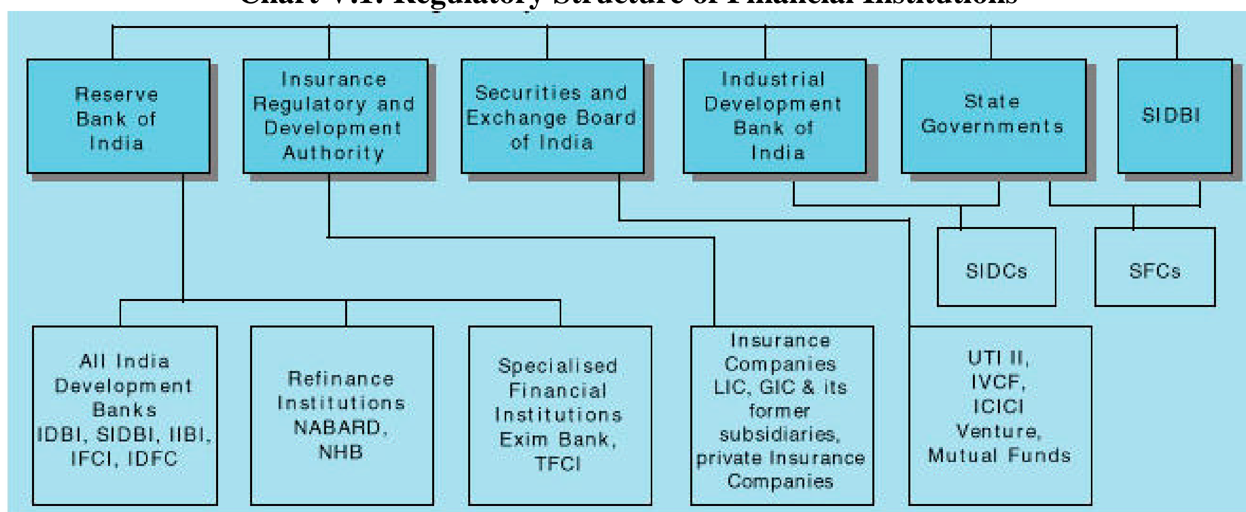
Chapter V
Financial Institutions

5.1 The financial institutions (FIs) are in the process of great change in the context of the ongoing financial sector reforms and the emerging competitive financial system. FIs were set up when the capital markets were relatively underdeveloped and were incapable of meeting the long-term financing needs of the economy adequately. With the widening and deepening of markets for long-term funds, the justification for further prolonging the role of subsidised credit from FIs has weakened; more so because prolonged concessional finance by the Government has been deemed to be neither sustainable nor desirable. This is consistent with the process of financial sector reforms, with its focus on allocative efficiency and stability. With the withdrawal of concessional sources of finance of FIs and blurring of distinction between FIs and banks, FIs not only have to raise resources at market-related rates but also have to face a competitive environment on both asset and liability sides. Moreover, structural changes in the financial system coupled with the industrial slowdown in recent years have adversely impacted the volume of business and profitability of FIs. In view of this changed environment, FIs are in the process of adjusting and diversifying their business in terms of clients, activities and products.

5.2 The FI sector in India comprises diverse entities like term-lending institutions, investment institutions, specialised FIs and refinance institutions. Of these, nine FIs, *viz.*, Industrial Development Bank of India (IDBI), IFCI Ltd., Industrial Investment Bank of India Ltd. (IIBI), Small Industries Development Bank of India (SIDBI), Export Import Bank of India (Exim Bank), Tourism Finance Corporation of India Ltd. (TFCI), Infrastructure Development Finance Company Ltd. (IDFC), National Bank for Agriculture and Rural Development (NABARD) and National Housing Bank (NHB), fall within the regulatory and supervisory domain of the Reserve Bank (Chart V.1). The review of policy developments and performance of FIs in this Chapter, therefore, is primarily focussed on the above-mentioned nine FIs. Wherever necessary, specific references are made to other FIs as well.

Chart V.1: Regulatory Structure of Financial Institutions



5.3 In contrast to the rising trend in financial assistance sanctioned and disbursed by the FIs[1] during 1996-2000, the sharp decline recorded during 2001-02 continued during 2002-03 as well.

Lack of demand for new projects, virtual exhaustion of unutilised capacities for meeting the increased demand for industrial products, competition from low rates provided by the commercial banks and delays in implementation of projects, have all contributed to the substantial decline in the financial assistance sanctioned and disbursed by select all-India FIs. Part of the decline, however, was also due to the merger of ICICI with ICICI Bank on March 30, 2002. Furthermore, the recent spurt in the growth of services sector may not have generated commensurate demand for project finance as a number of service industries are human capital-intensive with somewhat limited requirement of long-term finance.

5.4 During 2002-03, the financial performance of the FIs as a group showed further deterioration over the previous year. This can be attributed to declines in spread and non-interest income and rise in other expenses, with IFCI and IIBI accumulating high non-performing assets (NPAs) and related provisioning leading to their declining profitability and erosion of capital. If these two institutions are excluded, all FIs, however, are seen to have registered positive operating and net profit, as was the case in the previous year. The increase in NPAs in a number of FIs can be ascribed to the slow economic recovery and sectoral bottlenecks.

2. Policy Initiatives for Financial Instituitons

5.5 The focus of Reserve Bank's policy initiatives for select all-India FIs has, in recent years, been on the twin objectives of enhancing their stability and efficiency. Thus, the emphasis was on strengthening the prudential regulatory and supervisory framework of the FIs, improving their accounting and auditing standards, enhancing transparency and developing their technological infrastructure, while simultaneously introducing flexibility in their operations.

Prudential Norms

Capital Adequacy

5.6 Since February 20, 2002, FIs have been permitted to extend guarantees in respect of infrastructure projects in favour of other lending institutions, provided that the bank issuing the guarantee takes a funded share in the infrastructure project at least to the extent of 5 per cent of the project cost and undertakes normal credit appraisal, monitoring and follow-up of the project. In this context, risk weight for the loan extended by an FI against the guarantee of a bank in the capital to risk-weighted assets ratio (CRAR) computation of the FI were stipulated on August 8, 2002. Accordingly, a risk weight of 20 per cent would apply to that part of the loan which is covered by the banks' guarantee and the remaining amount of loan would attract 100 per cent risk weight. In line with the international practice, housing loans extended by the FIs to individuals against the mortgage of residential housing properties have been revised with effect from August 31, 2002. The details are presented in Table V.1.

Table V.1: Risk Weight for Housing Loans, Mortgage Backed Securities and Loans against Bank Guarantee

(per cent)

Category	Old Risk Weight	New Risk Weight with effect from August 31, 2002

	1	2	3
1.	Housing loans to individuals against the mortgage of Residential housing properties	100	50
2.	Loans against the security of commercial real estate	100	100
3.	Loans to their own employees #	20	20
4.	Other loans not covered by banks guarantee	N.A.	100
5.	Investments by the FIs in Mortgage Backed Securities (MBS)	N.A.	50 (plus 2.5 for market risk) @
6.	If the assets underlying the MBS include commercial properties	100	100
7.	Loans against bank guarantee (for infrastructure projects)	N.A.	20

N.A. Not Applicable.

: Only those which are fully secured by superannuation benefits and the mortgage of flats/house.

@: Provided the assets underlying the MBS are the residential loan assets of the Housing Finance Companies which are recognised and supervised by NHB and satisfy certain conditions.

Asset Classification in respect of Projects Under Implementation

5.7 In order to ensure that the loan assets relating to projects under implementation are properly valued, they have been classified, on the basis of their project cost and their date of financial closure, under the following three categories, *viz.*,

(a) projects where financial closure had been achieved and formally documented (Category I);

(b) projects with original project cost of Rs.100 crore or *more* and whose date of financial closure has not been formally documented (Category II); and

(c) projects with original project cost of *less* than Rs. 100 crore and whose date of financial closure has not been formally documented (Category III).

5.8 Accordingly, in the case of Category I, the two-year time period should be counted from the date of completion of the project, as envisaged at the time of original financial closure and the asset may be treated as standard only for a period not exceeding two years. The asset classification of projects falling under Category II is required to be decided with reference to the 'deemed date of completion' of such projects decided by the Independent Group of experts from outside as well as lending institutions. In such cases assets may be treated as standard assets only for a period not exceeding two years from the deemed date of completion. In the case of Category III, the date of commencement of commercial production would be deemed to be the date exactly two years after the date of completion of the project as originally envisaged. In such cases the assets may be treated as standard only for a period of two years. It was advised to FIs that, as a prudential measure, the provisions held by the FIs in respect of such accounts should not be reversed even in cases where, certain accounts might become eligible for upgradation to the 'standard' category.

Compromise Settlement of Chronic NPAs

5.9 The FIs were advised to implement the revised guidelines for compromise settlement of chronic NPAs that had earlier been issued to public sector banks. These guidelines will provide a simplified, non-discretionary and non-discriminatory mechanism for achieving the maximum realisation of dues from the stock of NPAs within a stipulated time. The revised guidelines will cover NPAs (up to Rs.10 crore) relating to all sectors including the small-scale sector. The guidelines will not, however, cover cases of wilful default, fraud and malfeasance. The FIs should identify cases of wilful default, fraud and malfeasance and initiate prompt action against

them. The last date for receipt of the applications under the revised One-Time Settlement Scheme was extended from April 30, 2003 to September 30, 2003 and the date of completion of processing of the applications was also extended from October 31, 2003 to December 31, 2003.

Investments

5.10 In view of certain suggestions and queries by some of the FIs, the Reserve Bank issued further clarifications / modifications in July 2002 on a number of issues relating to investments (Box V.1).

Exposure Norms

5.11 For the purpose of exposure norms, FIs' lending on infrastructure projects guaranteed by banks is treated as follows- the entire loan of the FIs is to be reckoned as an exposure on the borrowing entity and not on the bank guaranteeing the loan. This is expected to correctly reflect the degree of credit concentration. In case the funded facility is by way of a term loan, the level of exposure should be reckoned, as per the existing norm, *viz.*,

- before commencement of disbursement, the sanctioned limit or the extent up to which the FI has entered into commitment with the borrowing entity in terms of the agreement, as the case may be; and
- after commencement of disbursement, the aggregate of the outstanding amount *plus* the undisbursed or undrawn commitment.

5.12 Investments of FIs in mortgage backed securities would constitute an exposure not to the housing finance company originating the housing loan, which was securitised, but to the pool of assets / mortgages / obligors underlying such securities. The investing institution, therefore, should guard against the concentration of exposure to a particular industry / sector, institution or a geographical area. In case of a large number of underlying obligors, the exposure may be treated against the sector to which the pool of assets belongs. Thus, exposures need to be measured with reference to the industry or sector to which a security actually belongs.

Box V.1: Investment Norms for Financial Institutions*

No.	Items	Norms
1.	Holding Period	• Till maturity for investments 'Held to Maturity' (HTM). • No prescribed period for investments 'Available for Sale' (AFS). • Not more than 90 days for investments 'Held for Trading' (HFT).
2	Amount	• The investments included under HTM should not exceed 25 per cent of the bank's total investments. • Freedom to decide on the extent of holdings for AFS and HFT.
3.	Eligible Instruments	• Only fixed income securities are to be classified under the HTM category. However, certain exceptions in respect of preference shares, equity in joint ventures and subsidiaries, bonds / debentures in the nature of advance have been permitted. • Fis are free to decide on the quantum and nature of investments to be placed in AFS and HFT categories.
4.	Method of Valuation	• HTM: Mark to market is not necessary. To be carried at acquisition cost unless acquisition cost is more than face value, where premium is to be amortised over the period remaining to maturity.

	• AFS: Mark to market - annually or more frequently. Net appreciation in each classification is to be ignored, net depreciation is to be provided for. • HFT: Mark to market - monthly or more frequently. Net appreciation and depreciation can be taken to income account.
5. Valuation of Specific Instruments	Market value for the purpose of valuation. Investments in the AFS and HFT categories would be the market price of the scrip as available form various sources like stock exchanges, Primary Dealers Association of India (PDAI), Fixed Income Money Market and Derivatives Association (FIMMDA), *etc*. In respect of unquoted securities the procedure is as under:
a) Central Government Securities	• YTM Rates put out by PDAI / FIMMDA. • Treasury Bills at carrying cost.
b) State Government Securities	50 basis points above YTM of Central Government securities of equivalent maturity put out by PDAI / FIMMDA.
c) Other approved Securities	25 basis points above the yields of the Central Government securities of equivalent maturity put out by PDAI / FIMMDA.
d) Debentures/ Bonds	All debentures / bonds, other than those which are in the nature of advance, should be valued on YTM basis. Such debentures may be of different companies having different ratings. These will be valued with appropriate mark-up over the YTM rates for Central Government securities as put out by PDAI / FIMMDA periodically. The mark-up will be graded according to the ratings assigned to the debentures / bonds by the rating agencies. The unrated / quoted instruments with arrears of dues are to be valued in the manner specified.
e) Preference Shares	The valuation of preference shares should be on YTM basis. These will be valued with appropriate mark-up (according to the rating assigned by the rating agencies) over the YTM rates for Central Government securities put up by the PDAI / FIMMDA periodically subject to the specified conditions.
f) Equity Shares	Investment in equity shares as part of the project finance should be compulsorily placed in the AFS category. Such equity should be valued by notionally extending to it the asset-classification of the outstanding loans of the issuing company and provision for depreciation in the value of equity made accordingly. In case the said loans are in the standard category, provision as applicable to the standard loan assets would be required for the depreciation in the equity value but in case the loans are in the doubtful category, the equity held should be treated as an unsecured facility and fully provided for. - Other investments in equity shares should be valued at: • Market price, if quoted. • Break-up value if not quoted. • Re 1 per company, if balance sheet is not available. - Thinly traded shares, as defined by the Reserve Bank, should be valued in the manner specified.
g) Mutual Fund Units	Investment in quoted mutual fund units should be valued as per stock exchange quotations. Investment in non-quoted mutual fund units is to be valued on the basis of the latest re-purchase price declared by the mutual fund in respect of each particular scheme. In case of funds with a lock-in period, where repurchase price / market quote is not available, Units could be valued at net asset value (NAV). If NAV is not available, these could be valued at cost, till the end of the lock-in period.
h) Commercial Paper	Commercial paper should be valued at the carrying cost.

* The entire investment portfolio of the FIs (including SLR securities and non-SLR securities) should be classified under three categories, *viz*,. ‘Held to Maturity’, ‘Available for Sale’ and ‘Held for Trading’.

5.13 The norms relating to credit exposures were modified and the non-fund based exposures are presently to be reckoned at 100 per cent value, instead of the present limit of 50 per cent. For

determining the credit exposure in respect of forward contracts in foreign exchange, and other foreign exchange derivative products, such as, currency swaps or options, these should be included at their replacement cost in determining the individual / group borrower exposures. The Reserve Bank has suggested to FIs two methodologies for arriving at the 'replacement cost' of derivatives, *viz.*, Original Exposure Method and Current Exposure Method. Under the Current Exposure Method, the FIs need to mark-to-market derivative products at least on a monthly basis and they may follow their internal methods for determining the mark-to-market values of the derivative products. However, FIs will not be required to calculate potential credit exposure for single currency floating / floating interest rate swaps. The credit exposure on these contracts will be evaluated solely on the basis of their mark-to-market value. The FIs are encouraged to follow, with effect from April 1, 2003, the Current Exposure Method, which is a more accurate method of measuring credit exposure in a derivative product, for determining individual / group borrower exposures. In case an FI is not in a position to adopt the Current Exposure Method, it may follow the Original Exposure Method. However, its endeavour should be to move over to Current Exposure Method in course of time[2].

3. Supervision and Audit

Consolidated Accounting and Consolidated Supervision

5.14 The consolidated supervision of financial intermediaries has acquired special significance in the Indian context due to the emergence of complex group structures. The primary objective of consolidated supervision is to evaluate the strength of an entire group taking into account all the risks (including those arising from the operations of related entities) that may affect the supervised entity in the group. This is regardless of whether these risks are carried in the books of the supervised entity or the entities related to it. Failures of large and established international banks in the past on account of the operations of their subsidiaries illustrate the magnitude of such risks. Against this background, the Reserve Bank had set up a multi-disciplinary Working Group on Consolidated Accounting and Other Quantitative Methods to Facilitate Consolidated Supervision (Chairman: Shri Vipin Malik) which submitted its recommendations in December 2001. Draft guidelines were issued on the basis of the recommendations of the Working Group and with appropriate modifications for the select all-India FIs. As the availability of appropriate management information system (MIS) is a prerequisite to support the consolidated supervision, the FIs were advised to build up the requisite MIS for the purpose of development of the database.

5.15 In light of the feedback received from the FIs, the Reserve Bank issued final guidelines on August 1, 2003 to be implemented for the year 2003-04. The supervisory framework for consolidated supervision of the FIs comprises the following three components, *viz.*, (a) consolidated financial statements; (b) consolidated prudential returns; and (c) application of prudential regulations like capital adequacy, large exposures and liquidity gaps on group-wide basis.

Rotation of Auditors

5.16 Instances of auditors being appointed by certain FIs for a long period were examined by the

Reserve Bank, and FIs were advised to ensure rotation of the partner of the audit firm conducting audit, if the firm continues for more than four years.

Computer Audit

5.17 Pursuant to the directions of the Audit Sub-Committee of the Board for Financial Supervision (BFS), a 'Committee on Computer Audit' was constituted in October 2001 with members from the Reserve Bank, Institute of Chartered Accountants of India and select commercial banks. The Report was forwarded to FIs in December 2002 for its consideration by their Board of Directors. The Committee classified the possible areas of audit interest in the information system environment into 15 broad categories and prepared 'standardised checklists' under each category to facilitate the conduct of computer audit[3]. These checklists are only in the nature of guidelines and FIs are free to develop more elaborate checklists to conduct Information System Audit suitable to the information technology environment in which they operate and propose to operate.

Modification of Audit Review and Reporting System

5.18 The submission of the monthly concurrent audit report by the FIs to Reserve Bank has been replaced with half-yearly reviews of the investment portfolio of FIs. Such reviews need to include the major irregularities, if any, observed in the concurrent audit report of the treasury transactions during the half-yearly reporting period.

Supervisory Rating System for the FIs

5.19 A supervisory rating model for the FIs has been developed based on capital adequacy, asset quality, management, earnings, liquidity and systems (CAMELS) and introduced from the annual financial inspections conducted with reference to the position as on March 31, 2002 (June 30, 2002 in case of the National Housing Bank). The basic purpose of assigning the supervisory rating is to provide a summary measure of the performance and health of the FI concerned for requisite supervisory intervention.

On-site inspection

5.20 The Reserve Bank has been undertaking on-site inspection of nine FIs under section 45N of the Reserve Bank of India Act, 1934 from 1995 onwards. The annual financial inspection of all nine FIs supervised by the Reserve Bank was taken and completed during the inspection cycle of 2002-03. Further, the inspection cycle of 2003-04 has been set in motion and inspection of all the nine FIs would be taken up with reference to the date of balance sheet of the FIs for the accounting year 2002-03.

Off-site Surveillance System

5.21 The FIs presently submit the off-site returns, *viz.*, Financial Institutions Division -Off-Site Monitoring and Surveillance System (FID-OSMOS) to the Reserve Bank. The review of the performance of the FIs based on the off-site returns submitted by them is being presented to the

Board for Financial Supervision (BFS) on a quarterly basis. During 2002-03 (July-June), the BFS reviewed three quarterly and one annual reviews. The latest quarterly report placed before the BFS related to the quarter ended June 2003. The Board reviewed overall and institution-specific issues, such as, utilisation of special reserves for provisioning or meeting other liabilities, scope of the Reserve Bank regulation and supervision of FIs, negative spreads observed in the FIs, NPA levels of FIs, financial position of FIs, inspection reports of FIs, restructuring of assets and liabilities of FIs and their asset quality. The BFS provides guidance on matters of regulatory and supervisory policy issues. It also gives directions on specific issues which are complied with promptly. Based on the feedback received from the FIs, certain modifications have been undertaken in the software used for the returns to be submitted by FIs.

4. Other Policy Developments

Connected Lending

5.22 Matters relating to "connected lending" by FIs have been engaging the attention of the Reserve Bank and in consultation with the Government of India, detailed guidelines were issued to FIs (Box V.2).

Box V.2: Connected Lending by the select All-India Financial Institutions

In order to obviate the possibility of conflict of interest in the lending operations of the FIs, it has been decided in consultation with the Government of India that the FIs should not:
(a) grant any loan or advance on the security of its own shares; or
(b) enter into any commitment for granting any loan or advance to or on behalf of:
(i) any of its Directors, or
(ii) any firm or company (with some exceptions) in which any of its Directors is interested as Partner, Manager, Employee or Guarantor, or
(iii) any individual in respect of whom any of its Directors is a Partner or a Guarantor.
While extending non-fund based facilities, such as, guarantees, Letters of Credit (LCs), acceptances, on behalf of Directors and the companies / firms in which the Directors are interested, the FIs were advised to ensure that:
(a) adequate and effective arrangements have been made so that the commitments would be met by the applicants out of their own resources;
(b) the FI will not be called upon to grant any loan or advance to meet the liability consequent upon the invocation of guarantee or devolvement of LCs; and
(c) no liability would devolve on the FI on account of LCs / acceptances.

Furthermore, without prior approval of the Board or without the knowledge of the Board, no loans or advances should be granted, except to the extent permitted, to the undernoted categories of counterparties:

(a) relatives of the FI's Directors (including Chairman / Managing Director);
(b) Directors of other FIs and banks and their relatives;
(c) Directors of subsidiaries / trustees of mutual funds/ trustees of venture capital funds set up by the financing FIs or other FIs and banks, and their relatives.

In order to obviate the possibility of development of reciprocal arrangements amongst the FIs / banks, sanction by the Board of Directors / Management Committee is required for advances, aggregating Rs. 25 lakh and above for the abovementioned categories of borrowers. The proposals for credit facilities of an amount less than Rs.25 lakh to these borrowers may be sanctioned by the appropriate authority in the financing FI, but the matter should be reported to the Board.

In cases where the FIs have already entered into transactions covered within the prohibitions stipulated above, immediate steps should be initiated to recover the amounts due to the FI within the period stipulated at the time of grant of the loan or advance, or where no such period has been stipulated, before December 21, 2003. In case of any difficulty in complying with the foregoing provisions, the Reserve Bank may extend the period for the recovery of the loan or advance but not beyond the period of three years.

The above norms relating to grant of loans and advances will equally apply to awarding of contracts.

Transactions in Dematerialised form

5.23 The Reserve Bank has over a period of time, been encouraging the holding of government securities in dematerialised mode. FIs were advised to comply fully with Reserve Bank instructions whereby they should necessarily hold their investments in Government securities in either of the following entities, *viz.*, a) Subsidiary General Ledger (SGL) (with the Reserve Bank) or Constituent Subsidiary General Ledger (CSGL)[4], b) Stock Holding Corporation of India Ltd. (SHCIL), and c) in a dematerialised account with depositories.[5] Only one CSGL or dematerialised account can be opened by any such entity. In case the CSGL accounts are opened with a scheduled commercial bank or state cooperative bank, the account holder has to open a designated funds account (for all CSGL related transactions) with the same bank. In case a CSGL account is opened with any of the non-banking institutions, the particulars of the designated funds account (with a bank) should be intimated to that institution. The entities maintaining the CSGL / designated funds accounts will be required to ensure availability of clear funds in the designated funds accounts for purchases and of sufficient securities in the CSGL account for sales before putting through the transactions. No further transactions by a regulated entity should be undertaken in physical form with any broker. A specific time-frame has been separately indicated for each category of regulated entities to comply with these guidelines. Extension of dates for compliance, however, would be considered by the Reserve Bank in case of those having genuine difficulties in meeting the time schedule.

Issue of Certificates of Deposits (CDs)

5.24 In compliance with the announcement of the annual Monetary and Credit Policy Statement of April 2002, the Fixed Income Money Market and Derivatives Association (FIMMDA) issued standardised procedures, documentation and operational guidelines for issue of CDs on June 20, 2002. In order to impart more transparency and to encourage secondary market transactions, the existing outstanding CDs were required to be converted into demat form by October 2002. The

existing regulations require CDs to be issued at a discount to face value and the issuing bank is free to determine the discount rate. With a view to providing more flexibility for pricing of CDs and to give additional choice to both investors and issuers, banks and FIs may issue CDs on floating rate basis provided the methodology of computing the floating rate is objective, transparent and market-based. The interest rate on floating rate CDs would have to be reset periodically in accordance with a predetermined formula that indicates the spread over a transparent benchmark. The standard procedures and documentation in this regard would be issued separately by FIMMDA in consultation with market participants.

5. Review of Operations

Financial Assistance: Sanctioned and Disbursed

5.25 The rising trend in financial assistance sanctioned and disbursed by all-India FIs (AIFIs)[6] during 1996-2000 was reversed during 2001-02 and the sharp declining trend continued during 2002-03 (Chart V.2 and Table V.2). The merger of ICICI with ICICI Bank explains a part of the decrease in financial assistance. Sanctions and disbursements, however, increased sharply during April-September 2003.

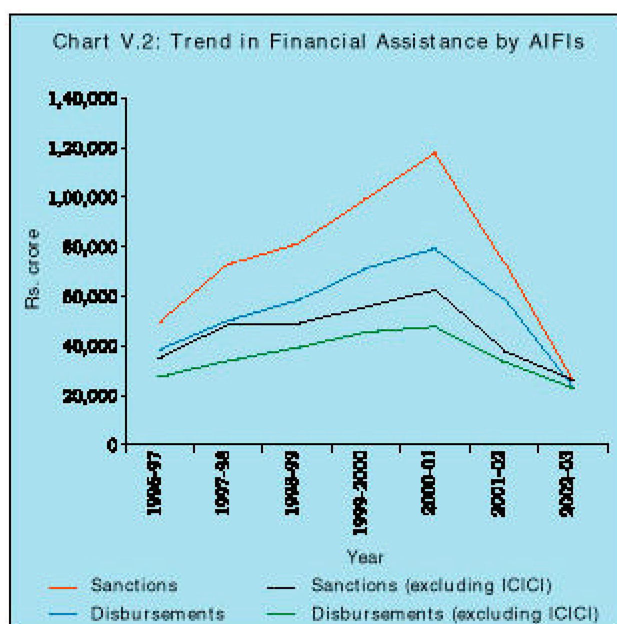


Table V.2: Financial Assistance Sanctioned and Disbursed by Financial Institutions

(Year: April-March)

(Amount in Rs. crore)

	Institution	2001-02		2002-03		Percentage variation during 2002-03	
		S	D	S	D	S	D
	1	2	3	4	5	6	7
A.	All India Development Banks (IDBI, IFCI, SIDBI, IIBI, IDFC)	27,619	20,725	19,335	14,501	-30.0	-30.0
B.	Specialised Fis (IVCF, ICICI Venture, TFCI)	873	869	475	490	-45.6	-43.6

C.	Investment Institutions (LIC, UTI, GIC #)	9,363	11,668	6,200	8,112	-33.8	-30.5
D.	**Total Assistance by All-India FIs (A+B+C)**	**37,855**	**33,262**	**26,010**	**23,103**	**-31.3**	**-30.5**

S : Sanctions D : Disbursements

: Data include GIC and its former subsidiaries.

Source : Respective FIs and IDBI for UTI.

5.26 Sanctions and disbursements essentially constitute gross financial assistance by FIs to the commercial sector, in terms of, *inter alia*, project loans, venture capital, underwriting, direct subscription, guarantees, non-project finance, refinance, bills rediscounting, direct discounting, loans and subscription to shares / bonds of FIs, and loans to leasing companies. This provides a lead to the investment climate, in terms of planned investments and their fructification. Due to existence of alternative sources of project finance for the Indian corporates, as well as reflecting the paucity of new business in view of the economic slowdown, the net flow of resources from FIs in recent years have shown some downturn. Illustratively, net flow of resources from all-India Development Banks to the corporate sector continued to be negative both for 2001-02 and 2002-03 (Table V.3).

Table V.3: Resource Flow from All-India Development Banks to the Corporate Sector*

(Rs. crore)

Item	2001-02	2002-03
1	2	3
Sanctions	27,619	19,335
Disbursements	20,725	14,501
Credit	-4,706	-5,321
of which:		
Investments in stocks / shares / bonds / debentures of industrial Concerns	762	-1,105
Loans and advances to Industrial concerns	-4,571	-2,960
Bills of Exchange and promissory notes discounted and rediscounted	-897	-1,256

* Includes IDBI, IFCI, IDFC, IIBI and SIDBI.

5.27 The subdued performance of the FIs is consistent with the general receding contribution of the FIs in the financing pattern. Nevertheless, sluggish capital market, lack of demand for new projects and increase in industrial production through utilisation of unused capacities all may have contributed to lower demand for long-term financial assistance. Even in the area of project finance, a core function of FIs, there is some attenuation of the role of FIs (Box V.3). Besides, the commercial banks, due to their access to low cost of funds, in view of the relatively shorter maturity structure of their liabilities, were able to lend at a relatively lower rates as compared to the FIs. Delays in implementation of projects could have also hindered the demand for fresh financial assistance. Furthermore, the recent spurt in the growth of the services sector may not have generated commensurate demand for project finance, as most of the service industries are human capital intensive with limited requirement of long-term finance. During 2002-03, the financial assistance sanctioned and disbursed by select all-India FIs as well as investment institutions showed a further decline than the previous year (Appendix Table V.1).

Box V.3: Declining Role of Financial Institutions in Project Financing

Project financing, being the core activity of the FIs, is a component of direct finance and accounts for a substantial share in their total sanctions and disbursements. However, with financial liberalisation, banks have also started financing projects and, thus, have been competing with FIs. During 2002-03, assistance sanctioned towards project finance by all-India FIs (including insurance institutions but excluding UTI) declined sharply. A similar trend was also seen in disbursements.

The withdrawal of concessional sources of funds and restrictions on raising short-term funds of maturities of less than one year forced the FIs to raise high cost funds directly from a relatively under-developed long-term debt market. The blue-chip companies could raise financial resources for industrial projects directly from the capital market more cost effectively. Thus, FIs financed mostly riskier industrial projects which were unable to raise funds directly from the market. Among others, they financed large-scale infrastructure projects carrying low returns and long gestation periods. With the opening up of infrastructure and core sectors to private sector investment, there was an initial spurt in lending to these sectors on account of expected opportunities. As the FIs could raise resources only at high fixed rates of interest for lending to industrial projects, over the long-term, their operations became unsustainable in the face of declining interest rates over a period.

As can be seen from Table A, the share of equity capital (including preference capital) in the financing of projects increased significantly during the 1990s. Thus, the overall share of loans and bonds / debentures in financing of projects decreased during the same period.

Component-wise, of the total loan financing of projects, it has been found that the share of Development Financial Institutions (DFIs) declined during the 1990s, while the share of banks rose from a low level during 1985-90 by more than double during 1995-2001, thereby overtaking the position of FIs in project finance. Thus, DFIs have been facing competition from banks as well as the capital market in their core business of project financing. Further, as several DFIs had to borrow from the market for a relatively shorter tenure of 3-4 years and invest in projects with long gestation periods, the locking up of funds in projects adversely affected their cash flows and led to a further maturity mismatch in assets and liabilities.

Table A: Share of Different Sources in Project Finance

(as percentage of total project cost)

Period	No. of Companies	Equity	Reserves and Surplus	Loan	Bonds / Debentures	Others
1	2	3	4	5	6	7
1970-71 to 1974-75	356	28.5	12.2	53.5	4.4	1.4
1975-76 to 1979-80	408	32.0	5.1	59.8	0.9	2.2
1980-81 to 1984-85	1,554	26.9	8.3	49.2	14.1	1.5
1985-86 to 1989-90	1,620	41.4	1.6	30.0	26.2	0.8
1990-91 to 1994-95	2,040	47.0	1.9	43.4	7.1	0.6
1995-96 to 2000-01	1,012	53.0	0.3	43.0	3.4	0.3

Note : Data are for all non-financial and non-Government companies which issue prospectus.
Source: Department of Company Affairs, Ministry of Finance, Government of India.

Asset and Liability Structure of FIs

5.28 The balance sheet of select FIs, as a group, showed a growth of 5.7 per cent during 2002-03 over the previous year. The pattern of liabilities, however, remained broadly similar to that of the previous year. Bonds / debentures constituted a major share in the total, as bonds / debentures provide more flexibility of structuring with call / put options as also the tradable facility in the secondary market by way of listing on the stock market. With interest rate liberalisation and general softening of the interest rates, especially the deposit rates, deposits of the FIs improved its share while the share of borrowings declined during the year (Table V.4).

5.29 The composition of assets similarly did not register any marked change. Loans and advances, the dominant component, recorded a marginal decline in its share, reflecting the decline in the sanctions and disbursements of loans and advances. As the activities in the capital market continued to remain subdued during the major part of 2002-03, there was a marginal decline in the share of investments (Table V.4).

Table V.4: Composition of Liabilities and Assets of Financial Institutions

(Amount in Rs. Crore)

Item	Outstanding as at end-March		Distribution (per cent)	
	2001-02	2002-03	2001-02	2002-03
1	2	3	4	5
Liabilities	**1,73,900**	**1,83,751**	**100.0**	**100.0**
Capital	6,811	6,784	3.9	3.7
Reserves	16,836	18,259	9.7	9.9
Bonds and Debentures	83,595	89,639	48.1	48.8
Deposits	15,088	20,144	8.7	11.0
Borrowings	24,400	21,862	14.0	11.9
Other Liabilities	27,170	27,063	15.6	14.7
Assets	**1,73,900**	**1,83,751**	**100.0**	**100.0**
Cash	5,628	8,014	3.2	4.4
Investments	21,671	21,760	12.5	11.8
Loans and Advances	1,31,510	1,36,823	75.6	74.5
Bills Discounted/ Rediscounted	2,987	1,606	1.7	0.9
Fixed Assets	3,226	2,988	1.9	1.6
Other Assets	8,878	12,560	5.1	6.8

Note : Data include IDBI, IFCI, IIBI, IDFC, TFCI, Exim Bank, NABARD, NHB and SIDBI
Source : Balance Sheets of respective FI.

Sources and Uses of Funds

5.30 Total sources and deployment of funds of FIs (excluding ICICI) declined by 2.1 per cent during 2002-03 as against an increase of 19.8 per cent in the previous year. In view of the large liquidity overhang in the system and the continuance of the declining interest rate environment, the dependence on external funds increased during the year. The share of internal sources in the total continued to account for half of the total resources though its share declined as compared with the previous year (Table V.5).

Table V.5: Pattern of Sources and Deployment of Funds of Financial Institutions*

(Amount in Rs. Crore)

Sources / Deployment of Funds	2001-02		2002-03	
	Amount	Share (per cent)	Amount	Share (per cent)
1	2	3	4	5
Sources of Funds	**97,613**	**100.0**	**95,562**	**100.0**
Internal	51,241	52.5	49,048	51.3
External	28,438	29.1	32,280	33.8
Other Sources	17,934	18.4	14,234	14.9
Deployment of Funds	**97,613**	**100.0**	**95,562**	**100.0**
Fresh Deployments	48,289	49.5	52,028	54.4
Repayment of past borrowings	20,815	21.3	17,478	18.3
Other Deployments	28,509	29.2	26,056	27.3
of which: Interest Payments	14,222	14.6	10,733	11.2

* Financial Institutions comprise IDBI, IFCI, IIBI, Exim Bank, TFCI, IDFC, NABARD, SIDBI and NHB.

Note : Share is expressed as a percentage of total of that category.

5.31 With the pick up in industrial production in the later part of 2002-03, the share of fresh deployments in the total uses of funds showed an increase. Taking advantage of the falling interest rate environment, the FIs retired their high cost old debt and replaced it with cheaper debts; despite that the share of repayment of borrowings fell during 2002-2003 as against an increase in the previous year. Other deployments also came down on account of a decline in the interest payments. The combined share of repayment of past borrowings and interest payment during 2002-03 is higher than that of share of external sources of funds. This implies that internal or other sources of funds are being used to meet the repayment of the high cost borrowings of the past (Appendix Table V.2).

Financial Assets of all-India FIs

5.32 The modest acceleration in financial assets of FIs could be attributed to a mild pick up in the economic activity in the latter half of the year and financial restructuring of some of the FIs in the current year as against the slow pace of economic activity in the previous year. Institution-wise, Exim Bank registered maximum rise followed by NHB, IDFC, NABARD, and IFCI, while IDBI recorded the maximum decline [Appendix Table V.3 (A)]. During 2002-03, the growth of aggregate financial assets of banks and FIs accelerated as compared to the previous year. The growth in the financial assets of banks was sharper as compared to the FIs resulting in a modest increase in the share of banks in total assets [Table V.6 and Appendix Table V.3 (B)].

Table V.6: Financial Assets* of All-India Financial Institutions and Banks

(Amount in Rs. crore)

	As at the end of March		Variation during
	2002	2003	2002-2003
1	2	3	4
A.All-India Financial Institutions	1,70,247	1,82,223	11,976 (7.0)

B.Scheduled Commercial Banks#	12,23,008	13,98,967	1,75,959 (14.4)
C. Total (A+B)	**13,93,255**	**15,81,190**	**1,87,935 (13.5)**
Memo:			
FIs' assets as percentage of total assets	12.2	11.5	
SCBs' assets as percentage of total assets	87.8	88.5	

* Include investment, loans and advances, money market assets, deposits, cash in hand and balances with banks and other assets excluding fixed assets.
# As per returns under Section 42 of the Reserve Bank of India Act, 1934 and include cash in hand and balances with the banking system, investments, bank credit and dues from banks. Hence, it does not include non-SLR investments, foreign currency assets and bank reserves.
Note: Figures in brackets are percentage changes.

Financial Performance of FIs

5.33 During the financial year ended March 2003, the performance of all-India FIs as a group showed further deterioration over the previous year on account of declines in spread and non-interest income and rise in other expenses. IFCI and IIBI registered losses during the year. Excluding these two institutions, all FIs, however, registered positive operating and net profit. It is significant to note that, notwithstanding the decline in operating profit, the increase in net profit for all FIs was achieved through a sharp decline in tax provisions (Table V.7). In order to enhance transparency, FIs are required to provide additional financial parameters from 2000-01 (Appendix Table V.4). IFCI recorded some improvement in return on average assets and net profit per employee but the ratios continued to remain in the negative zone.

Table V.7: Financial Performance of Select All India Financial Institutions@

(Amount in Rs. Crore)

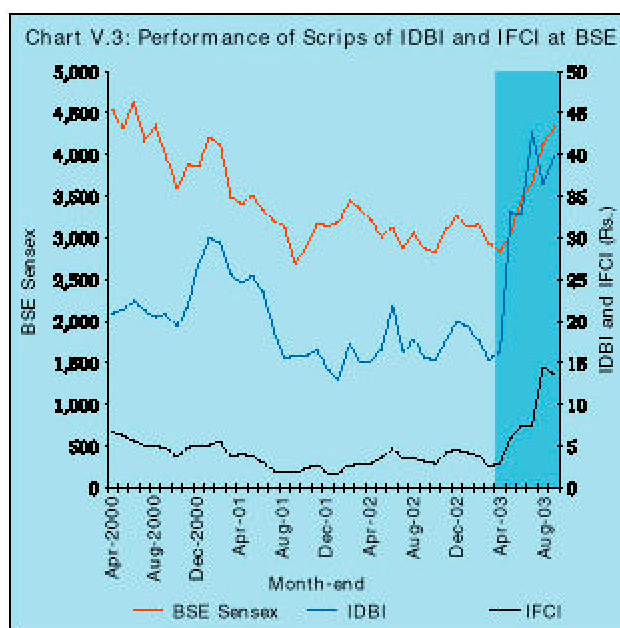
Item		2001-02	2002-03	Variation during 2002-03	
				Amount	Percentage
1		2	3	4	5
1.	**Income (a+b)**	**17,206**	**15,822**	**-1,383**	**-8.0**
	a) Interest Income	14,391	13,194	-1,197	-8.3
	b) Non-interest Income	2,815	2,628	-187	-6.6
2.	**Expenditure (a+b)**	**14,443**	**13,182**	**-1,261**	**-8.7**
	a) Interest expenditure	13,284	11,825	-1,459	-11.0
	b) Other Expenses	1,159	1,358	198	17.1
	Of which: Wage Bill	404	391	-13	-3.2
	c) Provisions for Taxation	1,501	947	-553	-36.9
3.	**Profit**				
	Operating Profit	2,763	2,640	-122	-4.4
	Net Profit	1,262	1,693	431	34.2
4.	**Financial Ratios (as percentage of Total Assets)**				
	Operating profit	1.6	1.4		
	Net Profit	0.7	0.9		
	Income	9.9	8.6		
	Interest Income	8.3	7.2		
	Other Income	1.6	1.4		

Expenditure	8.3	7.2
Interest Expenditure	7.6	6.4
Other Operating Expenses	0.7	0.7
Wage Bill	0.2	0.2
Tax Provisions	0.9	0.5
Spread (Net Interest Income)	0.6	0.7

@ Include IDBI, IFCI, IIBI, TFCI, IDFC, Exim bank, NABARD, NHB and SIDBI.
Notes : 1. In case of NHB, net profit is after deduction of transfer to IFR.
2. Net profit refers to profit after taxation.
Source : Annual accounts of respective FI.

Performance of FIs' Scrips / Stocks

5.34 Of the nine FIs under the Reserve Bank's regulatory domain, two FIs (*viz.*, IDBI and IFCI) are listed on the National Stock Exchange (NSE) and The Stock Exchange, Mumbai (BSE). The performance of stocks of IDBI and IFCI was rather lacklustre during 2002-03. Nevertheless, since April 2003, there has been significant recovery in the stock prices of these two FIs. This may be attributed to the restructuring packages of these two institutions offered by the Government supported by the general upbeat confidence witnessed in the stock prices of financial intermediaries (Chart V.3).



Prime Lending Rate (PLR)

5.35 In line with the downward trend in the general interest rate during 2002-03, the long-term PLRs of IDBI also declined during the year under review. The medium-term and short-term PLR of IDBI, however, remained unaltered. In case of IFCI the long- and short-term PLRs remained unchanged (Table V.8).

Table V.8: Lending Rate Structure of Major Financial Institutions

(Per cent per annum)

Effective from	PLR	IDBI	IFCI

1	2	3	4
March 2001	Long-term PLR	14.0	13.0
	Medium-term PLR	12.5	—
	Short-term PLR	12	12.5
July 2001	Long-term PLR	13.1	13.0
	Medium-term PLR	12.5	-
	Short-term PLR	12.0	12.5
March 2002	Long-term PLR	11.5	12.5
	Medium-term PLR	12.5	—
	Short-term PLR	12.0	12.5
July 2002	Long-term PLR	10.7	12.5
	Medium-term PLR	12.5	—
	Short-term PLR	12.0	12.5
March 2003	Long-term PLR	10.2	12.5
	Medium-term PLR	12.5	—
	Short-term PLR	12.0	12.5

Note :Interest rates are exclusive of interest tax unless stated otherwise. PLR = Prime Lending Rate.
Source:Respective FIs.

Capital Adequacy

5.36 The performance of select FIs in respect of maintenance of a minimum capital to risk-weighted assets ratio (CRAR) reveals that, except IFCI and IIBI, all FIs had a CRAR much above the norm of 9 per cent during 2002-03. IFCI, in recent years, has been facing the problem of asset-liability mismatches, arising out of bunching of repayments as also requirement for meeting heavy provisioning due to high NPAs and consequent financial loss. All these factors have led to erosion of IFCI's capital. Furthermore, raising resources in a cost-effective manner has become difficult due to downgrading of IFCI by the rating agencies. Consequently, shoring up of capital by way of fresh issue of equity has become difficult. In order to mitigate this problem and augment its capital, the Government initiated a capital restructuring package. In the case of IIBI, accumulation of high NPAs and consequent provisioning coupled with the problem of declining profitability contributed to the sharp decline in its CRAR (Table V.9).

Table V.9: Capital Adequacy Ratio of Select Financial Institutions
(end-March)

(Per cent)

Institution	1997	1998	1999	2000	2001	2002	2003
1	2	3	4	5	6	7	8
1. IDBI	14.7	13.7	12.7	14.5	15.8	17.9	18.72
2. IFCI	10.0	11.6	8.4	8.8	6.2	3.1	-2.95
3. IIBI	10.6	12.8	11.7	9.7	13.9	13.6	3.51
4. IDFC	N.A.	N.A.	235.5	119.7	85.5	56.9	57.13
5. Exim Bank	31.5	30.5	23.6	24.4	23.8	33.1	26.92
6. TFCI	N.A.	16.4	15.4	16.2	18.6	18.5	20.85
7. SIDBI	31.5	30.3	26.9	27.8	28.1	45.0	43.92
8. NABARD	40.4	52.5	53.3	44.4	38.5	36.9	41.59
9. NHB	N.A.	16.7	17.3	16.5	16.8	22.1	22.29

N.A. Not Available
Source: Respective FIs.

Non-Performing Assets

5.37 There was an increase in net non-performing assets (NPA) of the select FIs during 2002-03. This could be attributed both to the slow economic recovery and to sectoral bottlenecks (like time and cost overruns). The increase in net NPAs in the case of some refinancing institutions as expected was marginal. Nevertheless, in terms of ratio of net NPA to net loans and advances, the performance of term lending institutions like IIBI, IFCI and TFCI has remained a matter of concern (Table V.10 and Appendix Table V.5).

Table V.10: Net Non-Performing Assets*
(end-March)

(Amount in Rs. crore)

	Net NPAs		Ratio of Net NPAs / Net Loans (per cent)	
Institution	2002	2003	2002	2003
1	2	3	4	5
Term Lending Institution	**11,372**	**14,297**	**15.0**	**18.8**
1. IDBI	6,355	7,157	13.4	15.8
2. IFCI	3,873	5,983	22.5	34.8
3. IIBI	539	819	24.1	40.3
4. Exim Bank	448	184	7.4	2.2
5. TFCI	157	152	20.2	20.5
6. IDFC	—	3	0.0	0.1
Refinancing FI	**382**	**474**	**0.7**	**0.7**
7. SIDBI	382	473	3.0	3.8
8. NABARD	—	1	—	—
9. NHB	—	—	—	—
Total	**11,754**	**14,771**	**8.8**	**10.6**

* Net of provisioning and write offs.
Source : Respective FIs.

Mobilisation of Resources by way of Bonds / Debentures by Select all-India FIs

5.38 During 2002-03, total resources mobilised by way of issue of rupee bonds / debentures (including private placement and public issue) by select all-India FIs increased mainly on account of substantial borrowings by IDBI, Exim Bank and NHB (Table V.11). Some of the FIs exercised call options to retire their high-cost borrowings. With the rising demand in the housing sector, NHB mobilised substantial funds for its refinancing operations. Similarly, mobilisation of resources by Exim Bank increased sharply. Consequently, the total outstandings increased at a higher rate as compared with the previous year. Inclusive of other instruments, such as, CDs, CPs, ICDs, term money borrowings, there was a similar increase (Appendix Table V.6).

Table V.11: Resources Raised by Way of Rupee Bonds / Debentures by Select All-India Financial Institutions

(Amount in Rs. crore)

	Resources raised (during the year)		Outstandings (end-March)	
Institution	2001-02	2002-03	2001-02	2002-03

1	2	3	4	5
IDBI	4,213	5,009	45,464	45,280
IIBI	551	150	1,807	1,468
IFCI	651	267	19,789	20,046
TFCI	48	93	689	632
Exim Bank	625	2,505	3,067	5,424
IDFC	250	400	1,000	1,400
SIDBI	1,224	961	3,020	2,498
NABARD	2,549	2,988	6,078	8,703
NHB	238	1,877	3,003	4,675
Total	**10,349**	**14,250**	**83,917**	**90,126**

Source : Respective FIs.

5.39 Of the total resources raised by the select FIs, private placements continued to constitute a major proportion. Private placements are relatively less expensive and less time consuming. During 2002-03, however, the share of private placement declined, due to larger public issues by IDBI, the only FI (among the select group) to access the market through public issues (Table V.12).

Table V.12: Resources Raised through Public Issues / Private Placement of Bonds / Debentures by Select All-India Financial Institutions

(Amount in Rs.crore)

Financial Institution	Public Issue of Bonds/Debentures		Private Placement of Bonds/Debentures		Total	
	2001-02	2002-03	2001-02	2002-03	2001-02	2002-03
1	2	3	4	5	6	7
IDBI	654	2,825	3,559	2,184	4,213	5,009
IFCI	0	0	651	267	651	267
IIBI	0	0	551	150	551	150
IDFC	0	0	250	400	250	400
TFCI	0	0	48	93	48	93
Exim Bank	0	0	625	2,505	625	2,505
NHB	0	0	238	1,877	238	1,877
SIDBI	0	0	1,224	961	1,224	961
NABARD	0	0	2,549	2,988	2,549	2,988
Total	**654**	**2,825**	**9,695**	**11,425**	**10,349**	**14,250**
	(6.3)	**(19.8)**	**(93.7)**	**(80.2)**	**(100.0)**	**(100.0)**

Data are provisional.
Figures in brackets indicate the share in the total resources raised during the year in percentage.
Source: Respective FIs.

5.40 With yields falling across different maturities in Government securities, the weighted average interest rate across FIs at which the resources were mobilised by way of rupee bonds / debentures, declined over the previous year (Table V.13 and Appendix Table V.7). No such general trend was observed in the case of the weighted average maturity of instruments across FIs.

Table V.13: Weighted Average Cost/Maturity of Resources Raised by way of Rupee Bonds/ Debentures by Select All-India Financial Institutions

	Weighted Average Cost (per cent)		Weighted Average Maturity (years)	
Institution	2001-02	2002-03	2001-02	2002-03
1	2	3	4	5

IDBI	10.3	8.4	4.3	2.8
IIBI	12.9	12.8	6.4	7.0
IFCI	11.1	6.8	8.7	5.1
TFCI	10.5	10.1	7.0	8.5
Exim Bank	10.8	8.9	6.4	6.1
IDFC	9.0	7.6	5.0	5.6
SIDBI	7.5	6.6	1.0	2.3
NABARD	8.0	6.1	2.6	3.2
NHB	8.7	6.4	7.4	4.0

Data are provisional.
Source: Respective FIs.

FIs' Money Market Operations

5.41 With a view to moving towards a pure inter-bank call / notice money market, it was announced in the Monetary and Credit Policy Statement for the year 2001-02 on April 19, 2001 that access of non-bank entities, *i.e.*, FIs, mutual funds (MFs) and insurance companies, in this market would be gradually reduced in four stages. Accordingly, as part of Stage I, they were allowed to lend up to 85 per cent of their average lending during 2000-01. Thereafter, since June 14, 2003, as part of Stage II, non-bank entities were permitted to lend, on average in a reporting fortnight, up to 75 per cent of their average lending during 2000-01. Accordingly, the effective limit for twelve FIs (*viz.*, UTI, LIC, IDBI, NABARD, GIC, Exim Bank, NHB, SIDBI, IIBI, ECGCI, IFCI and TFCI) which have been permitted to lend in call / notice money market now stands at Rs. 2,749 crore. As a result, the average daily lending by FIs has declined during the year 2003-04 so far. With effect from fortnight beginning December 27, 2003, non-banks would be allowed to lend, on average in a reporting fortnight, up to 60 per cent of their average daily lending in the call / notice money market during 2000-01.

5.42 During the year 2002-03, one major insurance company had requested for enhanced access to the call / notice money market in view of unexpected large inflows and the Reserve Bank accorded the permission for a limited period.

5.43 Nine institutions, *viz*., IDBI, IFCI, EXIM Bank, SIDBI, IIBI, TFCI, NABARD, IDFC and NHB are given umbrella limits to raise resources equivalent to 100 per cent of their net owned fund (NOF) as per their latest audited balance sheet. They are permitted by the Reserve Bank to raise resources by way of term money, issue of CDs and CPs, acceptance of term deposits and Inter-Corporate Deposit (ICDs), wherever applicable.

5.44 The average aggregate amount of resources raised by the FIs by way of these instruments declined from Rs. 10,081 crore (32.9 per cent of limits) for the year 2001-02 to Rs. 6,472 crore (25.6 per cent of limits) for the year 2002-03 (Table V.14). ICDs and term deposit continued to remain the most preferred instrument followed by CPs, CDs and term money.

5.45 During the first half of 2003-04, the average aggregate amount of resources raised by the FIs by way of these instruments declined further.

Reserve Bank Assistance to FIs

5.46 During 2002-03 (July-June), no long-term assistance was sanctioned by the Reserve Bank to any FI. While there were no outstanding long-term borrowings with any institution under the National Industrial Credit (Long Term Operations) funds as at end-June 2003, the outstanding credit to NHB under the National Housing Credit (Long Term Operations) funds was Rs.175 crore as at end-June 2003 (Table V.15). The Reserve Bank sanctioned *ad hoc* borrowing limits aggregating Rs.166 crore to State Financial Corporations (SFCs) during 2002-03 at the Bank Rate, against *ad hoc* bonds guaranteed by the respective State Governments/ Union Territories for not less than two years.

Table V.14: Money Market Operations of select All-India Financial Institutions

(Rs. crore)

Sr. No.	Instrument	2002-03	2003-04	2002-03
1	2	3	4	5
I.	**Average Lendings**		(Up to October 3, 2003)	(Up to October. 4, 2002)
	1. Call / Notice Money	2,508	1,903	2,763
II.	**Average Borrowings**		(Up to September 5, 2003)	(Up to September. 6, 2002)
	1. Term Money	373	202	476
	2. Term Deposit	1,548	2,253	1,183
	3. Inter Corporate Deposits	3,078	1,760	4,193
	4. Certificates of Deposit	504	397	519
	5. Commercial Paper	964	1,649	552
	Total #	**6,467**	**6,261**	**6,923**

: Total may not tally due to rounding off.

Table V.15: RBI Assistance to FIs

(Amount outstanding in Rs.crore)

Type of Assistance	June 30, 2002	June 30, 2003
1	2	3
Long Term Credit [NHC(LTO)Fund]		
NHB	175.0	175.0
Medium / Short Term Credit		
SFCs	30.8	17.0
Total	**205.8**	**192.0**

Notes :
(1) RBI's assistance to FIs under long-term credit NIC (LTO) is nil for both the years.
(2) Medium/short-term credit to IDBI was nil for both the years.

Role of FIs in Technological Progress

5.47 Banks, the major competitors of FIs, have a wide network of branches, and diversified portfolios especially in short-term assets and liabilities, and limited deposit insurance by virtue of being part of the payment and settlement system. The spread ratio, a major determinant of profitability, ruled much higher in the case of banks *vis-à-vis* FIs. Predominance of short-term

liabilities in the balance sheet of banks, however, restrain the banks from lending large long-term loans in keeping with the prudent principles of asset liability management. FIs are advantageously placed in extending investment credit at minimal transaction cost *vis-à-vis* banks.

5.48 The contribution of a particular group of FIs, *viz.*, DFIs have been particularly significant in a specific field, *viz.*, technological progress. In absence of institutions like Venture Capital Funds, DFIs acted as important technology policy vehicles as they promote knowledge creation and their absorption by an economy. Cross-country as well as the Indian experience is replete with examples where DFIs played a significant role in technological innovation (Box V.4).

6. Restructuring of Financial Institutions

5.49 Around the world, the FIs, mostly established and supported by the Government, have diversified / restructured due to changes in their operating environment in recent years, in many countries (Box V.5). The financial liabilities of two major FIs, *viz.*, IDBI and IFCI Ltd., were restructured during the year with the intervention of the Government of India to bring down the cost of funds of these FIs.

Restructuring package for IDBI

5.50 As part of the restructuring exercise of IDBI, under the aegis of Government of India, a consensus was reached that on maturity of the existing investments / bonds, PSU banks / FIs having exposure to IDBI would rollover their investments in IDBI for a further similar period of maturity. The re-investment would be at the rates of interest prevailing in the market at the time of reinvestment. IDBI would continue to service the interest on its existing borrowings at the originally contracted rate of interest. However, Government would reimburse the difference between the contracted rate and 8 per cent to IDBI.

Industrial Development Bank of India (Transfer of Undertaking and Repeal) Bill, 2002

5.51 With the Narasimham Committee's recommendations for conversion of DFIs into either commercial bank or non-banking finance companies, followed by the suggestion of the Working Group for Harmonising the Role and Operations of DFIs and Banks (Chairman: Shri S.H.Khan) for IDBI's conversion into a bank, the Government had proposed necessary legislative changes in its Budget 2002-03 to corporatise IDBI within the next year. Accordingly, Industrial Development Bank of India (Transfer of Undertaking and Repeal) Bill, 2002 was introduced in the Lok Sabha on December 4, 2002.

5.52 Some of the important features of the Repeal Bill are as follows:

- On the date to be decided by the Government, the Industrial Development Bank of India Act shall stand repealed and the undertaking of the IDBI shall vest in the company to be called 'Industrial Development Bank of India Limited'.
- The new company shall be deemed to be a banking company under Section 5(C) of the Banking Regulation Act, 1949 and carry on the banking business as per the provisions of the Act and is not required to obtain license from the Reserve Bank.
- Further, the new company would be given exemption from maintaining the SLR under

Section 24 of the Banking Regulation Act, 1949 for a period of five years from the appointed day.

Box V.4: Role of Development Financial Institutions (DFIs) in Technological Progress

The aim of technology policy is to promote knowledge creation and its exploitation for economic development. There is often a need for a catalyst, particularly in developing countries, to convert knowledge creation to knowledge commercialisation for sustained technological progress. Firms, in the initial stages of development, need some assistance in acquiring, assimilating, transforming and exploiting knowledge.

DFIs have played an important role in this context. The long-standing debate on the relative merits of stock market-based (U.S., U.K.) *versus* bank-based (Germany, Japan) financial systems in technological progress needs to be flagged in this context. Attributing the success of the information technology revolution in the U.S. to market-based financial system, some have argued that stock markets are better at choosing the information technology winners than the bank-based systems. Others, however, have pointed out that stock markets are neither necessary nor sufficient condition for promoting information technology. In particular, developing countries suffer from underdeveloped stock markets which may make the price discovery process of a firm inadequate and may not accurately reflect the true long-term profitability of firms.

DFIs were set up in a number of countries with the objective of developing the absorptive capacity of firms for commercial exploitation of innovative technology over time. Apart from providing long-term loans, DFIs have been expected to promote projects, enhance managerial skills, develop entrepreneurship and help develop technological capabilities. By working closely with the Government, technology institutions and firms, DFIs were expected to influence technology policy and ensure that development of technological capabilities is achieved through policy implementation. DFIs are the only organised source of venture capital in many developing countries.

In India, in the absence of developed capital market, DFIs were the major source of much needed long-term finance to industry. They provided conditional grants or subsidised loans for technology development and new venture creation activities. Venture capital activity was initiated by a DFI. The DFIs played a role in providing impetus to interaction between firms and technology institutes by developing programs and providing facilities to encourage such interaction (Table A).

With the decline in the number of DFIs, in the face of financial sector reforms, innovative financing mechanisms of banks and capital markets together are expected to take care of the need for project financing. The Government of India has been proactively involved in coming out with restructuring packages for some of the select FIs taking into account their weak financial performance, growing NPAs and adverse market conditions for raising of resources by the FIs. Restoration of the financial health of the FIs is expected to revive project financing activities over time in tune with the risk-return profile.

Table A: Support of the DFIs to Technology Development in India: An Illustration

Support	SIDBI	IFCI
Infrastructure support	Common facilities, testing	Science and technology parks
Technical knowledge support	Quality programs	Technology consulting, project profiles
Informational support	Awareness workshops, Technology Institute -firm interaction	Market surveys, opportunity identification
Purchasing support	On some programs	Technology source identification
Marketing support	Quality programs, modernisation programs	Market surveys
Planning support	On some programs	On some programs
Financial support	Loans to small scale industry, venture capital, environmental funding	Project loans
Managerial support	Modernisation packages	Diagnostics, turnaround assistance
Educational support	Skill upgradation, entrepreneurship development programs	Support to entrepreneurship development programs

References:

Allen, F. (1993), "Stock Markets and Resource Allocation", in C. Mayer and X. Vives (eds.), *Capital Markets and Financial Intermediation*, Cambridge, Cambridge University Press.

George, G. and G. N. Prabhu (2003), "Developmental financial institutions as technology policy instruments: implications for innovation and entrepreneurship in emerging economies", *Research Policy*.

Singh, Ajit and B. Weisse (2001), "Information Technology, Venture Capital and the Stock Market", *Cambridge University Working Paper*.

Box V.5: Cross Country Experience of Development Financial Institutions

Development Finance Institutions (DFIs) were established to resolve a typical market inadequacy: the shortage of long-term investments and the perceived risk aversion of savers and creditors. In view of the inadequate provision of long-term credit through banks or markets, many of these institutions were sponsored by national governments. Although the oldest such government sponsored institution began with the establishment of the Societe Generale pour favoriser I'Industrie National in France in 1822, it was well over two decades later that development banking came into its own with the establishment of the Credit Mobiliser in France in 1848 for financing of Continental European railway expansion. In Asia too, such institutions were established as early as in the early 20th century - an important example being the Industrial Bank of Japan (IBJ) founded in 1900. The IBJ assisted not only in the development of the domestic capital markets, but it also performed the role of obtaining portfolio capital for the industrial firms in Japan.

DFIs emerged as specialised FIs to develop and promote specific strategic industrial sectors and to promote social and economic development. In most countries, governments played an

important role in promoting DFIs to mitigate the problems of underinvestment and undertransmittance of expertise in long-term industrial finance. Historically, the DFIs played a key role in the speedy industrial development of Europe and Japan. A distinction has also been made between industrial banking and development banking. In the German-Japanese model of industrial banking, the banks assume an active entrepreneurial role in order to achieve industrial development. In contrast, the Anglo-Saxon model is based on financial orthodoxy but it recognises the problems engendered by the lack of capital markets in developing countries. Development banks in developing countries tend to take a passive role of waiting for potential entrepreneurs.

DFIs have also been used as a channel for government support to the priority sector or to counter the effects of problems in any sector (*e.g.*, support in response to problems in banking sector in Japan, channel for fiscal policy and directing of flow of funds to targeted sectors for economic recovery in Malayasia, support to small and medium enterprise (SME) sector in Korea and Thailand). The DFIs have been provided support by governments by guaranteeing or underwriting their bonds issued (*e.g.*, Japan, France).

With drying up of subsidised sources of funds and financial sector reforms in a number of countries, the DFIs have chartered into totally new areas, such as, lending to the

SME sector, infrastructure and basic industries, industrial restructuring, foreign trade, environment conservation programs, preservation of natural resources, improvement of environmental quality, health, environmental education, sustainable agriculture, energy, venture financing, and banking services. For example, Industrial Bank of Korea (IBK), a premier term-lending FI established in 1961 under the Industrial Bank of Korea Act, diversified over time into other related activities, such as, credit card services, electronic banking, venture capital, trust account management and treasury operations. The retail banking operations of IBK form an important source of steady and relatively low-cost funds for its SME lending activities. Brazil has also witnessed similar diversification. Some DFIs have transformed themselves into universal banks (*e.g.*, Singapore). The strategies adopted have been mergers and acquisition, changes in the legal framework, enabling legislation, financial restructuring, re-engineering, debt restructuring and corporate governance.

In developing countries, however, DFIs, which were unable to transform themselves with the changing environment, are beset with the problems of high and growing NPAs, poor cost-benefit evaluations of projects, and widespread mismatches in their asset-liabilities requiring large provisions. Furthermore, their inability to mobilise long-term fixed-rate resources led to erosion of profits and in some cases erosion of net worth. Financial sector reforms to foster efficiency, transparency and stability in the financial system and calibrated globalisation have led to the debate on the role of DFIs and the support provided by the Government. Efficiency of government sponsorship can be enhanced with conditionalities as in the case of France. Besides, an appropriate legal framework for effective regulation and supervision needs to be customised to suit the macroeconomic and socio-political conditions, the stage of financial development and the nature of industrial development specific to each country.

References:

de Aghion, Beatriz Annendariz (1999), 'Development Banking', *Journal of Development*

Economics, Vol. 58.

Murinde, V. (1996), *Development Banking and Finance*, Avebury, Ashgate Publishing, Aldershot, U.K.

Richard Wong, Y. C. and M. L. Sonia Wong,(2001) 'Competition In China's Domestic Banking Industry', *Cato Journal*, Vol. 21, No. 1 (Spring/Summer).

5.53 The Bill was referred to the Standing Committee on Finance and the Committee had in turn recommended some more regulatory forbearances, *inter alia*, exemptions from maintenance of CRR for five years and certain tax exemptions for the newly converted banking company. The Cabinet approved the amendments to the Bill on August 11, 2003 to incorporate provision in the Bill so as to ensure that the new banking company also continues to be a development bank which will provide term lending to large, medium and small industries.

Restructuring of IFCI Ltd.

5.54 The Government of India had assured IFCI Ltd. that all small investors of below Rs. one lakh would be serviced by it and borrowings from Asian Development Bank and a leading development bank of Germany, KfW, would also be taken over by it. Further, Government would also bear the difference between the existing coupon rate of the IFCI bonds and the current Government securities rate on SLR bonds held by public sector banks/ FIs till its maturity.

SLR Liabilities

5.55 The principal and interest falling due on or after April 1, 2002 on SLR bonds would be rolled over to a period of 10 years from their respective date of maturities at an interest rate prevailing for Government securities for similar maturities at the time of rollover.
Non-SLR Liabilities

5.56 Fifty per cent of non-SLR liabilities to PSU banks / FIs, would be converted into Zero Coupon Optional Convertible Debentures (OCDs) payable after 20 years, with effect from April 1, 2002. It would, however, have a right of recompense and the remaining 50 per cent, will be reinvested for 10 years at an interest rate of 6 per cent.

5.57 It was agreed upon by the Government to rollover overdue preference share capital as well as the outstanding preference share capital which is yet to fall due for a period of 20 years at a coupon rate of 0.10 per cent.

5.58 Some of the banks and FIs had also agreed for rollover of both secured and unsecured loans, amounting Rs. 604 crore and Rs. 245 crore, respectively, to IFCI for a period of 20 years at 6 per cent rate of interest.

5.59 LIC, SBI and IDBI had, as a special arrangement, advanced Rs. 200 crore, Rs. 200 crore and Rs. 100 crore, respectively, to IFCI for varying tenors in 2001. These institutions agreed

to rollover the advances for a further period of 20 years at an interest rate of 6 per cent per annum.

7. Other Developments

Asset Reconstruction Companies

5.60 The balance sheets of term-lending FIs have been affected substantively by NPAs resulting in erosion of their net worth. In pursuance of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002[7] , the Reserve Bank issued detailed guidelines to bank and FIs on the sale of financial assets to securitisation companies (SCs) and reconstruction companies (RCs) in order to facilitate asset reconstruction on smooth and sound lines. Consequently, Asset Reconstruction Companies (ARCs)[8] are now being set up and promoted by FIs and banks.

Progress towards Consolidated Accounting

5.61 With the issue of draft guidelines by the Reserve Bank to all India FIs on consolidated accounting, FIs that have subsidiaries, have initiated the necessary steps towards consolidated accounting. Listed FIs have already commenced preparation / publishing Consolidated Annual Accounts as a part of their Annual Report, as mandated by the Accounting Standard 21 of Institute of Chartered Accountants of India effective from the financial year 2001-02.

Corporate Debt Restructuring (CDR) - Status[9]

5.62 Based on the recommendations made by a High Level Group (Chairman: Shri Vepa Kamesam) and in consultation with Government of India, the Reserve Bank revised the scheme of Corporate Debt Restructuring. The revised guidelines were issued in supercession of the earlier guidelines. Following this, the CDR mechanism has been put in place in all the FIs, in accordance with Reserve Bank's guidelines.

5.63 The CDR mechanism effectively became operational from March 2002 with the execution of Inter-Creditor Agreement (ICA) on February 25, 2002 by 47 FIs / banks. As of date, 61 institutions / banks comprising all-India FIs (12), public sector banks (27) and private sector banks (22) have signed the ICA. UTI (among FIs), seven private sector banks and 41 foreign banks are yet to sign the ICA. During 2002-03, the CDR Standing Forum met twice, the Core Group met five times, and the Empowered Group met 16 times. Of the 60 applications received (four from 2001-02), the CDR Cell has referred all the cases to the Empowered Group within the stipulated time of 30 days. The Empowered Group approved final schemes in respect of 29 cases in which aggregate assistance by financial system amounted to Rs.29,167 crore; 18 cases, involving outstanding assistance of Rs.6,826 crore, were rejected and the remaining 13 cases with aggregate outstanding assistance of Rs 8,376 crore are being processed.

Mutual Funds

Policy Developments relating to Mutual Funds

5.64 Several measures were undertaken during 2002-03 to improve the operations and governance of the mutual funds. Some of these measures include, disclosure of performance of benchmarks, guidelines for valuation of unlisted equity shares, emphasis on the code of conduct and insider trading regulations, guidelines on risk management norms, mandatory registration of mutual funds intermediaries engaged in selling and marketing of mutual funds units.

Resource Mobilisation by Mutual Funds

5.65 Resource mobilisation by mutual funds declined sharply during 2002-03 mainly due to the substantial net outflow of funds from UTI, which was restructured during the year (Table V.16 and Appendix Table V.8). Private sector mutual funds also recorded a decline in mobilisation of funds while public sector funds (other than UTI) recorded a modest increase. However, resource mobilisation by mutual funds witnessed a sharp increase during April-September 2003. While UTI registered net inflows as compared to outflows during 2002-03, the private sector mutual funds also recorded huge mobilisations.

Restructuring of UTI

5.66 During the last few years, several measures have been undertaken to contain the fallout of the events in the UTI, which adversely affected investors' perception. As proposed in the reform package announced by the Cabinet Committee on Economic Affairs (CCEA) on August 31, 2002, the Unit Trust of India Act, 1963 was repealed through an ordinance on October 30, 2002. The ordinance also sought to restructure the UTI by splitting it into two parts, *viz.*, UTI-I comprising US-64 and assured return schemes to be placed under a Government-appointed Administrator, and UTI-II [later renamed as UTI Mutual Fund (UTIMF)] consisting of the NAV-based schemes, professionally managed and brought under the regulatory purview of SEBI. The schemes including the operational aspects of distribution of assets and liabilities between the two bodies were effected in January 2003. At present all the schemes of UTI-I are being managed by Specified Undertaking of UTI run by the Administrator. The Government also signed a Memorandum of Understanding with the four sponsors of UTIMF, *viz.*, State Bank of India, Punjab National Bank, Bank of Baroda and Life Insurance Corporation of India, which marked the transition of UTI from a hybrid institution to a mutual fund.

Table V.16: Resource Mobilisation by Mutual Funds

(Rs. crore)

Mutual Fund		2001-02	2002-03
1		2	3
I.	Public Sector*	1,474.4	1,988.2
II.	Unit Trust of India	-7,284.0	-9,434.0
III.	Private Sector	12,947.9	12,025.9
Total (I+II+III)		**7,138.3**	**4,580.1**

* excludes UTI.

Notes : 1. Data are provisional.

2. For UTI, the figures are net sales (with premium), including re-investment sales, and for other mutual funds, figures represent net sales under all schemes.

Source : Respective mutual funds for 2001-02 and

SEBI for 2002-03.

5.67 The Government had committed to small investors to meet all obligations for US-64 Scheme and other assured income schemes. The US-64 units were converted into bonds and started trading in the secondary market in June 2003. The Union Budget 2003-04 exempted UTI-I from dividend distribution tax.

5.68 Several measures have been undertaken by UTIMF to improve its performance including improved transparency and disclosure, well laid down investment guidelines and greater emphasis on risk management, launch of innovative schemes, merging of schemes, conversion of units into bonds, delegation of power, organisational beef up, and other related matters. Reflecting these measures, UTIMF has witnessed a turnaround in its resource mobilisation with a positive inflow of Rs.637 crore during April-September 2003 as compared to a negative resource mobilisation by UTI during the past two years.

---

[1] Includes all-India development banks, specialised FIs, investment institutions and State level FIs. For the names of FIs included, reference may be made to Appendix Table V.1.
[2] Box II.2 in Chapter II gives the details of the two exposure methods.
[3] Details are provided in Chapter II.
[4] With a scheduled commercial bank / State Cooperative Bank / Primary Dealer (PD) / FI.
[5] National Securities Depository Ltd. (NSDL) / Central Depository Services (India) Ltd. (CDSL).
[6] Comprising IDBI, IFCI, IIBI, SIDBI, IDFC, IVCF, ICICI Venture, TFCI, LIC, UTI and GIC.
[7] The SARFAESI Act is dealt with in more detail in Chapter II.
[8] ARCs are discussed in Chapter VI.
[9] Details are provided in Chapter II.