CHAPTER I

BANKING DEVELOPMENTS AND POLICY PERSPECTIVES

Introduction

The banking system in India in 1997-98 (April-March) showed an improvement in terms of profitability and other financial parameters. Many banks including Public Sector Banks (PSBs) have increased their non-traditional banking activities during 1997-98 as evident from the substantial increase in non-interest income. The Indian financial system was relatively unaffected by the South-East Asian crisis due to several reasons including their meagre exposure to real estate sector, short-term external debt and the relatively transparent financial infrastructure.

1.2 During 1997-98 and the first quarter of 1998-99, a majority of the banks showed strong growth. Financial Institutions (FIs) too performed well with their sanctions and disbursements showing accelerated growth. Besides, a number of initiatives were taken to streamline the functioning of non-banking financial companies (NBFCs) including registration, regulation and supervision so as to harmonise their functioning with banks and FIs. The Committee on Banking Sector Reform (Chairman: Shri M. Narasimham) was constituted on December 26, 1997 to review the progress of implementation of financial sector reforms recommended by the Committee on Financial Systems (CFS) (1991), and to suggest remedial measures for strengthening the banking system, covering areas of banking policy, institutional structure, supervisory system, legislative and technological changes. The recommendations of the Committee, submitted in April 1998, were considered in consultation with the Government of India and some of the decisions were announced on October 30, 1998 as part of 'Mid-Term Review of Monetary and Credit Policy for 1998 -99'. These are summarised in Box 1.1.

1.3 As in the earlier years, deposit growth of scheduled commercial banks (SCBs) continued to be strong during 1997-98 and the first half of 1998-99. Although the credit expansion remained subdued during the first half of 1997-98, it started picking up in the second half, resulting in an impressive growth in flow of credit to the commercial sector. Besides, banks' investments in commercial paper, bonds/debentures/shares of Public Sector Undertakings (PSUs) and private corporate sector have shown accelerated growth as compared with that in the previous year, with the result that the total flow of resources to the commercial sector during 1997-98 was significantly larger than that in the preceding year.

1.4 In this Chapter while sections 2 to 8 provide an overview of major banking developments, section 9 provides the policy perspectives.

2. Financial Sector Reform Measures

A. Interest Rate Deregulation

1.5 Interest rates in India were further deregulated during 1997-98. The minimum period of maturity of term deposits was reduced from 30 days to 15 days in April 1998 and interest rates on them too have been deregulated. Interest rates on small loans up to Rs.2 lakh each, were not to exceed the lending rates that are applicable to the prime borrowers in the category of over Rs.2 lakh. During 1997-98 and 1998-99 so far, the Bank Rate was utilised as a signalling mechanism for influencing the direction of interest rate movements in the economy.

BOX 1.1: BANKING SECTOR REFORMS

	Narasimham Committee (1998) Recommendations	Decisions Announced*
(i)	5 per cent weight for market risk for Government/approved securities. (Para No.3.11)	To be implemented in phases 2.5 per cent risk weight by the year ending March 31, 2000. Balance of 2.5 per cent will be announced later. An additional risk weight (of 20 per cent) is proposed for securities of government undertakings which do not form part of the approved market borrowing programme with effect from the financial year 2000-2001. This will be implemented in the case of outstanding stock of such securities as on March 31, 2000, in two phases at the rate of 10 per cent each in 2001-2002 and 2002-2003.
(ii)	The risk weight for Government guaranteed advances to be the same as for other advances. (Para No.3.12)	Risk weights will be assigned for Govt. guaranteed advances sanctioned from April 1, 1999 as under: Against the guarantee of the :

		[a] Central Government : 0 per cent [b] State Governments : 0 per cent [c] State Governments who have remained in default as on March 31, 2000 in cases where the guarantee has been invoked : 20 per cent [d] State Governments who continued to be in default after March 31, 2001 in respect of such invoked guarantees : 100 per cent
(iii)	Foreign exchange open position limit to carry 100 per cent risk weight. (Para No.3.13)	To be implemented from the current financial year ending March 31, 1999.
(iv)	A minimum target of 9 per cent CRAR to be achieved in the year 2000 and 10 per cent by 2002. (Para No.3.15 & 3.16)	Banks should achieve a minimum CRAR of 9 per cent as on March 31, 2000. Decision about further enhancement of CRAR will be announced later.
(v)	An asset be classified as doubtful if it is in the sub-standard category for 18 months in the first instance and eventually for 12 months and loss if it has been so identified but not written off. (Para No.3.18)	An asset will be treated as doubtful, if it has remained in sub-standard category for 18 months instead of 24 months, by March 31, 2001. Banks may make provisions therefor, in two phases as under: As on March 31, 2001 : Provisioning of not less than 50 per cent on the assets which have become doubtful on account of the new norms, i.e., reduction of the period from 24 months to 18 months. As on March 31, 2002 : Balance 50 per cent of the provisions should be made in addition to the provisions needed as on March 31, 2002. The proposal to introduce the norm of 12 months will be announced later.

	Recommendation	Action taken
(vi)	[a] The Government guaranteed advances which have turned sticky to be classified as NPAs. (Para No.3.21)	The State Government guaranteed advances in respect of which guarantee has been invoked and the concerned Government has remained in default for more than two quarters are to be classified as NPAs with effect from April 1, 2000.
	[b] Income recognition, asset classification and provisioning norms should apply to Government guaranteed advances in the same manner as for any other advances. (Para No.3.37)	Provisions on these advances should be made over a period of 4 years as detailed below: Provisions against existing/old State Government guaranteed advances where guarantee has been invoked and the concerned State Government has remained in default for more than two quarters are to be made during the next four years from the year ending March 31,2000 to March 31, 2003 with a minimum of 25 per cent, each year.
(vii)	A general provision of 1 per cent on standard assets be introduced. (Para No.3.36)	To start with, banks should make a general provision of a minimum of 0.25 per cent for the year ending March 31, 2000. The decision to raise further the provisioning requirement on standard assets would be announced in due course.
(viii)	Banks and Financial Institutions should avoid the practice of evergreening. (Para No.3.22)	The Reserve Bank reiterates that banks and financial institutions should adhere to the prudential norms on asset classification, provisioning, etc., and avoid the practice of "evergreening".
(ix)	Any effort at financial restructuring must go hand in hand with operational restructuring. With the cleaning up of the balance sheet, simultaneously steps to be taken to prevent/limit re-emergence of new NPAs. (Para No.3.27)	The banks are advised to take effective steps for reduction of NPAs and also put in place risk management systems and practices to prevent reemergence of fresh NPAs.

(x)	To enable banks in difficulties to issue bonds for Tier II capital. Government will need to guarantee these instruments which would then make them eligible for SLR investment. (Para No.3.29)	Public Sector Banks are encouraged to raise their Tier II capital. Government guarantee to these instruments does not seem appropriate.
(xi)	There is a need for disclosure in a phased manner of the maturity pattern of assets and liabilities, foreign currency assets and liabilities, movements in provision account and NPAs. (Para No.3.38)	Banks have already been advised to put in place a formal Asset-Liability Management (ALM) system with effect from April 1, 1999. Instructions on further disclosures will be issued in due course.
(xii)	Concentration ratios need to be indicated in respect of bank's exposure to any particular industrial sector as also to sectors sensitive to asset price fluctuations such as stock market and real estate. These exposure norms need to be carefully monitored. (Para No.3.40)	Banks are advised to strictly comply with instructions which are already in place.
(xiii)	Banks should bring out revised operational manuals and update them regularly. (Para No.4.3)	Arrangements should be put in place for regular updating. Compliance has to be reported to RBI by April 30, 1999.
(xiv)	There is need to institute an independent loan review mechanism especially for large borrowal accounts and to identify potential NPAs. (Para 4.12-4.16)	Banks should ensure a loan review mechanism for larger advances soon after its sanction and continuously monitor the weaknesses developing in the accounts for initiating corrective measures in time.

* As part of the 'Mid-Term Review of Monetary and Credit Policy for 1998-99'.

Bank Rate

1.6 In the context of slowdown in industrial production, the Bank Rate was reduced by one percentage point to '11.0 per cent per annum' with effect from April 16, 1997. Further, the interest rates on accommodation from the Reserve Bank which were hitherto not related to the Bank Rate were linked to it. In view of the limited offtake of bank credit and in the light of the prevalence of sufficient liquidity, the Bank Rate was reduced further from '11.0 per cent per annum to 9.0 per cent per annum', in two stages, by one percentage point each with effect from June 26, 1997 and October 22, 1997, respectively. However, on account of the volatility in the foreign exchange market, with effect from the close of business on January 16, 1998, the Bank Rate was increased by two percentage points, i.e., from '9.0 per cent per annum to 11.0 per cent per annum'. On a review of the monetary and credit situation and in view of the onset of orderly conditions in the foreign exchange market, the increase in the Bank Rate was partially rolled back to '10.0 per cent per annum' with the reduction in two steps of one half of one percentage point each with effect from the close of business on March 18 and April 2, 1998, respectively. The Bank Rate was further reduced by one percentage point to '9.0 per cent per annum' effective from April 29, 1998, thus restoring the rate to the level prevailing before January 17, 1998.

Domestic Term Deposits

1.7 The ceiling on interest rate on domestic term deposits for maturity of 30 days and upto one year was linked to the Bank Rate and accordingly was reduced from the then existing 10.0 per cent per annum to the 'Bank Rate minus two percentage points per annum' (i.e. 9.0 per cent) with effect from April 16, 1997. Effective June 26, 1997, the ceiling on interest rate was reduced to 8.0 per cent per annum from the earlier 9.0 per cent per annum consistent with the reduction in the Bank Rate.

1.8 With a view to giving banks full freedom to determine the interest rates on term deposits of different maturities, effective October 22, 1997, interest rates on domestic term deposits of 30 days and above were deregulated. Banks, however, could determine the rates only after obtaining prior approval from their respective Boards.

1.9 The Monetary and Credit Policy announced on April 29, 1998 covered various measures aimed at providing greater freedom to banks in respect of several aspects of their deposit/lending operations. The minimum period of maturity of term deposits was reduced from 30 days to 15 days. Banks were permitted to determine their own penal interest rates for premature withdrawal of domestic term deposits and banks were advised to ensure that depositors are made aware of the applicable penal rate along with the deposit rate. Restriction on banks that they must offer the same rate on deposits of the same maturity irrespective of the size of such deposits was removed for domestic term deposits of Rs.15 lakh and above. Banks should, however, disclose in advance the schedule of interest rates payable on deposits including deposits on which differential interest rates would be paid and the rates are not subject to negotiation between the depositor and the bank. The Boards of banks are required to lay down policy in this regard.

Deposits under Non-Resident (External) (NRE) Rupee Accounts Scheme

1.10 In line with the changes effected in the prescription of interest rates on domestic term deposits, the interest rates on term deposits under Non-resident (External) Rupee Accounts (NRE) Scheme of over one year were freed with effect from April 16, 1997 and were brought on par with those on domestic term deposits. The ceiling on interest rate was reduced by three percentage points from 12.0 per cent per annum to 'Bank Rate minus 2 percentage points per annum' (i.e. 9.0 per cent) on maturity of 6 months and upto one year. The ceiling interest rate was further reduced to 8.0 per cent from 9.0 per cent, effective June 26, 1997. Effective September 13, 1997, banks were given freedom to fix their own interest rates on NRE term deposits of six months and over. On April 29, 1998, as in the case of FCNR(B) deposits, banks were permitted to determine their own penal interest rates for premature withdrawal of NRE deposits and depositors would need to be informed of the applicable penal rate. Further, banks were permitted to fix their own overdue interest rates in respect of NRE deposits remaining overdue for period exceeding 14 days, subject to these deposits being renewed.

Interest Rates on Deposits under Foreign Currency Non-Resident Accounts (Banks) [FCNR(B)] Scheme

1.11 Freedom was given to banks to determine their own rates on deposits under the Foreign Currency Non-Resident (Banks) [FCNR(B)] Scheme subject to ceilings prescribed by the Reserve Bank from time to time, effective April 16, 1997. Effective October 22, 1997, the ceiling rates were prescribed at the relevant London Interbank Offered Rate (LIBOR) prevailing on the last working day of the previous week for relevant maturity and currency, in respect of deposits of six months and above but less than one year and floating rate deposits. In respect of deposits of maturity of one year and above, the interest would be within the ceiling of swap rates for the respective currencies/maturities. Subject to the above, banks are free to offer either fixed or floating rate of interest on such deposits.

1.12 Taking into account the international developments which pointed to the problems relating to short-term external liabilities and large unhedged positions of corporates in some of the South East Asian countries, banks were encouraged to mobilise longer-term, rather than short-term deposits. Accordingly, on April 29, 1998, the interest rate ceiling on FCNR(B) deposits of one year and above was increased by 50 basis points and that on such deposits below one year and floating rate deposits was reduced by 25 basis points. Further, banks were permitted to fix their own overdue interest rates in respect of FCNR(B) deposits remaining overdue for periods exceeding 14 days, subject to these deposits being renewed.

Lending Rates

1.13 As a part of the process of deregulating interest rates on credit limits up to Rs.2 lakh and in view of the movements in the interest rates, effective October 22, 1997, the lending rate prescription for credit limits of over Rs.25,000 and up to Rs.2 lakh, was changed from a fixed rate of 13.5 per cent to a ceiling prescription of 'not exceeding 13.5 per cent'.

In order to remove the disincentive to the flow of credit to small borrowers, effective April 29, 1998, the interest rates on loans upto Rs.2 lakh were not to exceed the prime lending rate (PLR) which is the rate available to the prime borrowers with credit limits of over Rs.2 lakhs of the concerned bank.

Prime Term Lending Rate

1.14 With a view to giving banks more freedom to determine the interest rates, banks were allowed in October 1997 to prescribe separate Prime Term Lending Rates (PTLRs) with approval of their Boards, for term loans of 3 years and above, apart from the freedom to fix separate PLRs for cash credit and loan components given earlier.

Housing Finance Intermediary Agencies

1.15 The stipulation that banks should extend finance to housing finance intermediary agencies for onlending at 1.5 percentage points below PLR was withdrawn and effective October 22, 1997, banks were given freedom to charge different interest rates provided these are below each bank's PLR.

Advances against Term Deposits

1.16 It was announced on April 29, 1998 that all advances against term deposits would be at interest rates equal to PLR or less.

Loans against FCNR(B) Deposits and Loans out of FCNR(B) Pools

1.17 As a matter of rationalisation, multiple prescriptions linked to loans against FCNR(B) deposits and loans out of FCNR(B) pools and loans against foreign currency were dispensed with, effective October 21, 1997 and banks were given freedom in relation to uses and rates as available in the case of advances in general.

Bank Credit for Imports

1.18 In the context of developments in the foreign exchange market, an interest rate surcharge of 15.0 per cent of the lending rate was imposed on bank credit for imports with effect from December 18, 1997, which was further enhanced to 30.0 per cent, effective January 17, 1998.

B. Measures Relating to Reserve Requirements

Cash Reserve Ratio (CRR) on Domestic Term Deposits

1.19 With a view to facilitating the development of a more realistic rupee yield curve and term money market, liabilities of all SCBs [excluding Regional Rural Banks (RRBs)] to banking system were exempted from the requirement of Cash Reserve Ratio (CRR) with effect from the fortnight beginning April 26, 1997, releasing an amount of Rs.950 crore of resources of banks.

1.20 In accordance with the stance of phased reduction in statutory pre-emption of banks' resources, Monetary and Credit Policy during the second half of 1997-98 announced reduction in the CRR to be maintained by SCBs (excluding RRBs) by 2.0 percentage points from 10.0 per cent of Net Demand and Time Liabilities (NDTL) to 8.0 per cent in eight phases of 0.25 percentage point each with effect from the fortnights beginning October 25, 1997, November 22, 1997, December 20, 1997, January 17, 1998, February 14, 1998, February 28, 1998, March 14, 1998 and March 28, 1998. As a result of a two percentage points reduction in CRR, the resources of banks were estimated to be augmented by about Rs.9,600 crore (Rs.1,200 crore for each phase of reduction). It was indicated in the policy announcement that giving effect to the reduction in CRR during the months of February and March, 1998 would, however, be contingent on the monetary and price situation at that time.

1.21 Taking into account the overall liquidity position and the developments in the financial markets, in particular, the possible spill-over effects on the foreign exchange markets, the envisaged reductions in CRR was deferred from the fortnight beginning December 20, 1997, and the phasing of CRR reductions was to be made effective from fortnights beginning January 31, 1998 upto April 11, 1998. However, in view of the situation prevailing in financial and foreign exchange markets, effective from the fortnight beginning December 6, 1997, the CRR to be maintained by SCBs (excluding RRBs) was increased by one half of one percentage point from 9.5 per cent to 10.0 per cent. The schedule of reductions in CRR announced on November 28, 1997 was kept in abeyance. On a review of the monetary and credit situation and in view of then prevailing volatility in the foreign exchange market, as a part of the package of measures announced on January 16, 1998, the CRR to be maintained by SCBs (excluding RRBs) was increased by one-half of one percentage point from 10.0 per cent to 10.5 per cent of NDTL, effective from the fortnight beginning January 17, 1998. As a result, the resources of SCBs were impounded to the extent of Rs.2,500 crore. This measure was rolled back subsequently. The CRR to be maintained by SCBs (excluding RRBs) was reduced by 0.5 percentage point from 10.5 per cent to 10.0 per cent in two phases of 0.25 percentage point each with effect from the fortnight beginning March 28, 1998 and April 11, 1998. In view of the re-emergence of volatile condition in the foreign exchange market, the Reserve Bank increased CRR from 10.0 per cent to 11.0 per cent, effective from August 29, 1998.

Release of Impounded Cash Balances

1.22 In the light of the then foreign exchange situation and the consequent need to contain overall demand by moderating monetary expansion, effective May 4, 1991, banks were required to maintain incremental CRR of 10.0 per cent on the increase in NDTL over the level as on May 3, 1991. Banks were exempted from the maintenance of the 10.0 per cent incremental CRR for any increase in NDTL over the level as on April 17, 1992 but the balances remained impounded. One-third of the amount impounded between May 4, 1991 and April 17, 1992 was subsequently released in three equal instalments in October 1992.

1.23 In May 1998 it was decided to release the remaining two-third balances impounded during the period from May 4, 1991 and April 17, 1992. These balances would be released in twelve equal monthly instalments from the fortnight beginning May 23, 1998 and extending upto March 13, 1999. Six instalments have been released so far, upto September 26, 1998.

CRR on Deposits under NRE, NRNR and FCNR(B) Schemes

1.24 Simultaneous with freeing the reserve requirements on liabilities to the banking system in April 1997 and with a view to bringing all liabilities to the public under the umbrella of reserve requirements, with effect from the fortnight beginning April 26, 1997, a CRR of 10.0 per cent on the increase in liabilities under Foreign Currency Non-Resident Accounts (Banks) [FCNR(B)] scheme, Non-Resident Non-Repatriable Rupee (NRNR) Accounts scheme and Non-Resident (External) Rupee (NRE) Accounts Scheme over the level outstanding as on April 11, 1997 was imposed. These liabilities were subject to zero CRR prescriptions at that time.

1.25 Subsequently, from the fortnight beginning December 6, 1997, the liabilities under NRE Accounts and NRNR Accounts were exempted from maintenance of incremental CRR of 10.0 per cent. The amount thus impounded under 10.0 per cent incremental CRR upto December 5, 1997 under NRE Accounts and NRNR Accounts was released on December 6, 1997. However, the CRR prescription in respect of FCNR(B) Scheme was left unchanged.

Interest on Cash Balances Maintained with the Reserve Bank under CRR

1.26 All SCBs (excluding RRBs) were paid interest on eligible cash balances maintained with the Reserve Bank under the CRR requirements according to a two-tier formula. Under the two-tier formula, interest was paid at the rate of 10.5 per cent per annum on eligible cash balances based on NDTL outstanding as on March 23, 1990, and no interest was paid on the increase in the eligible cash balances (based on the increase in NDTL over the level as on March 23, 1990), maintained with the Reserve Bank. The effective rate of interest on the entire eligible cash balances worked out to about 3.5 per cent. With a view to rationalising the system of payment of interest on eligible CRR balances, with effect from the fortnight beginning October 25, 1997, banks would be paid interest at the rate of 4.0 per cent per annum on all eligible cash balances maintained with the Reserve Bank under the Reserve Bank of India Act, 1934. This had the effect of improving the return on such balances since the revised rate would be applicable on the entire eligible cash balances.

Statutory Liquidity Ratio

1.27 Effective the fortnight beginning April 26,1997, liabilities to the banking system were also exempted from maintenance of Statutory Liquidity Ratio (SLR) in line with the exemption for CRR requirements. With a view to rationalising the prescription of SLR, simplify the multiple prescriptions into a single prescription, with effect from fortnight beginning October 25, 1997, all SCBs were required to maintain a uniform statutory liquidity ratio of 25 per cent on their entire NDTL which is the minimum stipulated under Section 24 of the Banking Regulation Act, 1949.

C. Measures Relating to Export Credit

1.28 With a view to providing export credit at internationally competitive rates to exporters, a number of measures were announced. There was an overall decline in the interest rates charged on both pre-shipment and post-shipment credit in 1997-98 and thereafter in the current year so far (Table 1.1). In August 1998, post-shipment credit upto 90 days and pre-shipment credit upto 180 days were made available to exporters at 9 per cent per annum, which is equal to the Bank Rate in existence.

D. Measures Relating to Refinance

Export Credit Refinance

1.29 As a move towards further rationalisation of export credit refinance to banks and in the context of introduction of a new General Refinance facility, with effect from the fortnight beginning April 26, 1997, SCBs were provided export credit refinance only on the basis of their incremental export credit, i.e., equivalent to 100 per cent of the increase in outstanding export credit eligible for refinance over the level of such credit as on February 16, 1996. With a view to enabling the Bank Rate to emerge as a reference rate, the rates of interest on the Reserve Bank refinance facilities were linked to the Bank Rate since April 1997. Accordingly, the interest rate on refinance was modified along with the changes in the Bank Rate. As a temporary measure, refinance rate was fixed at 2 percentage points below the Bank Rate i.e. 7.0 per cent per annum with effect from August 6, 1998. This revision would be applicable upto March 31, 1999.

1.30 On a review of the monetary and foreign exchange situation then prevailing in the country and also taking into account the international developments, effective from the fortnight beginning January 17, 1998, banks were provided export credit refinance to the extent of 50 per cent of the increase in outstanding export credit eligible for refinance over the level of such credit as on February 16, 1996. After reviewing the changed situation, it was decided to restore the export credit refinance limits of banks to the level of 100 per cent of the incremental export credit eligible for refinance, effective the fortnight beginning May 9, 1998.

General Refinance

1.31 In the context of a move from sector-specific refinance facilities to a general refinance facility, and to enable the Bank Rate to emerge as a reference rate as also to enable banks to tide over their temporary liquidity shortages, effective from the fortnight beginning April 26, 1997, SCBs (excluding RRBs) were provided General Refinance equivalent to 1.0 per cent of each bank's fortnightly average outstanding aggregate deposits of 1996-97. The facility would be provided for two blocks of four weeks each. The interest rate would be at the ‘Bank Rate’ for the first four weeks and at the ‘Bank Rate plus one percentage point' for the second block of four weeks. Banks availing of the facility for eight weeks would face automatic debiting of their accounts with the Reserve Bank. Banks can avail of this refinance facility afresh if there is a gap of 2 weeks during which there is no borrowing under this facility. The entitlement to the banking system under this facility was of the order of Rs.4,460 crore.

Table I.1 : Interest Rates on Export Credit

(Per cent per annum

Export Credit	Rates Effective									
	April 16, 1997	June 26, 1997	Sept. 13, 1997	Oct. 22, 1997	Nov. 27, 1997	Dec. 15, 1997	Dec. 18, 1997	Jan. 1, 1998	Apr. 30, 1998	Aug. 6, 1998
1	2	3	4	5	6	7	8	9	10	11
1. Pre-shipment Credit										
i) Upto 180 days	13.00	13.00	13.00	12.00	12.00	12.00	12.00	12.00	11.00	9.00
ii) Beyond 180 days and upto 270 days	15.00	15.00	15.00	14.00	14.00	14.00	14.00	14.00	14.00	12.00
iii) Against incentives receivable from Govt. covered by ECGC Guarantee upto 90 days	13.00	13.00	13.00	12.00	12.00	12.00	12.00	12.00	11.00	9.00
2. Post-shipment Credit										
i) Demand Bills for transit period (as specified by FEDAI)	Not Exceeding 13.00	Not Exceeding 12.00	Not Exceeding 11.00	Not Exceeding 11.00	Not Exceeding 11.00	Not Exceeding 11.00	Not Exceeding 11.00	Not Exceeding 11.00	Not Exceeding 11.00	9.00
ii) Usance Bills (for total period comprising usance period of export bills, transit period as specified by FEDAI and grace period wherever applicable)										
a) Up to 90 days	Not Exceeding 13.00	Not Exceeding 12.00	Not Exceeding 11.00	Not Exceeding 11.00	Not Exceeding 11.00	Not Exceeding 11.00	Not Exceeding 11.00	Not Exceeding 11.00	Not Exceeding 11.00	9.00
b) Beyond 90 days and up to six months from the date of shipment	15.00	14.00	13.00 (FDA)	13.00	15.00	15.00 (FDA)	15.00 (FDA)	13.00	13.00	11.00
c) Beyond six months from the date of shipment	Free	Free	Free	Free	Free	Free	20.00 (Min.) (FDA)	20.00* (Min.)	--	--
iii) Against incentives receivable from Government covered by ECGC Guarantee (up to 90 days)	13.00	13.00	13.00	Not Exceeding 11.00	Not Exceeding 11.00	Not Exceeding 11.00	Not Exceeding 11.00	Not Exceeding 11.00	Not Exceeding 11.00	9.00
iv) Against undrawn balance (up to 90 days)	13.00	13.00	13.00	Not Exceeding 11.00	Not Exceeding 11.00	Not Exceeding 11.00	Not Exceeding 11.00	Not Exceeding 11.00	Not Exceeding 11.00	9.00
v) Against retention money (for supplies portion only) payable within one year from the date of shipment (up to 90 days)	13.00	13.00	13.00	Not Exceeding 11.00	Not Exceeding 11.00	Not Exceeding 11.00	Not Exceeding 11.00	Not Exceeding 11.00	Not Exceeding 11.00	9.00
3. Deferred Credit Deferred credit for the period beyond 180 days	Free (FDA)	Free (FDA)	Free (FDA)	Free (FDA)	Free (FDA)	Free (FDA)	Free (FDA)	Free (FDA)	Free (FDA)	Free (FDA)
4. Export Credit not otherwise specified	Free	Free	Free	Free	Free	Free (FDA)	20.00 (Min.)	20.00* (Min.)	--	--
a) Pre-shipment credit	- -	- -	- -	- -	- -	- -	- -	- -	Free	Free
b) Post-shipment credit	- -	- -	- -	- -	- -	- -	- -	- -	20.00 (Min.)	20.00 (Min.)

FDA : From date of advance.
Min. : Minimum.
-- : Not Applicable.
*Chronic Cases, i.e. overdues as on July 1, 1997 exempted / the prescription of higher rate of interest from the date of advance withdrawn retrospectively from December 18, 1997.
Note : 'Free' means banks are free to charge interest at rates decided by them.

1.32 In view of the situation in the domestic foreign exchange market and international developments, effective from the fortnight beginning January 17, 1998, this refinance was reduced to 0.25 per cent of each bank's fortnightly average outstanding aggregate deposits in 1996-97.

E. Measures Relating to the Money Market

Certificates of Deposit

1.33 In April 1997 the minimum size of the issue of Certificates of Deposit (CDs) to a single investor was reduced from Rs.25 lakh to Rs.10 lakh, in multiples of Rs.5 lakh and further reduced to Rs 5 lakh, in multiples of Rs. 1 lakh in October 1997. With effect from May 9, 1998, the minimum lock-in period for CDs was reduced from 30 days to 15 days.

Money Market Mutual Funds

1.34 Prior to October 1997, the resources mobilised by Money Market Mutual Funds (MMMFs) were required to be invested exclusively in call/notice money, CDs, Commercial Papers (CPs), commercial bills arising out of genuine trade/commercial transactions and Treasury Bills and Government dated securities having an unexpired maturity upto one year.

1.35 With a view to making the scheme of MMMF more flexible, MMMFs were permitted to invest also in rated corporate bonds and debentures with a residual maturity of upto one year. However, the prudential measure that the exposure of MMMFs to CP issued by an individual company should not exceed 3.0 per cent of the resources of the MMMF would continue, with the ceiling of 3.0 per cent to include bonds and debentures as well. With effect from May 9, 1998, the minimum lock-in period for units of MMMFs was reduced from 30 days to 15 days.

Routing of Transactions through DFHI

1.36 In April 1991, due to liberalisation of policy relating to participation in the call/notice money market, certain entities were given access to it as lenders with certain restrictions including the provision that the transaction should be routed through the Discount and Finance House of India (DFHI). With effect from the fortnight beginning April 26, 1997, the facility of routing such transactions was extended to all primary dealers(PDs). The minimum size of a transaction was reduced from Rs.20 crore to Rs.10 crore in April 1997. This was further reduced to Rs.5 crore in October 1997 and to Rs.3 crore with effect from May 9, 1998.

Other Measures

1.37 In the mid-term review of Monetary and Credit Policy for 1998-99, the following measures were announced:

(i) The Narsimham Committee II has recommended that the call/ notice money market and term money market should be strictly restricted to banks and PDs. In the Committee's view, non-bank parties can be provided free access to other money market instruments like CP, CDs, bill rediscounts, Treasury Bills and MMMFs. The Reserve Bank, has agreed in principle, with the Committee on this matter.

(ii) In the backdrop of the inter-bank liabilities having been exempted from the requirements of maintenance of CRR (except for the statutory minimum requirement of 3 per cent) and with a view to enabling banks and other participants in the repo market to adjust their liquidity in a more flexible manner, it was decided to withdraw the restriction of the minimum period of 3 days for ready-forward (repo) transaction effective from October 31, 1998.

(iii) The Reserve Bank also agreed with the Committee's suggestion that there must be clearly defined prudent limits for bank's reliance on the call money market. It is expected that the Asset-Liability Management guidelines would enable banks to organise their treasury operations without placing heavy reliance on call money borrowings.

(iv) The Reserve Bank broadly agreed with the Committee's suggestion that the RBI support to the market should be through a Liquidity Adjustment Facility (LAF) operated by way of repo providing a reasonable corridor for market play. While it is recognised that the repo is technically an efficient route for LAF, in view of certain procedural and technological constraints in transfer and settlement of securities, it may not be possible to introduce a scheme of LAF immediately. However, it was decided to take all actions that will enable in due course to replace the present general refinance facility. The export credit refinance will continue as a separate scheme and reviewed independently. Besides, collateralised intra-day/ over-night facility with adequate margin is also being considered to facilitate smooth operation of payment and settlement system to be placed eventually on real time gross settlements (RTGS) basis.

F. Improving Credit Delivery System

Loan System for Delivery of Bank Credit

1.38 As a measure of imparting an element of discipline in the utilisation of bank credit, the percentage of ‘loan component' in the working capital credit limit had been enhanced in stages for borrowers with working capital credit limits of (a) Rs. 10 crore or above and less than Rs. 20 crore and (b) Rs. 20 crore and above. With effect from October 22, 1997, the ‘loan component' level has been made uniform at 80 per cent for the above categories of borrowers.

‘Bill' Finance for Settlement of dues of SSI Suppliers

1.39 With a view to ensuring prompt settlement of dues of Small Scale Industrial (SSI) units and also for encouraging bill culture, banks were advised to ensure that with effect from January 1, 1998, of the total inland credit purchases of the borrowers, not less than 25 per cent should be through bills drawn on them by the concerned sellers.

Bridge Loans

1.40 Banks have been permitted on October 21, 1997 to sanction bridge loans to companies against expected equity flows/issues. As a prudential measure, it has been stipulated that such bridge loans should not exceed one year and should be accommodated within the ceiling of 5 per cent of incremental deposits of the previous year prescribed for individual bank's investment in shares/convertible debentures.

3. Government Securities Market

Primary Dealers

1.41 The Primary Dealers' (PDs) presence in Government securities market has brought in an element of dynamism, both in primary and secondary markets. It may be recalled that in pursuance of the ‘Guidelines for PDs in the Government Securities Market' issued by the Reserve Bank on March 29, 1995, approval has been given to six entities, viz., Discount & Finance House of India (DFHI), Securities Trading Corporation of India (STCI), I-Sec, subsidiary of State Bank of India (SBI) - "SBI Gilts Ltd.", subsidiary of Punjab National Bank (PNB)- "PNB Gilts Ltd". and subsidiary of Canara Bank set up jointly with Bank of

Baroda and Corporation Bank - "Gilts Securities Trading Corporation Ltd". While DFHI and STCI became operational effective March 1, 1996, the other four entities commenced their operations from June 1, 1996. Furthermore, on October 29, 1998 in principle approval has been granted to seven entities, viz., DSP Merrill Lynch, Kotak Mahindra Capital Company (unlimited), Ceat Financial Services Ltd., Tata Finance Securities Ltd., J.P. Morgan Securities India Private Ltd., ABN-Amro Bank (Subsidiary) and Deutche Bank (Subsidiary) to be accredited as PDs in the Government securities market.

Incentives to PDs

1.42 It may be recalled that with a view to providing incentives to PDs to develop the secondary market in Government securities, the Reserve Bank was paying commission on their primary purchases (including the devolvement) of Central Government securities, effective July 10, 1996. This scheme was, however, later replaced in June 1997 by a ‘Scheme for Payment of Underwriting Fee to PDs', whereby a minimum of 25 per cent of each issue of Government of India dated securities and Treasury Bills would be offered for underwriting by PDs and the underwriting amount and fee would be determined on the basis of bids submitted and accepted by the Reserve Bank. This scheme also replaced the system of commiting the PDs' devolvement percentages. The underwriting scheme of PDs is under constant review to make it more efficient and effective as an instrument for primary sales of securities. On a review, the ‘Scheme of Payment of Underwriting Fee to PDs' was modified in August 1998, as follows :

(i) PDs will be offered upto a maximum of 50 per cent of the notified amount for underwriting in respect of all issues where amounts are notified.

(ii) In cases, where the amount of issue is not notified, the Reserve Bank would offer such amount, as may be determined at its discretion, for underwriting.

(iii) Depending upon the bids submitted for underwriting, the Reserve Bank will decide the fee and the underwriting amount up to which bids would be accepted. Bids would be accepted at the fee as quoted by individual PDs up to the cut-off fee.

(iv) Devolvement will be taken by PDs to the extent of underwriting amount, after setting off the accepted bids in the auction.

(v) A PD shall offer to underwrite an amount not more than five times of its net owned funds or the balance liquidity support available from the Reserve Bank, whichever is higher at the time of making commitment for underwriting.

Liquidity Support to PDs

1.43 PDs in Government securities market have been provided liquidity support through repos operations in 91-day, 364-day auction Treasury Bills and Central Government dated securities at the Bank Rate. On January 16, 1998 due to volatility in the foreign exchange market, the Reserve Bank announced that PDs in Government securities market will have access to liquidity support on a discretionary basis, subject to the Reserve Bank stipulations relating to their operations in the call money market. The Monetary and Credit Policy for the first half of the 1998-99 has announced that the practice of reverse repos with PDs in specified securities is being dispensed with and instead liquidity support against the security of holdings in Subsidiary General Ledger (SGL) Accounts will be provided. Accordingly in September 1998, it has been decided that liquidity support to PDs will henceforth be provided by way of demand loan against the security of their holdings in SGL accounts. Advances will be granted against the collateral of holdings of Government of India dated securities and 91/364- day auction Treasury Bills in SGL accounts maintained with the Reserve Bank.

Routing of Transactions through PDs

1.44 In pursuance of the Monetary and Credit Policy for the second half of the year 1997-98, effective October 22, 1997, the minimum lending limit for entities permitted to access call/notice money market as lenders who route their transactions through PDs was reduced from Rs.10 crore to Rs.5 crore. This limit was further reduced from Rs.5 crore to Rs.3 crore with effect from May 9, 1998.

Satellite Dealers

1.45 It may be recalled that on December 31, 1996, the Reserve Bank announced the guidelines for Satellite Dealers (SDs) in Government securities market. The SDs are intended to act as second tier in trading and distribution of Government securities. The Reserve Bank has already granted approval to nine entities for registration as SDs as on November 18, 1997, viz., 1) DSP Merrill Lynch Ltd., 2) Ceat Financial Services Ltd., 3) Kotak Mahindra Capital Company, 4) Birla Global Finance Co. Ltd., 5) Hoare Govett (India) Securities Ltd., 6) Dil Vikas Finance Ltd., 7) SREI International Securities Ltd., 8) Tower Capital and Securities Pvt. Ltd. and 9) Tata Finance Securities Pvt. Ltd.

1.46 Reserve Bank has also granted 'in principle' approval on November 18, 1997 to two banks viz., Bank of America and Bank of Madura Ltd. to be accredited as SDs in the Government securities market. The banks would be setting up separate units dedicated to the securities business and in particular, the Government securities market.

Ongoing Process of Enlistment/Registration of PDs/SDs

1.47 The schemes of both PDs and SDs have been placed on an ongoing basis and institutions satisfying the eligibility criteria could approach the Reserve Bank from time to time for enlistment/registration as PDs/SDs.

Liquidity Support to SDs

1.48 Liquidity support through reverse repos transactions with the Reserve Bank in Central Government dated securities and auction Treasury Bills up to 50 per cent of the outstanding stocks (face value) thereof at the end of the previous working day has been extended to SDs, effective December 24, 1997.

Ready Forward Transactions

1.49 The SDs have also been extended the facility of ready forward transactions since March 18, 1998.

Issue of Commercial Paper by SDs

1.50 Effective June 17, 1998, SDs in Government securities market have been permitted access to short-term borrowing by issuance of commercial paper. The eligibility for issuance of commercial paper by SDs which thereby raises deposits are as follows:

(i) They should obtain the specified minimum credit rating for issuance of CPs from a credit rating agency, ratings awarded being approved by the Reserve Bank for the purpose of issue of commercial paper. It should be ensured that at the time of issue of CPs, the credit rating obtained is current and not more than two months old or as may be specified from time to time by the Reserve Bank for this purpose.

(ii) The CPs shall be issued for maturities between fifteen days and more, but less than one year from the date of issue. It may be issued to any person including individuals, banks, companies, other corporate bodies registered or incorporated in India and unincorporated bodies and non-resident Indian (NRI) on non-repatriation basis subject to the condition that it shall not be transferable.

(iii) The CPs may be issued in multiples of Rs.5 lakh but the amount to be invested by any single investor shall not be less than Rs.25 lakh (face value) provided that the secondary market transactions may be for amounts of Rs.5 lakh or multiples thereof. Each issue of CPs (including renewal) shall be treated as a fresh issue. The aggregate amount to be raised shall not exceed the amount fixed by the Reserve Bank for the issue and shall be raised within a period of two weeks from the date of approval by the Reserve Bank, or may be issued on a single day or in parts on different dates provided that such CPs shall have the same maturity date.

(iv) The CPs shall be in the form of usance promissory note negotiable by endorsement and delivery and be issued at such discount to face value as may be determined by the SD issuing the CPs and shall bear the expenses of the issue including dealer's fee, rating agency fee, etc.

Developments in Treasury Bills Market

Bills of varied maturities

1.51 With a view to developing the Treasury Bills market further and providing investors with financial instruments of varying short-term maturities and to facilitate the cash management requirement of various segments of the economy, it was decided in April 1997 to issue Treasury Bills of varied maturities. Accordingly, the auction of 14-day Treasury Bills on a weekly basis was introduced from June 6, 1997. The Monetary and Credit Policy for the second half of the year 1997-98 announced the introduction of 28-day Treasury Bills on auction basis. In the Monetary and Credit Policy measure announced for the first half of the year 1998-99, it was further decided to reintroduce 182- day Treasury Bills auctions on a fortnightly basis and changing 364-day Treasury Bills auctions to a monthly basis. However, this could not be put in place owing to reduced investor interest in Treasury Bills due to unprecedented market developments.

Non-Competitive bidders

1.52 Non-competitive bidders in 14-day and 91-day Treasury Bills auction were being allocated bid amounts within the notified amount. In other countries, though non-competitive bidders are generally allocated within the notified amounts, such bidders are small investors. In India, the State Governments, who are the major non-competitive bidders, offer large bid amounts which are also highly volatile, which rendered the pricing pattern and allotment very uncertain for competitive bidders. Hence, with a view to ensuring transparency and certainty for competitive bidders, it was decided to keep non-competitive bids outside the notified amounts. This measure was announced as a part of Monetary and Credit Policy for the second half of 1997-98, and became effective from April 1, 1998.

Notified amount

1.53 Hitherto, as a transitional arrangement, the amounts of issue were being notified in respect of 91-day Treasury Bills auctions and dated securities while the amounts were not notified in respect of 364-day and 14-day Treasury Bill auctions. In pursuance of the Monetary and Credit Policy for the second half of 1997-98, it was decided to notify amounts in case of all auctions with effect from April 1,1998. While the procedure of notifying amounts in all auctions would necessitate the Reserve Bank to participate as a non-competitive bidder, the possibility of devolvement on the Reserve Bank could, however, be reduced through higher underwriting levels by PDs, and adjusting the notified amounts to reflect the market demand.

Auction Method

1.54 The method of multiple price auction is generally being followed at present, wherein every bidder gets allocations according to the actual bids quoted. The cut-off yield in the case of dated securities and cut-off price in the case of Treasury Bills determine the coupon rate/price and accordingly, all bidders at or below the cut-off yield were allocated upto the notified amount. It has been decided to introduce uniform price auction method in respect of 91-day Treasury Bill auction, as an experimental measure. Uniform price auction method is expected to eliminate the problem of winners' curse, encourage both aggressive bidding and secondary market trades.

Repos by the Reserve Bank

Fixed Rate Repos

1.55 The Reserve Bank decided to conduct fixed rate repos on a three to four day cycle as part of liquidity tightening measures on November 29, 1997. The Monetary and Credit Policy for the first half of 1998-99 has further proposed to use both fixed interest and auction based repos as appropriate. Furthermore, in addition to the current three days and four-days repos, it has been proposed to introduce one-day repos (including reverse repos) in due course to absorb (infuse) liquidity from (into) the system. Although the one-day repo has not yet been introduced, they will provide greater flexibility and maneuverability to the Reserve Bank in managing short-term liquidity.

Ready forward transactions in PSU Bonds and Private Debt Securities

1.56 With a view to expanding the base for repos market and developing the secondary market in public sector undertakings (PSUs) Bonds and private corporate debt securities and for providing liquidity to such instruments, it was decided that ready forward transactions would be permitted in PSU bonds and private corporate debt securities provided they are held, in dematerialised form in a depository and the transactions are done in recognised stock exchanges. The ready forward transactions in PSU bonds and private corporate debt securities would be initially permitted among those who operate in ready forward transactions in Government securities.

Other Developments

New Instruments - Introduction of Capital Indexed Bonds

1.57 The Government of India decided to introduce Capital Indexed Bonds for the first time where the repayment of the principal amount was indexed to inflation and first such bonds of five year maturity with 6 per cent coupon were introduced on December 29, 1997. The inflation adjustment for the repayment of the principal is on the basis of monthly average of the wholesale price index as worked out by the Reserve Bank. Such bonds provide a complete hedge against inflation for the principal amount of investment to investors and also increase the range of financial assets available in the system. The sale of these bonds was on tap between December 29, 1997 and January 28, 1998 and the amount mobilised was Rs.704.5 crore.

Retailing of Government Securities

(i) Scheme of Liquidity Support to Mutual Funds

1.58 In 1996-97, the Reserve Bank had announced a scheme of liquidity support to mutual funds dedicated to investments in gilts and permitted banks to undertake retailing of Government securities with non-bank clients. In order to promote the retail market segment and to provide greater liquidity to retail investors, in pursuance of the Monetary and Credit Policy for the second half of the year 1997-98, effective October 22, 1997, banks were allowed to freely buy and sell government securities on an outright basis at prevailing market prices, without any restriction on the period between sale and purchase subject to the stipulation that they should not undertake ready forward transactions in Government securities with non-bank clients.

(ii) Constituents' SGL Account with the Reserve Bank

1.59 The Depositories Act was enacted in 1996 enabling holding of securities in dematerialised form. Following this, National Securities Depository Limited (NSDL) has been established. NSDL has shown keen interest in bringing Government securities also under its purview. In this context, it may be mentioned that pursuant to the introduction of Delivery Versus Payment (DVP) System for transactions in Government securities held in SGL accounts, the Reserve Bank has phased out the accounts of investors like Provident Funds/Trusts, etc. The Provident Funds/Trusts, which were earlier enjoying cost-free services from the Reserve Bank in SGL form, have shown reluctance to shift to SGL II (Constituents' Account) of banks. In these circumstances, the Provident Funds/Trusts have opted for Stock Certificates with the Reserve Bank. Consequent on the switch over by PFs/Trusts to Stock Certificates, the portfolio of Stock Certificates serviced by the Reserve Bank, Mumbai consists of an overwhelming number of over 50,000 pieces.

1.60 In the above background and with a view to enabling institutions like NSDL, to service the accounts of PFs/Trusts and as a step towards dematerialisation, the following three institutions have been allowed SGL facility in the books of Public Debt Office : (i) National Securities Clearing Corporation Limited (NSCCL), (ii) National Securities Depository Limited (NSDL) and (iii) Stock Holding Corporation of India Limited (SHCIL). These three institutions aim to assist PFs/Trusts/Individuals in acquiring/holding Government securities in dematerialised form while broadbasing/deepening the retail market for Government securities.

Investment in Central Government Securities by Foreign Institutional Investors (FIIs)

1.61 With a view to encouraging further flow of foreign capital into Indian capital market and help bridge the gap between domestic savings and investment in a more cost effective manner and also to provide more depth and liquidity to the Government securities market, since July 10, 1997, the Foreign Institutional Investors (FIIs) in the category of 100 per cent debt funds have been permitted to invest in Government dated securities. In pursuance of the Monetary and Credit Policy for the second half of the 1997-98, in addition to the category of 100 per cent debt funds, it was decided to permit FIIs with a ceiling of 30 per cent investments in debt instruments to invest in Government dated securities, within the ceiling of 30 per cent. Following amendments to SEBI's FIIs' Regulations, this has come into force effective April 20, 1998. In pursuance of the Monetary and Credit Policy announcements for the first half of 1998-99 to permit all categories of FIIs to purchase/sell Treasury Bills within the overall approved debt ceilings, SEBI has amended its above notification and it came into force from May 18, 1998. Accordingly, with effect from June 11,1998 the Reserve Bank guidelines was amended to enable equity funds to invest in Government dated securities and Treasury Bills within their debt ceiling of 30 per cent.

Valuation of Government Securities

1.62 It has been the endeavour of the Reserve Bank to ensure the banks increasingly mark their investments to the market i.e., earmark a higher portion of their investments to the current category to facilitate valuing all the Investments on fully marked to market basis. Accordingly, the ratio of investments in permanent category was brought down to 40 per cent for the year ending March 1998. It has further been decided to bring down the ratio for permanent category to 30 per cent for the year ending March 1999. New private sector banks are required to mark to market their entire investments in approved securities from end-March 1997. The Monetary and Credit Policy for the first half of 1998-99 has pointed out the need to increase the ratio of current investments in approved securities progressively to 100 per cent in the next three years. This would be in line with international best practices.

4. Capital Adequacy and Supervision

Recapitalisation of Public Sector Banks

1.63 The Government contributed a sum of Rs.2,700 crore during 1997-98 (as against Rs.1,509 crore to six banks during the year 1996-97)[1] towards recapitalisation of three banks, viz., Canara Bank (Rs.600 crore), Indian Bank (Rs.1,750 crore) and UCO Bank (Rs.350 crore). The capital contribution by the Government to nationalised banks so far amounts to Rs.20,046.12 crore.

Write-off of Capital

1.64 The Government provided a sum of Rs.1,532 crore during the year ended March 1997 to write-off the losses of two banks against their capital. Accumulated losses to the extent of Rs.1,000 crore and Rs.532 crore were written off against the capital of Indian Overseas Bank and Allahabad Bank, respectively, during the year ended March 1997. The write-off cleans up the balance sheets of the concerned banks and enables them to make an early public issue. Canara Bank was permitted by the Government to reduce its paid-up capital as on Mach 31,

1998 by Rs.507.10 crore against the loss arising from the CanStar Scheme. The aggregate capital allowed to be written off by nationalised banks till date is Rs.3,978.52 crore.

Refund of Capital

1.65 The Punjab National Bank returned to the Government of India, capital amount of Rs.138.33 crore during the year ended March 31, 1998. Till date four banks have returned to Government of India, paid-up capital aggregating Rs.642.80 crore. The reduction in capital results in an improvement in earning per share and helps the concerned banks in better pricing of their share at the time of public issue.

[1]The amount contributed by the Government of India to different banks were as follows: Andhra Bank (Rs 165 crore), Central Bank of India (Rs 500 crore), Punjab & Sind Bank (Rs.150 Crores), UCO Bank (Rs 54 crore), United Bank of India (Rs 338 crore) and Vijaya Bank (Rs. 302 crore).

Public Issue of Shares

1.66 The State Bank of India and the Oriental Bank of Commerce approached the capital market in December 1993 and October 1994 at an issue price of Rs.100 and Rs.60, respectively. During 1996-97, the Dena Bank, Bank of India and the Bank of Baroda issued their scrips at issue prices of Rs.30, Rs.45 and Rs.85, respectively. Three PSBs viz., Corporation Bank, State Bank of Bikaner and Jaipur and State Bank of Travancore have accessed the capital market during the year ended March 31, 1998 to raise their capital as given in Table 1.2. The issues were fully subscribed. The holding of shares by the Government of India in Corporation Bank subsequent to public issue came down to 68.33 per cent. As at the end of March 1998, PSBs have raised capital (including premium) worth Rs.6,015 crore, including proceeds from the GDR issue of SBI aggregating Rs.1,270 crore raised during 1996-97

Table I.2 : Details of Public Equities by Public Sector Banks : 1993 to 1998

(Amount in Rs.crore)

Name of the Bank Date of Issue	Equity Capital before public issue	Size of the Issue			Equity after public issue	Post issue Share Holding			
		Equity	Premium	Total		Govt. RBI/SBI	%	Others	%
1	2	3	4	5	6	7	8	9	10
State Bank of India December 1993	200.00	274.00	1,938.17 (Rs.90 per share)	2,212.17	474.00	314.34	66.34	159.67	33.66
State Bank of India (GDR) October 1996	474.00	52.28	1,218.12 (Rs.233 per share)	1,270.40	526.28	314.34	59.73	211.94	41.27
State Bank of Bikaner & Jaipur - November 1997	36.40	13.60	59.84 (Rs. 440 per share)	73.44	50.00	37.50	75.00	12.50	25.00
Oriental Bank of Commerce October 1994	128.00	60.00	300.00 (Rs.50 per share)	360.00	192.54*	128.00	66.48	64.54	33.52
Dena Bank December 1996	146.82	60.00	120.01 (Rs.20 per share)	180.01	206.82	146.82	71.00	60.00	29.00
Bank of Baroda December 1996	196.00	100.00	750.00 (Rs.75 per share)	850.00	296.00	196.00	66.88	100.00	33.12
Bank of India February 1997	489.00	150.00	525.00 (Rs.35 per share)	675.00	639.00	489.00	77.00	150.00	23.00
Corporation Bank October 1997	82.00	38.00	266.00 (Rs.70 per share)	304.00	120.00	82.00	68.33	38.00	31.67
State Bank of Travancore January 1998	35.00	15.00	75.00 (Rs.500 per share)	90.00	50.00	38.00	76.00	12.00	24.00
Total		**762.88**	**5,252.14**	**6,015.02**					

* Including oversubscription retained.

Issue of sub-ordinated debt instruments for inclusion in Tier II capital

1.67 During the year ended March 1998, the following banks raised subordinated debt for inclusion in their Tier II capital.

Name of the Bank	Amount permited	Amount raised
Punjab & Sind Bank	Rs. 100 crore	Rs. 100 crore
Bank of India	Rs.700 crore	Nil
Syndicate Bank	Rs. 80 crore	Rs. 60 crore
Dena Bank	Rs. 200 crore	Rs. 155 crore

Supervision of Banks

1.68 The new approach to on-site inspection of banks in accordance with the recommendations of the Padmanabhan Working Group (1995) has been adopted from the cycle of inspections commencing July 1997. It focuses on the mandated aspects of solvency, liquidity, financial and operational health, based on a modified version of the CAMEL model viz., CAMELS, which evaluates banks' Capital Adequacy, Asset Quality, Management, Earnings, Liquidity and Systems and Control, shedding the audit elements under the existing inspection system.

1.69 As part of the new supervisory strategy piloted by the Board for Financial Supervision (BFS), the Department of Banking Supervision (DBS) of the Reserve Bank set up an off-site surveillance function in 1995 with the primary objectives of monitoring the financial condition of banks in between on-site examinations, identifying banks which show financial deterioration and which could be in trouble in the near future and acting as a trigger for on-site examination of banks. The major components of this function are the establishment of a computerised data base system based on a prudential supervisory reporting framework which provides quarterly returns of financial data from banks and other credit institutions, building up of a ‘Memory' on all supervised institutions, and setting up a Market Intelligence and Surveillance Unit (MISU).

1.70 The role of external auditors in bank supervision has been strengthened. Besides auditing the annual accounts, auditors are now required to verify and certify certain other aspects like adherence to statutory liquidity requirements, prudential norms relating to income recognition, classification of borrowal accounts and provisioning as also financial ratios to be disclosed in the balance sheets of banks. The system of concurrent audit in major branches of all commercial banks has also taken firm root. The ‘Compliance Officer System' has been further strengthened by advising the banks to designate a senior official of the rank of General Manager as ‘Compliance Officer' to act as a nodal point for ensuring compliance with important Reserve Bank/Government directives/instructions and report directly to Chief Executive Officer.

1.71 Two Supervisory Rating Models based on CAMELS and CACS (Capital adequacy, Asset quality, Compliance and Systems) factors for rating of Indian commercial banks and foreign banks operating in India respectively, have been worked out on the lines recommended by the Padmanabhan Working Group (1995). These ratings would enable the Reserve Bank to identify the banks whose condition warrants special supervisory attention.

New Regulatory Framework for NBFCs

1.72 Exercising the powers derived under the amended Reserve Bank Act and in the light of the experience in monitoring of the activities of NBFCs, a new package of regulatory measures was announced by the Reserve Bank in January 1998. The salient features of the new framework are discussed in details in Chapter IV. Of about 9,000 applications of NBFCs found to be eligible for registration on the basis of minimum Net Owned Fund (NOF) of Rs.25 lakh, the Reserve Bank has already decided on the applications of 7,300 companies. The entire process of registration is expected to be completed by the end of December, 1998. Taking into account both the positive as well as the negative aspects of the NBFC sector, the Reserve Bank and Government have been open to suggestion and advice from experts and market participants to further refine the regulatory framework for NBFCs, develop self-regulatory mechanism for smaller NBFCs, and improve operational effectiveness.

1.73 In order to undertake a comprehensive examination of the regulatory experience so far and the problems that have arisen on the ground, the Government had setup a Task Force to make further recommendations for effective regulation of NBFC sector. The Reserve Bank was closely associated with the work of the Task Force. Proposal of the Task Force are now under consideration of the Government. The Reserve Bank will make appropriate changes in the regulatory framework as soon as decisions of the Government, including any legislative changes that may be required to give effect to Task Force recommendations become available. Until then, NBFCs are advised to strictly adhere the current regulation in force.

5. Financial Performance of Scheduled Commercial Banks during 1997-98

1.74 The year 1997-98 marked the sixth year of financial sector reforms and the working results of SCBs showed a significant improvement in their profitability and other indicators. Most of the banks were able to reduce their Non-performing assests (NPAs), increase their capital adequacy together with substantial increase in non-interest income .

a) Profitability

1.75 During 1997-98, profits (both operating and net) of all bank-groups improved significantly (Table I.3). Operating profits of SCBs increased from Rs.12,239 crore in 1996-97 to Rs.14,624 crore in 1997-98, recording an increase of 19.5 per cent. Operating profits of PSBs increased from Rs.8,887 crore in 1996-97 to Rs.10,264 crore in 1997-98, recording a rise of 15.5 per cent[2]. In the case of foreign banks, operating profits rose from Rs.2,032 crore in 1996-97 to Rs.2,544 crore in 1997-98. Similarly, the operating profits of old Indian private sector banks increased in absolute terms from Rs.840 crore in 1996-97 to Rs.1,082 crore in 1997-98. Operating profits of new Indian private sector banks increased from Rs.481 crore in 1996-97 to Rs.734 crore in 1997-98. Due to write back of depreciation provision reflecting lower yields on Government paper, banks' provisioning requirements regarding ‘mark-to-market' proportion of investments in Government securities were generally lower. Provisions and contingencies as a proportion to total assets of all banking group except those

of foreign banks and Indian private sector banks (old and new) declined during 1997-98. Consequently, net profits of SCBs increased from Rs.4,504 crore in 1996-97 to Rs.6,499 crore in 1997-98, showing a rise of 44.3 per cent. As a proportion of total assets, net profits increased from 0.67 in 1996-97 to 0.82 in 1997-98. Among the banking groups, net profit ratio (i.e., net profits to total assets ratio) improved in the case of PSBs but declined in the case of foreign banks, old Indian private sector banks and new private sector banks during 1997-98. The net profit ratio of public sector banks increased from 0.57 per cent in 1996-97 to 0.77 per cent in 1997-98. Among the PSBs, net profit ratio of SBI group increased from 0.84 in 1996-97 to 1.06 in 1997-98. On the other hand, the net profit ratio of old Indian private sector banks decelerated from 0.91 in 1996-97 to 0.80 in 1997-98. Similarly, the net profit ratio of foreign banks declined from 1.19 in 1996-97 to 0.96 in 1997-98.

b) Spread

1.76 Net interest income (spread) of scheduled banks (i.e., interest income minus interest expended) as a percentage to assets has shown a decrease of 27 basis points from 3.22 in 1996-97 to 2.95 in 1997-98. In the case of PSBs, net interest income decreased by 25 basis points i.e., from 3.16 in 1996-97 to 2.91 in 1997-98 while for old private sector banks there was a decline of 37 basis points, from 2.93 to 2.56 during the same period. In the case of new private sector banks, the decrease in net interest income was of the order of 70 basis points from 2.88 to 2.18. Foreign banks generally have a relatively higher spread. But, for foreign banks, the decrease in net interest income was of low order i.e., 21 basis points (from 4.13 to 3.92). The decline in spread is mainly due to banks' increasing recourse to non-traditional banking activities.

[2] All proportion mentioned in this section are in percentage terms.

Table I.3 : Working Results of Scheduled Commercial Banks - Bank Group-wise : Some Important Financial Indicators - 1995-96, 1996-97 and 1997-98

Year	Operating Profit (3+10)	Net Profit (4-7)	Income (5+6)	Interest Income	Non-Interest Income	Expenditure (8 + 9+10)	Interest Expended	Other Operating Expenses	Provisions & Conti-ngencies
1	2	3	4	5	6	7	8	9	10
State Bank Group (8)									
1995-96	3,912.88	793.13	20,566.78	17,114.46	3,452.32	19,773.65	10,871.81	5,782.09	3,119.75
	(2.10)	(0.42)	(11.02)	(9.17)	(1.85)	(10.59)	(5.82)	(3.10)	(1.67)
1996-97	4,457.81	1,707.05	23,276.85	19,923.05	3,353.80	21,569.80	12,819.44	5,999.60	2,750.76
	(2.18)	(0.84)	(11.39)	(9.75)	(1.64)	(10.56)	(6.27)	(2.94)	(1.35)
1997-98	4,732.34	2,459.77	24,871.11	21,208.84	3,662.27	22,411.34	13,904.15	6,234.62	2,272.57
	(2.03)	(1.06)	(10.69)	(9.11)	(1.57)	(9.63)	(5.97)	(2.68)	(0.98)
Nationalised Banks (19)									
1995-96	3,623.50	-1,160.50	33,074.58	29,418.26	3,656.32	34,235.08	20,089.00	9,362.08	4,784.00
	(1.14)	(-0.36)	(10.37)	(9.22)	(1.15)	(10.73)	(6.30)	(2.93)	(1.50)
1996-97	4,429.37	1,445.12	37,983.67	33,977.29	4,006.38	36,538.55	23,519.18	10,035.12	2,984.25
	(1.26)	(0.41)	(10.79)	(9.65)	(1.14)	(10.38)	(6.68)	(2.85)	(0.85)
1997-98	5,531.21	2,567.29	42,830.94	37,857.99	4,972.95	40,263.65	26,260.47	11,039.26	2,963.92
	(1.33)	(0.62)	(10.29)	(9.09)	(1.19)	(9.67)	(6.31)	(2.65)	(0.71)
Public Sector Banks (27)									
1995-96	7,536.38	-367.37	53,641.36	46,532.72	7,108.64	54,008.73	30,960.81	15,144.17	7,903.75
	(1.49)	(-0.07)	(10.61)	(9.20)	(1.41)	(10.68)	(6.12)	(2.99)	(1.56)
1996-97	8,887.18	3,152.17	61,260.52	53,900.34	7,360.18	58,108.35	36,338.62	16,034.72	5,735.01
	(1.60)	(0.57)	(11.01)	(9.69)	(1.32)	(10.45)	(6.53)	(2.88)	(1.03)
1997-98	10,263.55	5,027.06	67,702.05	59,066.83	8,635.22	62,674.99	40,164.62	17,273.88	5,236.49
	(1.58)	(0.77)	(10.43)	(9.10)	(1.33)	(9.65)	(6.19)	(2.66)	(0.81)
Foreign Banks (42)*									
1995-96	1,586.72	749.26	6,084.97	4,960.04	1,124.93	5,335.71	3,186.36	1,311.89	837.46
	(3.35)	(1.58)	(12.83)	(10.46)	(2.37)	(11.25)	(6.72)	(2.77)	(1.77)
1996-97	2,031.78	666.30	7,608.50	6,212.48	1,396.02	6,942.20	3,896.05	1,680.67	1,365.48
	(3.62)	(1.19)	(13.57)	(11.08)	(2.49)	(12.38)	(6.95)	(3.00)	(2.44)
1997-98	2,543.89	629.96	8,697.36	6,783.09	1,914.27	8,067.40	4,222.29	1,931.18	1,913.93
	(3.90)	(0.96)	(13.32)	(10.39)	(2.93)	(12.36)	(6.47)	(2.96)	(2.93)
Old Indian Private Sector Banks (25)									
1995-96	776.94	390.80	4,332.02	3,754.69	577.33	3,941.22	2,593.00	962.08	386.14
	(2.10)	(1.06)	(11.71)	(10.15)	(1.56)	(10.65)	(7.01)	(2.60)	(1.04)
1996-97	839.51	405.69	5,388.93	4,732.56	656.37	4,983.24	3,431.20	1,118.22	433.82
	(1.89)	(0.91)	(12.12)	(10.65)	(1.48)	(11.21)	(7.72)	(2.52)	(0.98)
1997-98	1,082.01	442.36	6,437.80	5,496.52	941.28	5,995.44	4,083.77	1,272.02	639.65
	(1.96)	(0.80)	(11.66)	(9.96)	(1.71)	(10.86)	(7.40)	(2.30)	(1.16)
New Indian Private Sector Banks (9)									
1995-96	249.881	166.76	999.60	834.98	164.62	832.84	578.89	170.83	83.12
	(2.77)	(1.85)	(11.08)	(9.25)	(1.82)	(9.23)	(6.41)	(1.89)	(0.92)
1996-97	481.02	280.08	1,967.20	1,638.55	328.65	1,687.12	1,172.64	313.54	200.94
	(2.98)	(1.73)	(12.17)	(10.14)	(2.03)	(10.44)	(7.26)	(1.94)	(1.24)
1997-98	734.46	399.52	3,011.18	2,385.60	625.58	2,611.66	1,821.00	455.72	334.94
	(2.84)	(1.55)	(11.65)	(9.23)	(2.42)	(10.10)	(7.04)	(1.76)	(1.30)
*Scheduled Commercial Banks (103) ***									
1995-96	10,149.92	939.45	65,057.95	56,082.43	8,975.52	64,118.50	37,319.06	17,588.97	9,210.47
	(1.69)	(0.16)	(10.86)	(9.36)	(1.50)	(10.70)	(6.23)	(2.94)	(1.54)
1996-97	12,239.49	4,504.24	76,225.15	66,483.93	9,741.22	71,720.91	44,838.51	19,147.15	7,735.25
	(1.82)	(0.67)	(11.33)	(9.88)	(1.45)	(10.66)	(6.66)	(2.85)	(1.15)
1997-98	14,623.91	6,498.90	85,848.39	73,732.04	12,116.35	79,349.49	50,291.68	20,932.80	8,125.01
	(1.84)	(0.82)	(10.79)	(9.27)	(1.52)	(9.97)	(6.32)	(2.63)	(1.02)

* The number of Foreign Banks in 1995-96, 1996-97 and 1997-98 were 33, 39 and 42 respectively.
** The number of Scheduled Commercial Banks in 1995-96, 1996-97 and 1997-98 were 94, 100 and 103 respectively.
Note: Figures in brackets are percentages to Total Assets.

c) Non-Performing Assets

1.77 The quantum of gross NPAs as a percentage of advances of PSBs declined from 17.8 per cent in 1996-97 to 16.0 per cent in 1997-98 (Table I.4). Gross NPAs as a proportion to total assets3 of PSBs declined from 11.8 per cent in 1992-93 to 7.0 per cent in 1997-98 [Bank-wise details are given in Appendix Table I.1(A),(C) and (E)]. Provisions have been made for one half of gross NPAs of PSBs. The net NPA4 as percentage of net advances

also declined from 9.2 per cent in 1996-97 to 8.2 per cent in 1997-98. Net NPAs to total assets declined from 4.0 per cent in 1994-95 to 3.3 per cent in 1997-98. The incremental NPAs to advances - both gross and net - during 1997-98 was less than 5 per cent. Advances in each of the four asset categories (i.e., standard, substandard, doubtful and loss) of the PSBs during 1993 to 1998 are given in Table 1.5; the proportion of standard assets of PSBs has increased from 82.2 per cent in end-March 1997 to 84.0 per cent in end-March 1998. Nearly one-half of the NPAs of PSBs was on account of priority sector (Table 1.6). The share of priority sector advances in gross NPAs of PSBs has come down from 50.0 per cent in end-March 1995 to 46.4 per cent in end-March 1998.

1.78 Out of the 27 PSBs, only one had net NPAs of more than 20 per cent of its net advances in 1997-98 [Table I.7 and Appendix Table I.1(B)]. None of the Indian private sector banks - both old and new- had net NPAs above 20 per cent whereas two foreign banks had net NPAs above 20 per cent in 1997-98 [Table I.8 and Appendix Tables I.1(D) and (F)].

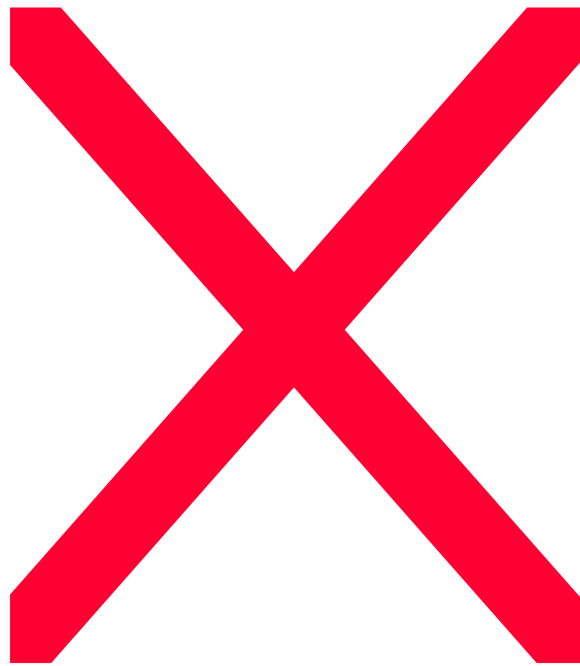
Table I.4 : Gross and Net NPAs of Public Sector Banks - 1992-93 to 1997-98

(Amount in Rs. crore)

End-March	Gross NPAs	% to Gross Adv.	% to Total Assets	Net NPAs	% to Net Adv.	% to Total Assets
1	2	3	4	5	6	7
1993	39,253	23.2	11.8			
1994	41,041	24.8	10.8			
1995	38,385	19.5	8.7	17,567	10.7	4.0
1996	41,661	18.0	8.2	18,297	8.9	3.6
1997	43,577	17.8	7.8	20,285	9.2	3.6
1998 (P)	45,653	16.0	7.0	21,232	8.2	3.3

[3] Total assets consists predominantly of loans and advances and SLR investments in addition to other assets.

[4] Net NPAs is derived from gross NPAs by excluding (i) balance in interest suspense account i.e., interest due but not received, (ii) DICGC / ECGC claim received and kept in suspense account pending adjustment (for final settlement), (iii) part payment received and kept in suspense account, and (iv) total provisions held.



d) Capital to Risk Weighted Assets Ratio

1.79 Capital adequacy ratio of PSBs improved from 10.0 per cent in 1996-97 to 11.53 per cent in 1997-98. Out of the 27 PSBs, 26 banks (25 banks last year), have attained the stipulated 8 per cent capital adequacy requirement. During 1997-98, 19 banks had CRAR exceeding 10 per cent (16 banks last year) while 7 banks' CRAR ranged between 8 to 10 per cent [Table 1.9 (A) and Appendix Table 1.2 (A)]. During 1997-98, there was only one bank with CRAR less than 4 per cent as opposed to two banks in 1996-97. The generally favourable development in this area has been facilitated to a considerable extent by large-scale recapitalisation of PSBs. Among the Indian old private sector banks, 4 banks had capital adequacy ratio below 8 per cent in 1997-98, while all the foreign banks exceeded the minimum capital adequacy ratio [(Table 1.9 (B) and Appendix Tables 1.2 (B) and (C)].

Table I.5 : Classification of Loan Assets : Public Sector Banks - 1992-93 to 1997-98

(as at end-March) (Rs. crore)

	1993	1994	1995	1996	1997	1998(P)
1	2	3	4	5	6	7
1. Standard Assets	1,30,087	1,24,580	1,58,967	1,89,660	2,00,637	2,39,318
	(76.8)	(75.2)	(80.6)	(82.0)	(82.2)	(84.0)
2. Sub-standard Assets	12,552	12,163	7,758	9,299	12,471	14,463
	(7.4)	(7.4)	(3.9)	(4.0)	(5.1)	(5.1)
3. Doubtful Assets	20,106	23,317	22,913	24,707	26,015	25,819
	(11.9)	(14.1)	(11.6)	(10.7)	(10.6)	(9.1)
4. Loss Assets	3,930	4,073	3,732	4,351	5,090	5,371
	(2.3)	(2.4)	(1.9)	(1.9)	(2.1)	(1.9)
5. Advances with balances less than Rs.25,000 included in NPA	2,665	1,488	3,982	3,304		
	(1.6)	(0.9)	(2.0)	(1.4)		
6. Total NPAs (2 to 5)	**39,253**	**41,041**	**38,385**	**41,661**	**43,577**	**45,653**
	(23.2)	**(24.8)**	**(19.4)**	**(18.0)**	**(17.8)**	**(16.0)**
7. Total Advances (1+6)	**1,69,340**	**1,65,621**	**1,97,352**	**2,31,321**	**2,44,214**	**2,84,971**
	(100.0)	**(100.0)**	**(100.0)**	**(100.0)**	**(100.0)**	**(100.0)**

P : Provisional.
Note : Figures in brackets are percentages to total advances.

6. Payments and Settlement System

1.80 The functioning of the payments and settlement system has a crucial bearing on the efficiency of money, capital and forex market and has manifold implications for the conduct of monetary policy. A number of initiatives were taken in 1997-98 to enlarge the coverage of payment systems. Mention may be made of increased utilisation of electronic clearing of debit and credit items in many major cities. The work relating to the satellite-based Wide Area Network to provide reliable communication framework for the financial sector has progressed and is expected to be operational before the end of 1998-99. The upgradation of the Cheque Clearing in the banking industry and the existing cheque processing systems at the four National Clearing Centres (NCC) has been taken up. The Year 2000 problem is being proactively dealt with by the Reserve Bank in coordination with IBA, banks and other sectors of the financial system.

Table I.6 : Sector-wise NPA of Public Sector Banks: 1994-95 to 1997-98

(Rs. crore)

Bank Group	Priority Sector	Non-priority Sector	Public Sector	Total
1	2	3	4	5
March 1995				
1. SBI	6,967	5,496	809	13,271
	(52.5)	(41.4)	(6.1)	(100.0)
2. Nationalised Banks	12,242	12,366	507	25,115
	(48.7)	(49.2)	(2.0)	(100.0)
3. PSBs (1+2)	19,208	17,861	1,316	38,385
	(50.0)	(46.5)	(3.4)	(100.0)
March 1996				
1. SBI	7,041	5,263	816	13,120
	(53.7)	(40.1)	(6.2)	(100.0)
2. Nationalised Banks	12,065	13,804	595	26,464
	(45.6)	(52.2)	(2.3)	(100.0)
3. PSBs (1+2)	019,106	19,067	1,411	39,584*
	(48.3)	(48.2)	(3.6)	(100.0)
March 1997				
1. SBI	7,247	6,291	829	14,368
	(50.4)	(43.8)	(5.7)	(100.0)
2. Nationalised Banks	13,527	15,049	632	29,209
	(46.3)	(51.5)	(2.2)	(100.0)
3. PSBs (1+2)	20,774	21,341	1,461	43,577
	(47.7)	(49.0)	(3.3)	(100.0)
March 1998 (P)				
1. SBI	7,470	7,390	662	15,522
	(48.1)	(47.6)	(4.3)	(100.0)
2. Nationalised Banks	13,714	15,717	700	30,131
	(45.5)	(52.2)	(2.3)	(100.0)
3. PSBs (1+2)	21,184	23,107	1,362	45,653
	(46.4)	(50.6)	(3.0)	(100.0)

* Revised to Rs.41,661 crore. P : Provisional.

Note : Figures in brackets are percentages to the total.

Table I.7 : Frequency Distribution of Net NPAs: Public Sector Banks : 1995 to 1998

(No. of banks)

Net NPAs/Net Advances	End - March			
	1995	1996	1997	1998
1	2	3	4	5
1. Upto 10 per cent	2	19	17	17
2. Above 10 and upto 20 per cent	15	6	9	9
3. Above 20 per cent	10	2	1	1

Table I.8 : Frequency Distribution of Net NPAs:

Indian Private Sector Banks and Foreign Banks : 1996 to 1998

(No. of Banks)

Net NPAs/Net Advances	End-March		
	1996	1997	1998
1	2	3	4
Old Indian Private Sector Banks			
1. Upto 10 per cent	22	22	21
2. Above 10 and upto 20 per cent	3	3	4
3. Above 20 per cent	Nil	Nil	Nil
New Private Sector Banks			
1. Upto 10 per cent	9	9	9
2. Above 10 and upto 20 per cent	Nil	Nil	Nil
3. Above 20 per cent	Nil	Nil	Nil
Foreign Banks in India			
1. Upto 10 per cent	30	36*	34@
2. Above 10 and upto 20 per cent	1	1	6
3. Above 20 per cent	Nil	2	2

* Out of 36 foreign banks, 16 banks had nil NPA as compared with 12 (out of 30) in 1995-96.

@ Out of 34 foreign banks 14 banks had nil NPA.

Table I.9 (A) : Frequency Distribution of CRAR :
Public Sector Banks - 1996-97 and 1997-98

Banks	1996-97				1997-98			
	Below 4 per cent	Between 4-8 per cent	Between 8-10 per cent	Above 10 per cent	Below 4 per cent	Between 4-8 per cent	Between 8-10 per cent	Above 10 per cent
1	2	3	4	5	6	7	8	9
1. SBI	-	-	-	1	-	-	-	1
2. SBI Associates	-	-	3	4	-	-	1	6
3. Nationalised Banks	2	-	6	11	1	-	6	12
Total	2	-	9	16	1	-	7	19

Table I.9 (B) : Frequency Distribution of CRAR : Indian Private Sector Banks and
Public Sector Banks - 1996-97 and 1997-98

Banks	1996-97				1997-98			
	Below 4 per cent	Between 4-8 per cent	Between 8-10 per cent	Above 10 per cent	Below 4 per cent	Between 4-8 per cent	Between 8-10 per cent	Above 10 per cent
1	2	3	4	5	6	7	8	9
1. Old Pvt. Sec. Banks	3	1	8	13	2	2	6	15
2. New Pvt. Sec. Banks	-	-	-	9	-	-	2	7
3. Foreign Banks	-	-	13	26	-	-	12	30

7. Overlapping functions of Banks and Financial Institutions

1.81 In recent years, there is an increasing convergence in the asset-liability structure of banks and financial institutions. With the drying up of concessional Long-Term Operations (LTO) funds from the Reserve Bank in the early 1990s, FIs have increasingly raised resources at the short end of the deposit market. Besides, they have entered increasingly into working capital financing, and short term financing. Commercial banks, on their part, have increasingly moved to term lending paving way for universal banking. The Working Group on Harmonising the Roles of Banks and Financial Institutions (Chairman: Shri S.H.Khan), in its report submitted in April 1998, made certain recommendations for strengthening the organisation of domestic institutions/banks which inter alia include, (i) a gradual move towards universal banking and evolving an enabling regulatory framework for this purpose; (ii) exploring the possibility of gainful mergers between different sets of financial entities (banks /FIs) based on commercial considerations; (iii) speedy implementation of legal reforms to expedite debt recovery; (iv) consolidated supervision of banks and FIs; (v) reducing CRR to internationally acceptable levels; and (vi) phasing out SLR. The Monetary and Credit Policy for the first half of 1998-99 has proposed to prepare a ‘Discussion Paper' which would contain the Reserve Bank's draft proposals for bringing greater clarity in the respective roles of banks and financial institutions and for greater harmonisation of facilities and obligations applicable to them, taking into account the recommendations of the

Narasimham Committee Report (1998) which have a bearing on the issues considered by the Working Group.

8. Rural Credit and Credit to Small Scale Industries (SSIs)

Rural Credit

1.82 Rural sector financing continued to be a major policy concern during 1997-98. The refinancing capacity of the National Bank for Agriculture and Rural Development (NABARD) was further enhanced by increasing (a) its capital base and (b) the General Line of Credit Limit. The General Line of Credit Limit from the Reserve Bank was increased from Rs.5,500 crore in 1996-97 to Rs. 5,700 crore during 1997-98. The share capital of the NABARD was increased from Rs.1,000 crore during 1996-97 to Rs.1,500 crore by 1997-98.

1.83 The policy to channelise shortfall in priority sector lending by banks into rural infrastructure investment continued during 1997-98 also. Apart from the RIDF III corpus of Rs. 2,500 crore, the Union Budget 1998-99 has announced the establishment of RIDF-IV with a corpus of Rs.3,000 crore. In order to strengthen the capital base of rural institutions, a sum of Rs.400 crore was released by Government of India for recapitalisation of 90 RRBs in 1997-98 of which 15 were included for the first time. The Union Budget 1998-99 has earmarked an amount of Rs.265 crore for further recapitalisation of RRBs.

Action taken on Gupta Committee Report

1.84 The one man committee under the Chairmanship of Shri R.V. Gupta which examined the problems faced by the borrowers in agricultural sector, had made several recommendations for ameliorating the problems in the flow of agricultural credit. The recommendations relating to several procedural modifications on agricultural credit have been advised to banks for implementation. These recommendations cover greater flexibility and discretion to the lending banks in matters of collateral, margin, security, dispensing with no dues certificates, introduction of a composite cash credit limits to cover farmers' production, post-harvest and household requirements, etc. Besides, IBA has been requested to work out simplifying application forms for agricultural loans and banks have been advised to delegate sufficient powers to their branch managers. Similarly, the recommendations which are to be considered by the Government like abolition of stamp duty for agricultural loans, assistance from State Governments for recovery of banks dues, matters relating to mortgage of land, banks finance to tenant farmers and also matters pertaining to subsidy-linked credit have been forwarded to the Government for necessary action. The action taken by banks was reviewed at a meeting of a select bankers on September 26, 1998. Bankers reported that they have initated action for implementing the recommendations of the committee.

Credit to Small Scale Industries

1.85 The Small Scale Industries (SSI) account for nearly 40 per cent of the gross turnover of manufacturing sector, 45 per cent of manufacturing imports and 35 per cent of total exports from the country. The limited accessibility of the SSI to institutional finance has been a major policy concern. A Committee was set up by the Reserve Bank in December 1997 (under the Chairmanship of Shri S.L. Kapur) to suggest measures for improving the Credit Delivery System for SSIs. The Committee submitted its report in June 1998 and the major recommendations of the Committee are as follows:

(i) Special treatment to smaller among small industries;
(ii) Removal of procedural difficulties to facilitate SSI advances;
(iii) Sorting out issues relating to the mortgage of land, including removal of stamp duty and permitting equitable mortgages;
(iv) Allowing access to low cost funds to SIDBI for refinancing SSI loans;
(v) Non-obtention of collaterals for loans up to Rs.2 lakh;
(vi) Setting up of a collateral reserve fund to provide support to the first generation of entrepreneurs who find it difficult to furnish collateral securities to third party guarantees;
(vii) Setting up of a Small Industries Infrastructure Development Fund for developing industrial areas in/around metropolitan and urban areas;
(viii) Change in the definition of sick SSI units;
(ix) Giving statutory powers to state level inter-institutional committee (SLIC);
(x) Setting up of a separate guarantee organisation and opening of 1000 additional specialised branches; and
(xi) Enhancing of SIDBI's role and status to match that of NABARD.

1.86 The Committee has made totally 126 recommendations covering wide range of areas relating to financing of SSI sectors. The Reserve Bank had examined these recommendations and decided to accept 35 recommendations for immediate implementation. These recommendations cover delegation of more powers to branch managers, simplification of applications, opening more SSI specialised branches, enhancement in the limit for composite loans, strengthening of recovery mechanism, etc. The remaining recommendations are under examination in consultation with NABARD, SIDBI and Government of India.

9. Perspectives

1.87 The improved performance of banks during 1997-98 essentially reflects the gains arising from financial sector reforms. The successful meeting of capital adequacy requirements and reduction of the level of NPAs in particular are significant. There has been clear evidence of prudent management of investment portfolios as reflected in their participation in primary auctions of Government securities, and in significant interest income from Government securities.

1.88 The agenda for further reforms was set out by the Narasimham Committee Report (1998) which include further refinements of prudential norms and enhancement of capital base of banks. The focus of further reforms has to be and has rightly been on improving efficiency and accountability and on further improving the functioning of financial markets.

Capital Adequacy Standards

1.89 In recent years, capital adequacy has been the cornerstone of prudential regulatory framework in India. Most of the PSB except one, have already attained 8 per cent minimum risk weighted capital adequacy ratios . Most of the infusions of capital for PSBs (more than Rs.20,000 crore) had come from the Government; a few banks raised capital from the market (including one through GDR). Still as Narasimham Committee Report (1998) had pointed out, there is need for improving capital adequacy, in the light of the significantly high "cost of servicing of the loans".

1.90 Taking into consideration the substantial off-balance sheet exposures of banks, the Narasimham Committee (1998) had recommended enhancement of capital adequacy ratio from the present stipulation of 8 per cent to 10 per cent by 2002. Endorsing this decison , the Union Budget, 1998-99 has announced raising of the minimum capital adequacy ratio to 9 percent by March 31, 2000 and to 10 percent as early as possible thereafter. Viewed from the regulatory and supervisory point of view, it is important to note that enhancement of bank capital has to be based on each bank's assessment of its optimal level of capital given its risk exposure and should not be at the expense of shedding loans. It must be reiterated that there is nothing like zero risk lending and banks have to develop in-house expertise to manage risks effectively. Moreover in a scenario where banks are increasing their non-traditional banking and off-balance sheet activities substantially, capital is the only resource available to banks to absorb any adverse effects on account of such activities. Therefore, an increase in capital standards would be the right signal from supervisors to banking industry.

1.91 The recommendations of Narasimham Committee needs to be seen in the context of an emerging view that Basle capital adequacy accord is no longer adequate and needs to be modified. The Basle Accord, it needs to be recognised, sets a minimum capital ratio, not a maximum insolvency probability and also is not a static framework, but is developed and improved continuously, as is evident from the January 1996 Amendment to introduce capital charges to market risk[5]. In this context, the recommendation of Narasimham Committee Report for recording a 5 per cent weight to investment in Government and approved securities requires to be examined.

Transparency

1.92 One of the important reasons for the recent turmoil in South East Asia is the absence of proper disclosures in the balance sheets of financial intermediaries. The transparency of the banking and financial system is an issue related to sound financial infrastructure (See Box I.2). In fact, the lack of transparency results in incentive to 'evergreen' loans, thereby impacting on the performance of assets.

1.93 A major element of the financial sector reforms in India has been the application of prudential norms and regulations introduced in 1992 aimed at ensuring safety and soundness of the financial system and at the same time encouraging markets to play increasing role. Prudential norms serve two primary purposes - first they reveal the true position of the bank's loan portfolio and secondly, they help arrest its deterioration. Prudential reforms introduced in India relate to income recognition, asset classification and provisioning for bad and doubtful debts and capital adequacy. Over a period of time, these measures have been tightened. For example, an account was considered non-performing in 1992-93 if its principal and interest was due for four quarters; this was reduced to two quarters by 1994-95. The disinvestment of shareholding of PSBs has also facilitated availability of further information about their functioning through quarterly financial results. These measures for ensuring greater transparency in operations of banks in India are vital for smooth functioning of financial markets. Transparency and availability of timely information facilitate markets to form their own expectations in a more rational and realistic manner.

[5] The Market risk is defined as the risk of losses in and off-balance sheet positions arising from the investment in market prices. The risk subject to this requirements are (1) the risk pertaining to interest rate related investments and equities in the trading book and (2) foreign exchange risk and comodities risk throughout the bank. (See Basle Commitee on Banking Supervision, Amendment to Capital Accord to Incorporate Market Risks, January 1996)

BOX I.2: THE ROLE OF TRANSPARENCY IN THE FUNCTIONING AND STABILITY OF BANKS

Banking operations worldwide have undergone phenomenal expansion in the last two decades. Financial liberalisation and technical change have created new and complex financial products and have increased their turnover in financial markets. Although the benefits of these developments have been substantial, they have also created more risks. The banking crisis episodes in Latin America and South-East Asia are testimony to this. This brought to the fore, the core issue of whether there is a need to closely monitor banking/financial institutions and the existing disclosure and transparency of information by banks are sufficient enough for various interested groups (including its depositors and shareholders) to judge these entities. It is increasingly recognised that transparency would facilitate better monitoring of banks by depositors/shareholders.

The growing globalisation of banks and the introduction of modern information technology by international banks have enabled the banks to rapidly expand their non-fund and off-balance sheet activities. Making the bank asset portfolio more transparent could help in the task of measuring capital and risks associated with banking transactions. Secondly, increased transparency could also facilitate market discipline - a highly desirable goal in our rapidly changing financial environment. It has the potential to allow regulation and supervision to be less bothersome. Thirdly, disclosure and transparency enable markets to discipline banks to pursue healthy and sustainable policies via funding costs, credit lines and share prices. Lastly, public disclosure can limit contagion effect during market turmoil as sound banks can distinguish themselves from the weak ones.

The financial accounting of banking operation and other qualitative information forming disclosure, vary from bank to bank and from country to country. Regarding transparency or public disclosure, there is the New Zealand model, which relies on market discipline and public disclosure. On the other hand, there are other developed countries, which apart from prescribing certain public disclosures of financial aspects of banks, have also adopted on-site inspection of banks (besides off-site surveillance) to understand their financial soundness. Auditors play a major role in determining the disclosure and soundness of the banking system reflecting true and fair view of financial position of banks. In an environment of advanced information technology, internal auditors have to adopt a pro-active stance in keeping the internal control systems in order, by ensuring higher level of transparency of information. External auditors have to play an important role in disclosure which goes beyond the certification that the balance sheet and profit and loss accounts exhibit the ‘true and fair' view of the affairs of the bank[6].

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[6] Rangarajan, C. (1997) 'The Role of External Affairs in the Banking Industry', Reserve Bank of India Bulletin, January, 73-77.

The Committee on the Financial System (Chairman Shri M.Narasimham) of 1992, and the Working Group to Review the System of On-Site Supervision over Banks (Chairman Shri S. Padmanabhan) of 1995 had recommended for proper strengthening of supervision of banks leading to sound and transparent banking system. In order to strengthen the internal control system for providing better guidance to banks, the Jilani Committee Report on Internal Control Systems provided the necessary input to set the house in order. However, in ensuring overall soundness of the banking system, the critical role of external auditors who has to express an opinion on the financial results viz., balance sheet and profit and loss account should not be underestimated. With the total report on the financial statements, they submit a report called Long Form Audit Report (LFAR) for banks. This report normally contains the opinion of the auditors on balance sheet, adequacy of information for the purpose of audit, whether profit and loss account indicates true and fair view of the accounts, etc. They have also been asked to be a part of statutory audit to verify compliance with SLR requirements. If the financial statements consisting of accounting and disclosure practices do not project the true state of affairs of banks, banking supervisors will have to impress upon the banks to devise methods for making their operational details transparent on the lines of internationally accepted standards.

In the context of the initiatives at the global level for greater transparency of financial intermediaries, a committee was set up by the Reserve Bank in March 1982 under the Chairmanship of Shri A. Ghosh for revising the format of presentation. The committee had revised and enlarged the formats of presentation of balance sheet and profit and loss accounts. It had also prepared necessary guidelines for compiling the final accounts with a view to ensuring uniformity in the presentation of final accounts by different banks. Furthermore banks were asked to give clarification notes in respect of the balance sheet and profit and loss items.

As globalisation of banking increases the risk of contagion effect of banking problems, the need to ensure transparency has become vital for the regulators. In fact there is a need for sharing information about banks among regulators within the country and outside. On the disclosure side, as there is not much uniformity in practices in various countries, it has become difficult to distinguish healthy banks from unhealthy ones. Differences in accounting standards across countries and the absence of serious penalties for publishing inaccurate information also obstruct a meaningful assessment of banks.

The Securities and Exchange Board of India (SEBI), as a regulatory institution for capital market activities, facilitates disclosure of information by all players in the market including banking intermediaries. This is primarily aimed at protecting the interests of investors in the first instance and for developing an efficient capital market system in the country. The SEBI, which came into being in 1992, issued guidelines on disclosure of information and investor protection for players in capital market. Some of the important disclosure requirements (to be published in the prospectus) of companies entering capital market include disclosure about past profit record of the company, details of contingent liabilities, pending cases against the company and cases associated with promoters of the company.

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Non-Performing Assets

1.94 The level of NPAs - both gross/net - of PSBs as a percentage to gross/net advances have been on decline. The percentage of gross NPAs to advances which was at 24.8 per cent in 1993-94 have come down to 16.0 per cent and in 1997-987. However, the absolute magnitude of the level of gross NPAs at Rs.45,653 crore and net NPAs at Rs.21,232 crore of PSBs in 1997-98 still remains a major hurdle, act as a deadweight loss for banks and has acted as an impediment to lower lending rates. It is our endeavour that such deadweight losses are brought down substantially so that banks' balance sheets are clean and they can start on a clean slate.

Asset Reconstruction Funds

1.95 Although the proposal for Asset Reconstruction Fund (ARF) was mooted by the Committee on Financial System (CFS) in 1991, it did not evoke much policy response at that time mainly due to the concerns of 'moral hazard' that it engenders. Given the slow pace at which Debt Recovery Tribunals (DRTs) have performed due to legal and other structural factors, it is useful to try ARF at least in a limited way while minimising the problem of moral hazard. It is in this context that the Union Budget for 1998-99 proposed the creation of Asset Reconstruction Companies (ARCs) which will take over the NPAs of the banks and swap them with special bonds. An amount of Rs.400 crore was set out in the Budget and it is important these funds be used only for the capital of ARCs and not to bail out weak banks - directly or indirectly. Beside the use of ARCs, it is necessary to strengthen the system of negotiated settlements between lenders and holders of NPAs to bring down the level of NPAs of banks. The crucial aspect of negotiated settlements is that they should be done in an efficient and transparent way.

Size and Issues of Merger

1.96 The increasing forays of banks into new areas (either departmentally or through subsidiaries) and the convergence in the nature of business operations of banks, FIs and NBFCs raise the issue of virtues of merger of banks. In fact Narasimham Committee Report had advocated merger between banks and DFIs and NBFCs based on business specific complimentaries. The issue of merger is related to the question of size - what constitute the optimum size of a financial intermediary in the emerging economic environment. A narrow view of the concept of size is the expansion of size of balance sheets of banks. But a broader view of this concept involve issues such as efficiency, competitive and strategic repositioning. In principle, merger and acquisition provide an opportunity for banks to share resources,reduce intermediation costs and expand delivery platforms, as also to improve chances for economies of scale to operate.

[7] As a proportion of total assets the corresponding figures comes to 10.8 per cent and 7 per cent respectively.

Banking Standards

1.97 In recent years, financial markets in Asia have been subject to considerable stress. In view of the growing integration of markets across borders, it is imperative that domino effects are minimised by refining and upgrading the financial infrastructure including instruments such as accounting standards, income and provisioning norms and insolvency laws. It is necessary to ensure that the standards attained are equivalent to international best practices.

1.98 In India, NPAs are defined as an advance that has not been serviced, as a result of 'past dues' accumulating for 180 days and over. Narasimham Committee Report 1998 had recommended that we move towards international norm of one quarter of a year. Although moving towards international best practices is desirable, it is necessary from the point of view of stability of the financial system to move in a gradual manner. In this connection, it is necessary to recognise that in many respects the NPA norms in India are considerably tighter than the international best practices. For example, it is customary to make a distinction between collateralised and non-collateralised NPA in most of the developed countries and accordingly for collateralised NPAs lower provisions are allowed. In India, the concept of NPA does not allow such concessions and almost all advances are collateralised. This implies that the prudential norms in India are tighter than some of the international best practices in a very substantive way, and the provisions made are beyond the requirement of prudence.

Risk Management

1.99 Risk management is emerging as an important area that financial entities will need to handle in view of the play of market forces in all financial markets and the need to reckon securities for the market valuation. Effective risk management can reduce the adverse effects of macro-economic instability on the soundness of the financial system. Banks in the process of providing financial services assume various kind of financial risks viz., credit, interest rate, foreign exchange and liquidity risks. To some extent these risks could be eliminated through sound business practices and the others through a combination of product design and pricing. In the past, banks had concentrated solely on asset management with liquidity and profitability being regarded as two opposing considerations. As a result, banks ended up distributing assets in such a way that, for given liquidity levels, the return was the maximum. Consequent to the liberalisation of domestic markets, the volatility in interest/exchange rates would be transmitted to the financial sector as a whole. In order to proactively address the risks, banks have to undertake a comprehensive Asset Liability Management (ALM) strategy. The Monetary and Credit Policy for the second half of 1997-98 emphasized the need for banks to put in place a comprehensive ALM system. This encompasses a process of continuous management (in terms of planning, organizing and controlling) of asset and liability volumes, rates and yields and incorporating the maturities of assets and liabilities into consideration as well. Management of assets and liabilities requires gathering of enormous amount of information, market research and quick empirical reports to enhance the Management Information Systems (MIS).

1.100 Pricing of risk is an important area, requiring prime attention. Banks have to move away from the relatively unscientific practices of pricing risks based on perception of customers to more scientific practice based on technical assessment of the risks involved while ensuring transparency. Embracing scientific risk management practices will not only improve banks' credit management processes and increase profits, but also enable them to nurture and develop mutually beneficial relationships with customers. Pursuant to these objectives, detailed draft guidelines were circulated to SCBs (excluding RRBs) in September 1998.

1.101 In recent years, financing infrastructure has become a challenge to banks. In view of the fact that financing of infrastructure involves large funds to be committed for long periods of time, banks could face asset-liability mismatches. In order to meet the financing requirements of infrastructure and other large investment projects, banks need to develop the necessary expertise. Consequently, banks have to gear themselves to develop adequate expertise in risk management backed up, as indicated earlier, by a proper MIS.

Supervision

1.102 The experience of Asian crisis has reiterated the need for sound regulatory and supervisory system in the course of financial liberalisation. The role of supervision is to promote financial market stability and minimise systemic risk. In this task, there is a broad consensus that for markets to operate in a fair, transparent and efficient manner, the financial sector reforms should proceed in an orderly fashion. The Narasimham Committee Report (1998) while laying down the signposts for second phase of banking sector reforms in India, suggested that the supervisory responsibility would need to guide the banking system in the charted path so as to achieve the desired goals. The key elements of this strategy include (a) sound capital adequacy standards, (b) market discipline, and (c) a dynamic risk-focussed approach to supervision. The cornerstone of bank supervisory processes is the promotion of prudent practices.

1.103 The supervisory strategy in India at present comprises both off-site surveillance and on-site inspections. A detailed off-site surveillance system based on 'prudential' supervisory reporting framework on a quarterly basis covering capital adequacy, asset quality, loan concentration, operational results and connected lending has been made operational. This is combined with a verification of prudent practices and financial condition of banks through on-site examination. In regard to on-site inspection, the focus is now on the evaluation of total operations and performance of the banks under the CAMELS system, i.e. capital adequacy, asset quality, management, earnings, liquidity and internal control systems. The new approach to annual financial inspections based on CAMELS framework commenced from July 1997. The main endeavour of this system is to detect problems before they manifest themselves. An efficient result-oriented on-site inspection system requires an efficient follow-up. The entire cycle of inspection and follow-up action are now completed within a maximum period of twelve months. Monitorable action plan for rectification of irregularities/deficiencies noticed during the inspection within a time frame is drawn up and progress in implementation pursued with the concerned bank. Thus the present supervisory system is a substantial improvement over the earlier system in terms of frequency, coverage and focus as also the tools employed. Nearly one-half of the Basle Core Principles for Effective Banking Supervision has already been adhered to and the remaining are at different stages of implementation (Box I.3).

BOX I.3 : THE BASLE CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

The Basle Committee on Banking Supervision, in April 1997, released the *Basle Core Principles for Effective Banking Supervision*, a set of twenty-five basic Principles which it advocates for a supervisory system to be effective. The Basle Core Principles have been drawn up by the Basle Committee in close consultation with the supervisory authorities in fifteen emerging market countries[8]. The 25 Core Principles represent the basic elements of an effective supervisory system and cover pre-conditions for effective banking supervision, licensing and structure, prudential regulations and requirements, methods of ongoing banking supervision, information requirements, formal powers of supervisors and cross-border banking. These principles are in the nature of minimum requirements and can be broadly categorised as :

[8]The document has been prepared in a group containing representatives form the Basle Commitee and from Chile, China, the Checz Republic, Honkong, Mexico, Russia and Thailand. Nine other countries (Argentina, Brazil, Hungary, India, Indonesia, Korea, Malaysia, Poland and Singapore) were also closely associated with the work.

Principle 1- Preconditions for effective banking supervision
Principles 2 to 5 - Licensing and Structure
Principles 6 to 15 - Prudential regulations and requirements
Principles 16 to 20 - Methods of ongoing banking supervision
Principle 21- Information requirements
Principle 22 - Formal powers of supervisors
Principle 23 to 25 - Cross-border banking

The Basle Core Principles are intended to serve as a basic reference for supervisory and other public authorities worldwide to apply in the supervision of all the banks within their jurisdictions. The Principles are *minimum requirements* and in many cases may have to be supplemented by other measures designed to address particular conditions and risks in the financial systems of individual countries. The Principles have been designed to be verifiable by supervisors, regional supervisory groups, and the market at large. The twenty-five Core Principles are set out below.

Preconditions for Effective Banking Supervision

1. An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banking organisations. Each such agency should possess operational independence and adequate resources. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking organisations and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

Licensing and Structure

2. The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined, and the use of the word 'bank' in names should be controlled as far as possible.

3. The licensing authority must have the right to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the banking organisation's ownership structure, directors and senior management, its operating plan and internal controls, and its projected financial condition, including its capital base; where the proposed owner or parent organisation is a foreign bank, the prior consent of its home country supervisor should be obtained.

4. Banking supervisors must have the authority to review and reject any proposals to transfer significant ownership or controlling interests in existing banks to other parties.

5. Banking supervisors must have the authority to establish criteria for reviewing major acquisitions or investments by a bank and ensuring that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.

Prudential Regulations and Requirements

6. Banking supervisors must set prudent and appropriate minimum capital adequacy requirements for all banks. Such requirements should reflect the risks that the banks undertake, and must define the components of capital, bearing in mind their ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the Basle Capital Accord and its amendments.

7. An essential part of any supervisory system is the evaluation of a bank's policies, practices and procedures related to the granting of loans and making of investments and the ongoing management of the loan and investment portfolios.

8. Banking supervisors must be satisfied that banks establish and adhere to adequate policies, practices and procedures for evaluating the quality of assets and the adequacy of loan loss provisions and loan loss reserves.

9. Banking supervisors must be satisfied that banks have management information systems that enable management to identify concentrations within the portfolio and supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers.

10. In order to prevent abuses arising from connected lending, banking supervisors must have in place requirements that banks lend to related companies and individuals on an arm's-length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks.

11. Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining appropriate reserves against such risks.

12. Banking supervisors must be satisfied that banks have in place systems that accurately measure, monitor and adequately control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.

13. Banking supervisors must be satisfied that banks have in place a comprehensive risk management process (including appropriate board and senior management oversight) to identify, measure, monitor and control all other material risks and, where appropriate, to hold capital against these risks.

14. Banking supervisors must determine that banks have in place internal controls that are adequate for the nature and scale of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding its assets; and appropriate independent

internal or external audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.

15. Banking supervisors must determine that banks have adequate policies, practices and procedures in place, including strict ‘know-your-customer’ rules, that promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally, by criminal elements.

Methods of Ongoing Banking Supervision

16. An effective banking supervisory system should consist of some form of both on-site and off-site supervision.

17. Banking supervisors must have regular contact with bank management and thorough understanding of the institution's operations.

18. Banking supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on a solo and consolidated basis.

19. Banking supervisors must have a means of independent validation of supervisory information either through on-site examinations or use of external auditors.

20. An essential element of banking supervision is the ability of the supervisors to supervise the banking group on a consolidated basis.

Information Requirements

21. Banking supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisor to obtain a true and fair view of the financial condition of the bank and the profitability of its business, and that the bank publishes on a regular basis financial statements that fairly reflect its condition.

Formal Powers of Supervisors

22. Banking supervisors must have at their disposal adequate supervisory measures to bring about timely corrective action when banks fail to meet prudential requirements (such as minimum capital adequacy ratios), when there are regulatory violations, or where depositors are threatened in any other way. In extreme circumstances, this should include the ability to revoke the banking licence or recommend its revocation.

Cross-border Banking

23. Banking supervisors must practise global consolidated supervision over their internationally-active banking organisations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organisations worldwide, primarily at their foreign branches, joint ventures and subsidiaries.

24. A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, primarily host country supervisory authorities.

25. Banking supervisors must require the local operations of foreign banks to be conducted to the same high standards as are required of domestic institutions and must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision.

The South-East Asian Crisis has revealed the necessity of adequate and effective supervision of financial intermediaries in the course of financial sector reforms. It is increasingly recognised that the implementation of these 25 core principles would have certainly lessened the severity and cost of the South - East Asian crisis.

The Bank for International Settlements (BIS) endorse the twenty-five core principles for adoption by all countries. India has been an active member which participated in the original drafting of the Core Principles. Thirteen of the twenty-five core principles of Banking Supervision have already been covered on the basis of legal provision enshrined in the Banking Regulation Act, RBI Act and/or executive instructions issued by the Reserve Bank. In regard to the remaining twelve core principles, there is a need to take certain steps which will include amendments in legal provisions and establishing mechanism for cooperation among Regulators to comply with those principles. Broadly, these relate to prescribing prudential requirements for additional capital charge for market risk, framing guidelines for addressing country and currency risk, need for assessing the sources and quality of Start up Capital, Supervisory Cooperation with Regulators inside and outside the country and consolidated supervision of institutions and their subsidiaries as conglomerates. It may be mentioned that the additional capital charges for market risk has already been partially introduced by way of stipulation of earmarking of 5 per cent of Tier I Capital for open position in foreign exchange and gold. The Reserve Bank has recently issued guidelines on 'Asset-Liability Management' which will be a step towards introduction of comprehensive Risk Management Systems in the banks. In respect of (i) Risk Management, (ii) Consolidated Supervision, (iii) Inter-agency Cooperation and (iv) Cross-border Supervision, steps are being taken for in-depth examination by groups internally created to identify specific actions needed for the purposes on hand.

1.104 The new regulatory framework introduced for NBFCs in January 1998 has sought to protect the interests of depositors and provide effective supervision over the NBFCs. The major thrust of this new framework is an implementation of prudential norms like liquidity ratios, in respect of these registered NBFCs having regulated deposits in their books. Compulsory registration of companies with the Reserve Bank has helped to give a fair idea of the magnitude of the problems involved in regard to inspection of NBFCs.

Customer Service

1.105 An area which has to be in the forefront in the second phase of financial sector reforms is in the arena of customer service. In India, the major component of intermediation cost, especially in public sector banks has been the wage bill, and the cost component on account of Information and Technology (IT) has been limited. It is the IT component which is crucial to customer service, given the large number of deposit accounts and the magnitude of debits and credits to these accounts. It is necessary that banks adopt new IT strategies to reduce the transaction time and costs so as to improve banking service and efficiency.

Universal Banking

1.106 The emerging scenario in the Indian banking system points to the likelihood of provision of multifarious financial services under one roof. This will present opportunities to banks to explore territories in the field of credit/debit cards, mortgage financing, infrastructure lending, asset securitisation, leasing, factoring, etc. At the same time, it will throw challenges in the form of increased competition and place strain on the profit margins of banks. Again, this brings into fore issues such as the mergers, capital adequacy, and risk management of banks.

1.107 The Khan Working Group (1998) had suggested a gradual move towards universal banking. In the light of the recommendations of the Group, the Reserve Bank, in consultation with the Government of India, has proposed to prepare a 'Discussion Paper'. The paper will contain the Reserve Bank's draft proposals for bringing greater clarity in the respective roles of banks and financial institutions and for greater harmonization of facilities and obligations applicable to them.

Harmonisation of the Role of Banks and DFIs

1.108 The reforms of the financial sector ushered in significant changes in the operating environment of banks and Development Financial Institutions (DFIs). The deregulation of interest rates, disintermediation and increasing participation by banks in project finance significantly altered the operating environment of banks. With DFIs, in turn, making forays into the realm of working capital or short term financing, the traditional operational divide between banks and DFIs is being increasingly blurred. In the light of these developments, the Khan Working Group (1998) has advocated harmonising the role and operations of DFIs and banks.

1.109 As part of the process of 'harmonisation' of the role and operations of Banks and DFIs, the Khan Working Group envisaged the need to provide a greater degree of manoeuverability and a level-playing field in resource mobilisation. One of the most significant strategic challenges facing DFIs is the ability to raise low-cost funds. Till 1991, DFIs had access to low cost LTO funds from the Reserve Bank. However, the drying up of low cost sources of funds has had two effects on the functioning of DFIs. First, DFIs have been forced to go in both domestic and international markets, for raising resources at market-determined interest rates. Secondly, they started competing for the same segments of business as banks namely the households. Consequently, their margins have been under pressure. Such squeeze on margins would necessitate a pro-active focus on portfolio quality and cost management. The comparative advantage and/or disadvantage of DFIs vis-à-vis banks in this regard depends, to a large extent, on the quality of their portfolios, the accounting policies that are practiced and personnel management. The banks, on the other hand, have a competitive edge in resource mobilisation through the route of retail deposits. However, there would now be greater competition for funds with the entry of private banks, non-banking financial institutions, and mutual funds.

1.110 There are certain regulatory issues also that need to be addressed to make harmonisation successful. First, banks are subject to CRR stipulation on their liabilities. DFIs, on the other hand, face no such pre-emptions on their funds. Secondly, although instrument-specific restrictions on resource mobilisation by DFIs by way of term deposits, term-money borrowings, CDs as also inter-corporate deposits have been replaced with umbrella limits, DFIs do not enjoy the advantage of branch network for resource mobilisation. This, in effect, curtails DFIs' ability to raise low-cost deposits. Thirdly, with the larger part of new loans going to capital-intensive projects like power, telecom etc., the DFIs would need to extend loans with longer maturities. On the other hand, due to interest rate uncertainties, DFIs are finding it attractive to raise more of short-term resources. Due to their past borrowings of long-term nature, the mismatch is still in their favour. This, however, raises a challenge for the DFIs to manage the maturity match of their assets and liabilities on an on-going basis.

Year 2000 Compliance

1.111 In India, as in any other country in the world, banks are confronted with the Year 2000 problem9. If measures are not taken to address the problem, normal operations of financial institutions will be disrupted, which would lead to disturbances in payment and settlement systems nationwide, the effects of which may spread to other sectors. In recent times, it has been increasingly recognised that the Year 2000 (Y2K) issue has cross-border implications. Recognising this dimension, the Basle Committee on Banking Supervision has advised bank supervisors to consider aspects such as (i) Foreign activities of domestic banks, including the readiness of foreign markets and infrastructures, and (ii) Domestic activities of foreign banks, including the quality of head office preparedness and the readiness of the local branch or subsidiary to conduct business, typically within the domestic market.

1.112 In India, a high level Working Group with members drawn from banking, regulatory, supervisory and information technology departments in the Reserve Bank, representatives of IBA, commercial banks and NIBM has been constituted. The Working Group reviews the progress by banks, their subsidiaries and financial institutions every month. The banks have to also indicate to the Reserve Bank/IBA about the steps taken to ensure that their customers are Y2K compliant. The banks have been advised to step up their efforts to assess, convert and thoroughly validate all systems and applications by September 30, 1998. They are also advised to validate interfaces/linkages with customers/ correspondents. Commencing October 1, 1998 the banks have been advised to continuously validate their renovated systems though testing and to identify alternative approaches if need be. Testing is required to be done with reference to critical dates relevant for Year 2000 testing. Similar monitoring and compliance has to be ensured by non-banking subsidiaries of commercial banks, financial institutions, co-operative banks, regional rural banks and non-banking financial companies. Each bank has been advised to constitute an internal Core Group and the progress is to be monitored regularly by their top management and their boards. Indian Banks Association is also conducting periodic reviews for the Y2K problem for the industry and coordinating with infrastructure agencies, trade bodies, etc. A public awareness campaign has been initiated by the Indian Banks' Association (IBA) by inserting an advertisement in various newspapers highlighting the millennium problem and the need to resolve it well in time. About 44 of 104 targetted commercial banks, and 12 of 41 non-banking subsidiaries of commercial banks are expected to be Y2K compliant by September 30, 1998. The majority of remaining banks will achieve the norm by December 1998. About 50 per cent of the financial institutions are expected to be Y2K compliant by the end of 1998. It is proposed to adopt the following strategies for attaining the full compliance of year 2000 problem in the financial sector.

(i) Certification of compliance by banks;
(ii) Verification of compliance efforts through onsite supervisory examination;
(iii) Statutory auditors to comment on process followed by banks for Y2K compliance;
(iv) Contingency plans of banks;
(v) Penal measures, if need be;
(vi) Banks to give their compliance position on web sites; and
(vii) Tackling cross border issues.

[9] Many computer operating system and applications used six-digits codes for dates-date fields - comprising two digits for the year, two digits for the month and two digits for day (for example, December 31, 1999 reads 991231). With such coding system, the code for year 2000 will be ''00'' which may be interpreted as the year 1900, not 2000. This will cause error in date-sensitive calculations and other issues. Such problems are called Year 2000, Y2K or millennium problem.