union Budget of 1998-99. The KCCs are issued by SCBs, including the RRBs and co-operative banks. These cards were introduced to simplify credit delivery. The banks were advised in June 2000 that they should consider issue of KCCs for limits below Rs.5,000 also, in order to facilitate wider coverage under the Scheme. They have also been advised to pay interest on the credit balances in the accounts under the KCC Scheme.

3.102 In pursuance of the Union Finance Minister's announcement in his Budget Speech for the year 2001-02, banks have been asked to provide personal accident insurance packages to the KCC holders, as is often done with other credit cards, to cover them against accidental death or permanent disability, up to a maximum amount of Rs.50,000 and Rs.25,000 respectively. The premium burden is to be shared by the card issuing institutions and the KCC holder in the ratio of 2:1. Cumulatively, 101.5 lakh KCCs have been issued by public sector banks since inception of the scheme up to March 2003. During the year 2002-03, public sector banks issued 26.9 lakh KCCs as against the self-set target of 25.8 lakh. All eligible agricultural farmers are required to be covered under the KCC scheme by March 2004. Accordingly, all commercial banks have been advised the revised targets to be achieved.

3.103 The work regarding National Impact Assessment Survey of KCC scheme for assessing the impact of the scheme on the beneficiaries has been entrusted to the National Council of Applied Economic Research (NCAER), New Delhi. The NCAER has since launched the survey and the report is expected by December 2003. The survey covers 53 districts in 10 states and also the state of Assam to cover the North-Eastern region.

Lead Bank Scheme

3.104 The main focus of the Lead Bank Scheme (LBS) has been on enhancing the proportion of bank finance to the priority sector. As at end-March 2003, the LBS covered 582 districts, including the two new districts formed due to reorganisation / bifurcation of the existing districts. The assignment of the new districts to public sector banks is detailed in Table III.36.

3.105 The period of temporary transfer of lead responsibility of Amanita, Badge, Plasma and Stringer districts in Jammu and Kashmir from the State Bank of India to Jammu and Kashmir Bank Ltd., has been extended up to March 2005.

Table III.36: Lead Bank Responsibility in Respect of New Districts

District	State	Date of Allocation	Name of the Lead Bank
1	2	3	4
Aral	Bihar	September 16, 2002	Punjab National Bank
Imphal (West) *	Manipur	January 6, 2003	United Bank of India
Imphal (East)*	Manipur	January 6, 2003	United Bank of India

* Original Imphal district has been bifurcated into these two districts.

Micro finance

3.106 Recognising micro finance interventions as an effective tool for poverty alleviation, the Reserve Bank had issued comprehensive guidelines to banks in February 2000 for mainstreaming micro credit and enhancing the outreach of micro credit providers. These guidelines stipulate that micro credit extended by banks to individual borrowers directly or through any intermediary would henceforth be reckoned as part of their priority sector lending. The Reserve Bank has not specified any model of micro finance (mF) institutions.

3.107 The Self-Help Group (SHG) Bank linkage programme has, however, emerged as the major programme and is being implemented by commercial banks, RRBs and co-operative banks. There are presently three models of the SHG- Bank linkage programme in the country.

- Model I, lending directly to SHGs without intervention/facilitation of any NGO, which accounts for 20 per cent of the total linkage under the programme.

- Model II, lending directly to SHGs with facilitation by NGOs and other formal agencies, which amounts to 72 per cent of the total linkage.

- Model III, lending through NGO as facilitator and financing agency, which represents the balance eight per cent of the total linkage.

3.108 While 523 districts in all the States/Union Territories have been covered under this programme, 504 banks including 48 commercial banks, 192 RRBs and 264 co-operative banks along with 2,800 NGOs are now associated with the SHG-Bank linkage programme. The number of SHGs linked to banks aggregated 7,17,360 as on March 31, 2003. This translates into an estimated 11.6 million very poor families brought within the fold of formal banking services as on March 31, 2003. More than 90 per cent of the groups linked with banks are exclusive women groups. Cumulative disbursement of bank loans to these SHGs stood at Rs.2,049 crore as on March 31, 2003 with an average loan of Rs.28,559 per SHG and Rs.1,766 per family. 3.109 Micro finance initiatives have shown that banking with the poor is a viable proposition; the repayment rates in this respect are also higher at nearly 95 per cent. The Reserve Bank has been making efforts to give a fillip to mF initiatives through creating an enabling environment. As a part of this effort a High-Level meeting (Chairman: Shri Vepa Kamesam) on mF was convened in October 2002 wherein four Groups were set up to look into issues relating to: (i) structure and sustainability; (ii) funding; (iii) regulations; and (iv) capacity building of mF institutions. The second High-Level meeting of the series was held in August 2003 wherein the group reports were discussed. Thereafter, for greater public debate, the reports of the groups were circulated among banks to elicit their responses before a final view could be taken on the recommendations, particularly on regulatory issues. The feedback has been received from banks and the recommendations are under consideration.

10. Local Area Banks

3.110 The five banks which are presently functional are:

1. Coastal Local Area Bank Ltd.,Vijayawada in the districts of Krishna, Guntur and West Godavari in Andhra Pradesh.

2. Capital Local Area Bank Ltd., Phagwara in the districts of Hoshiarpur, Jalandhar and Kapurthala in Punjab.

3. South Gujarat Local Area Bank Ltd., Navsari in the districts of Navsari, Surat and Bharuch in Gujarat.

4. Krishna Bhima Samruddhi Local Area Bank Ltd., Mehboobnagar in the districts of Raichur and Gulbarga in Karnataka and Mehboobnagar in Andhra Pradesh.

5. The Subhadra Local Area Bank Ltd., Kolhapur, which was issued licence on July 10, 2003, has commenced banking business from September 30, 2003 in the districts of

Kolhapur, Sangli and Belgaum.

3.111 The performance of the LABs as at end-March 2003 reveals that most of them had moderate to high credit-deposit ratios (Table III.37). During 2002-03, the operations of four local area banks continued to remain profitable. Their rise in income was marginal and expenses outpaced incomes. Given the higher provisioning levels, in spite of healthy operating profits, their net profits were substantially lower than the previous year as reflected in the lower return on assets (*i.e.*, net profits to total assets) (Table III.38).

11. Diversification in Banking Activities

3.112 The State Bank of India was given 'in principle' approval to its proposals (i) to convert the Discount and Finance House of India Limited (DFHI) into its subsidiary under Section 19(1)(a) of Banking Regulation Act, 1949 and (ii) to divest its stake in Securities Trading Corporation of India Limited (STCI).

3.113 Bank of India was given approval to merge with itself its wholly owned subsidiary, *viz.*, BoI Asset Management Company Limited.

Table III.37: Performance of Local Area Banks

(As at end-March 2003)

(Amount in Rs. crore)

Name of the LAB	Deposits	Advances	C-D ratio (per cent)
1	2	3	4
Coastal Local Area Bank Ltd.	24.1	18.0	74.8
Capital Local Area Bank Ltd.	75.4	45.3	60.1
South Gujarat Local Area Bank Ltd.	11.4	9.6	84.6
Krishna Bhima Samruddhi Local Area Bank Ltd.	2.5	3.9	162.5

3.114 During the year under review, 17 public sector banks, nine private sector banks and one foreign bank and a subsidiary of a private sector bank were given 'in principle' approval for acting as corporate agents of insurance companies to undertake distribution of insurance products on non-risk participation basis. For entering into a referral arrangement with insurance companies subject to prescribed conditions, five public sector banks, two private sector banks and one foreign bank were given approval during the year.

3.115 State Bank of India, Bank of Baroda and Punjab National Bank were given approval to promote a new Asset Management Company (AMC) 'UTI Asset Management Company Private Limited' and a trustee company, *viz.*, 'UTI Trustee Company Private Limited', with each bank contributing Rs.2.5 crore and Rs.2.5 lakh, respectively. These three banks were also given approval for promoting 'UTI Mutual Fund' with each bank contributing capital amounting to Rs.2,500 constituting 25 per cent of the corpus of the fund, subject to necessary clearance from Securities and Exchange Board of India (SEBI).

3.116 ICICI Bank Limited was given approval for investing in the equity of National Multi

Commodity Exchange of India (NMCE) up to an amount of Rs.8 crore subject to the condition that the bank will provide only normal banking service to NMCE and its members, and will not guarantee trades executed by the members of the exchange. Further, ICICI Bank Limited was given approval for making an additional contribution of up to Rs.81 crore to the share capital of ICICI Lombard General Insurance Company Limited. The bank was also given approval for making an additional investment of Rs.259 crore in the equity of ICICI Prudential Life Insurance Company Limited.

3.117 State Bank of India was given 'no objection' to its undertaking the portfolio management of SLR and non-SLR funds of the RRBs sponsored by the bank subject to prescribed conditions.

3.118 Central Bank of India, Corporation Bank, Bank of Baroda, Vysya Bank, Punjab National Bank and Vijaya Bank were also given approval for equity contribution to their subsidiaries / joint ventures companies.

Table III.38: Financial Performance of Local Area Banks

(Amount in Rs.crore)

			Variation during 2002-03	
Item	**2001-02**	**2002-03**	**Absolute**	**Percentage**
1	**2**	**3**	**4**	**5**
A. Income (a+b)	**15.1**	**17.1**	**2.0**	**13.7**
a) Interest income	11.0	12.7	1.7	15.6
b) Other income	4.1	4.4	0.3	6.8
B. Expenditure (a+b+c)	**12.1**	**16.9**	**4.8**	**39.1**
a) Interest expended	6.1	7.7	1.6	26.0
b) Provisions and contingencies	0.7	2.6	1.9	276.9
c) Operating expenses	5.4	6.7	1.3	25.3
of which :				
Wage Bill	2.0	2.4	0.4	22.8
C. Profit				
a) Operating Profit/Loss (-)	3.6	2.7	-0.9	-26.5
b) Net Profit/Loss (-)	2.9	0.2	-2.7	-92.6
D. Total Assets	**118.9**	**146.2**	**27.3**	**23.0**
E. Financial Ratios (as percentage of total assets)				
a) Operating Profit	3.1	1.8		
b) Net Profit	2.5	0.5		
c) Income	12.7	11.7		
d) Interest income	9.3	8.7		
e) Other Income	3.5	3.0		
f) Expenditure	10.2	11.6		
g) Interest expended	5.1	5.3		
h) Operating expenses	4.5	4.6		
i) Wage Bill	1.7	1.7		
j) Provisions and Contingencies	0.6	1.7		
k) Spread (Net Interest Income)	4.1	3.4		

Source: Based on Off-site returns.

Local Advisory Boards of Foreign Banks

3.119 On a review of the need for constitution of Local Advisory Boards, foreign banks have been advised in August 2003 that the constitution of Local Advisory Boards by them will no longer be a regulatory requirement and they may decide about their constitution according to their corporate needs. Such constitution of Local Advisory Boards would not require the regulatory approval of the Reserve Bank.

The Prevention of Money Laundering Act

3.120 The Prevention of Money Laundering Act (PMLA), 2002, which received Presidential assent provides the broad legal framework for countering money laundering as defined under the Act. Under the Act, banking companies, financial institutions and intermediaries are required to maintain a record of all transactions (the nature and value of which will be prescribed), and furnish information of such transactions to the Designated Authority (under the Act) within the prescribed time frame; they need to verify and maintain records of the identity of all its clients as prescribed by the Central Government by Rules. It has further been envisaged that they will not be liable to any civil proceedings against them for furnishing such information. The procedure and manner of maintaining and furnishing the information is to be prescribed by the Central Government by framing the relevant Rules in consultation with the Reserve Bank, which is currently in progress.

12. Banks' Liquidation and Amalgamations

3.121 There were 78 banks under liquidation as on December 31, 2002. The matter regarding early completion of liquidation proceedings is being pursued with official/court liquidators.

Amalgamation of Banks

3.122 Nedungadi Bank Limited had been recording profits consistently till the year ended March 31, 2000. However, the bank reported a net loss of Rs. 67.8 crore for the first time for the year ended March 31, 2001. The financial position of the bank did not improve subsequently in the year ended March 31, 2002. The net worth of the bank amounting to Rs.60.4 crore stood fully eroded by the accumulated losses of Rs. 65.5 crore and it was not possible to wipe out these losses in a reasonable time. As the bank's capital was fully eroded, its CRAR had turned negative at (-) 1.9 per cent as against the regulatory requirement of minimum of 9 per cent. As the bank required approximately Rs.125 crore to achieve the minimum CRAR of 9 per cent, there was no option available but to consider amalgamation of Nedungadi Bank Limited with another bank.

3.123 As a precursor to amalgamation, Nedungadi Bank was placed under moratorium for a period of three months from November 2, 2002. During this interim period, the Reserve Bank had prepared a Draft Scheme of Amalgamation of the Nedungadi Bank Limited with the Punjab National Bank, in exercise of powers conferred on it by sub-section (4) of Section 45 of the Banking Regulation Act, 1949.[8] The Reserve Bank on November 13, 2002 notified the draft scheme of amalgamation of Nedungadi Bank Limited with Punjab National Bank. The draft scheme was forwarded to both the banks for their comments and the Reserve Bank invited suggestions or objections on the draft scheme by November 30, 2002. The said Scheme of amalgamation was sanctioned by the Central Government in terms of sub-section (7) of Section 45 of the Act, through a notification dated January 31, 2003. The scheme of amalgamation of Nedungadi Bank Limited with Punjab National Bank came into force with effect from February

1, 2003.

13. Other Developments

Donation by Banks

3.124 As per the extant instructions, banks may make donations for various purposes during a financial year, within the prescribed limit of 1 per cent of their published profit for the previous year. On a review of the matter in the wake of representations received from Indian Banks' Association/banks, it has been decided that the donations made by banks to the Prime Minister's Relief Fund would be exempted from the above ceiling provided the proposal has the approval of the bank's Board and the donation amount is reasonable *vis-à-vis* its stated profit. However, the restriction on the overall limit on donations up to a maximum of Rs. 5 lakh for loss-making banks would apply in this case as well.

Insurance Business by Banks

3.125 As per existing guidelines for entry of banks into insurance business, banks which satisfy certain parameters, *i.e.*, minimum net worth of not less than Rs. 500 crore, CRAR not less than 10 per cent, net profit for the last three continuous years, reasonable level of non-performing assets and a satisfactory track record of the performance of their subsidiaries, if any, are eligible to set up insurance joint venture on risk participation basis. Banks which are not eligible as joint venture participants, as above, would be allowed to take up strategic investment up to a certain limit for providing infrastructure and services support, if these banks satisfy some of the criteria specified therein. Further, any SCB or its subsidiary would be permitted to undertake insurance business as agent of an insurance company and distribute insurance products without any risk participation. The referral model, by which banks can provide physical infrastructure to insurance companies within their select branch premises and earn fee for each referral made by them, was not specifically indicated in the earlier guidelines. As the referral arrangement is akin to sub-agency and is incidental to the main activities of an agency business, it was decided that banks can undertake this activity with prior approval of Reserve Bank/ Insurance Regulatory and Development Authority.

Progress in Use of Hindi

3.126 During the year, four quarterly meetings of the Official Language Implementation Committee (OLIC) of PSBs were held and the follow-up actions were taken on the decisions taken in these meetings, particularly regarding the use of Hindi in data processing and core banking solution facility to operate ATMs in Hindi / Regional languages, conduct of high-level meetings in Hindi and increase in bilingual data processing work in branches. In order to increase the number of branches doing data processing work in Hindi, guidelines were issued to banks by the Reserve Bank.

3.127 The 23rd Rajbhasha Sammelan of banks was held in Hyderabad in October 2002. Its various recommendations to increase the use of Hindi were approved by the Official Language Implementation Committee *viz.*, a) Department of Electronics, Government of India, should develop a Operating System (OS) in Hindi and ensure that all Hindi software developers follow Unicode standards; b) Special programmes may be conducted for senior executives for providing information regarding Official Language Act, Rules and various provisions of Official Language and the senior executives may address in Hindi in their top-level meetings; c) During the course of inspection of branches / tours, senior executives should also get information regarding use of Hindi; and d) Senior executives should initiate use of Hindi at their level.

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[1] The assets and liabilities of scheduled commercial banks are analysed primarily on the basis of end-March audited annual accounts.

[2] This sub-section is based on the statutory returns submitted by scheduled commercial banks under Section 42 (2) of the Reserve Bank of India Act, 1934.

[3] For the purpose of achievement of the target which was prescribed up to 2002-03, banks were allowed to deploy funds under housing finance allocation in any of the following categories: (a) direct finance; (b) indirect finance; (c) investment in bonds of NHB/HUDCO or combination thereof; and (d) investments by banks in rated securitised debt instruments issued by any Special Purpose Vehicle (SPV), or entity representing housing loans granted by approved housing finance companies (under the supervision of NHB).

[4] Net demand and time liabilities available with the banking system *less* statutory pre-emptions and credit off-take.

[5] As part of additional disclosures, banks have been mandated to disclose provisions towards loan losses from the year 1996-97 onwards in the 'Notes on Accounts' in the balance sheet.

[6] Bank-wise details of select parameters of PSBs, private sector banks and foreign banks are furnished in Appendix Tables III.15(A) to 15(I), III.16(A) to 16(H) and III.17(A) to 17(H), respectively.

[7] Non-performing assets refer to non-performing loans and advances.

[8] This Section deals with powers of Reserve Bank to apply to Central Government for suspension of business by a banking company.