Chapter VII

Financial Stability

7.1 Financial stability has evolved as an increasingly important goal of policy across countries with the experience of recurring financial crises in different countries during the 1990s. It is being increasingly recognised that financial stability is crucial for sustained economic growth but this cannot be achieved without strong financial systems[1]. Even with sound macroeconomic management, weak financial systems can destabilise the economy, making it more vulnerable to domestic and external shocks. There is a growing realisation that though price stability is a necessary condition for sustainable economic growth, it is not a sufficient one as it, in itself, is dependent on the stability of the financial system. In most countries, financial stability is considered as a concurrent objective of policy. It has been viewed that unlike price stability, financial stability is difficult to quantify, *viz.*, setting out an explicit targeting framework for achieving policy objectives. Nevertheless, several central banks have focused increasingly on financial stability, which is evident from various Reports produced on the subject on regular basis in recent years (Annex VII.1).

7.2 The Reserve Bank in its annual policy Statement for 2004-05 states:

'As the financial sector matures and becomes more complex, the process of deregulation must continue, but in such a manner that all types of financial institutions are strengthened and financial stability of the overall system is safeguarded. As deregulation gathers force, the emphasis on regulatory practice has to shift towards effective monitoring and assurance of implementation of regulations. In order to achieve these regulatory objectives, corporate governance within financial institutions must be strengthened, and internal systems need to be developed to ensure this shift in regulatory practice. Furthermore, as financial institutions expand and grow more complex, it is also necessary to ensure that the quality of service to customers, especially the common person, is focused on and improved'.

7.3 The pursuit of financial stability has emerged as the central plank of financial sector reforms in India. The Committee on the Financial System, 1992 (Chairman: Shri M. Narasimham) recognised financial stability as the *sine qua non* of rapid and sustainable economic progress. In the Indian context, the role of financial stability has been recognised, *inter alia*, from three principal perspectives[2]. Stability of the financial system has critical influence on price stability and sustained growth, which constitute the principal objectives of policy[3]. A stable financial system facilitates efficient transmission of monetary policy actions. From the perspective of regulation and supervision, safeguarding depositors' interest, and ensuring stability of financial system, in particular, the banking sector, is the mandate of the Reserve Bank.

7.4 Against this backdrop, this Chapter aims at providing a review and analysis of various policy initiatives undertaken under the aegis of reform of the financial sector toward achieving financial stability. Since the Chapter is introduced for the first time in this Report, it is designed to provide a conceptual backdrop on financial stability covering a historical overview as well as recent developments. The Chapter primarily focuses on the activities of the Reserve Bank relating to the policies, instruments, norms and tools applied to detect, prevent and manage systemic instability. The Chapter is organised in to nine sections with a discussion on definitions and approaches to financial stability and central banks' concerns in Section 2. The policy approach adopted is discussed in Section 3, followed by an analysis of prudential norms in

[1] Financial Stability Institute, Bank for International Settlements, Switzerland.

[2] Government of India, (1991), Report of the Committee on the Financial System (Chairman : M. Narasimham).

[3] Jalan, B., (2002), 'Finance and Development: Which Way Now?', RBI Bulletin, January.
Reddy, Y.V., (2004), 'Financial Stability: the Indian Experience', RBI Bulletin, October.

Section 4. Development of markets is reviewed in Section 5, and payment system and technology in Section 6. The architecture of regulation and supervision is outlined in Section 7, and measures towards crisis prevention and management are discussed in Section 8. The empirical assessment of financial stability based on a review of macroprudential indicators is provided in Section 9. The conclusions are outlined in Section 10.

2. Financial Stability: Approaches

7.5 Unlike monetary stability there is no universally accepted definition of financial stability. A stable financial system entails the capacity to prevent financial crises from occurring, or, when they do occur, to contain the effects thereof and to prevent them from spilling over into the real economy[4]. Unsafe financial institutions and markets interfere with production, consumption and investment, and therefore defeat national goals of all-round economic growth and development. Fragilities in the financial system could arise mainly on account of weak fundamentals, inadequate institutions, and asymmetric information. Preventing disruptions to the national payment system is key to the whole process[5].

7.6 The numerous definitions of financial stability take into consideration the country specific concerns pertaining to policies, institutions, markets and macroeconomic objectives. Broadly, however, there are two major perspectives on financial stability: one related to the prevention or containment of financial crises, and the other towards the development of strong and healthy institutions. Most definitions view financial stability through the prism of financial crises[6]. According to the crisis perspective, financial instability is manifested through banking failures, intense asset price volatility or a collapse of market liquidity, and ultimately in disruption of the payment and settlement system. This approach to financial stability entails identification of the sources of financial crises and gearing policies and institutions to overcome various deficiencies of the financial system. On the other hand, the perspective of sound and healthy financial systems focuses on a set of standards and codes and prudential norms, which ensure soundness, safety, stability and efficiency of financial institutions.

7.7 Despite several approaches to financial stability, some approaches seem to have found greater acceptance as they provide an encompassing framework for understanding various facets of financial stability. It is generally agreed that financial markets, institutions (*i.e.*, intermediaries), instruments, and regulatory constraints constitute the major elements of the financial system. Deriving from this general perspective, it is postulated that financial stability encompasses three pillars: stable institutions, stable markets, and stable prices[7]. Financial markets cannot function adequately in the absence of an appropriate institutional framework especially in a situation of rapid increase in the pace of globalisation. A commonly agreed approach entails that 'institutions' comprise a set of 'rules, enforcement mechanisms, and organisations that shape the functioning of markets'[8]. From the perspective of geo-political dimensions, financial stability entails stability in the external as well as the domestic environment. The stability of external environment assumes importance in the context of globalisation, and increasing integration of economies fostered by increasing cross border capital flows and rapid advances in information technology. The experience of the 1990s shows that instability in the global environment can be amplified due to the contagion effect of a crisis occurring in a particular country. There is a considered view that the primary responsibility for crisis prevention has to be that of the country itself[9].

[4] South African Reserve Bank (2004), Financial Stability Review, March.

[5] Reserve Bank of India, Report on Currency and Finance, 1998-99.

[6] Haldane, A., and Saporta, V., (2004), 'Financial Stability and Macroeconomic Models', Financial Stability Review, Bank of England, June 2004.

[7] Crocket, A., (1997), 'Why is Financial Stability a Goal of Public Policy', Bank for International Settlements, Policy Paper No. 1.

[8] G-20 (2004), 'Globalisation and Institution Building', Country Case Studies, March.

[9] Jalan, B., (2002), 'Bank of England Seminar on International Financial Architecture', at the symposium of Central Bank Governors hosted by the Bank of England in London on July 5, 2002.

3. Stance of Reform

7.8 In India, reform of the financial sector has served the country in terms of aiding growth while at the same time avoiding crises, enhancing efficiency of financial intermediaries and imparting resilience to the system. The approach towards financial sector reforms is based on *panchasutra* or five principles; gradualism entailing cautious and appropriate sequencing of reform measures, mutually reinforcing norms, complementary reforms across sectors (most importantly monetary, fiscal and external sectors) based on extensive consultations with the stakeholders at each stage, development of financial institutions and development of markets[10]. Although there is a broad commonality in the objectives and instruments of reform for all types of financial intermediaries, the pace and sequencing in each segment of the financial sector is being determined keeping in view its state of development.

7.9 The financial system in India comprises commercial banks including public sector, private sector, and foreign banks, co-operatives, development finance institutions (DFIs) and various other institutions in the areas of insurance, mutual funds, and Government securities. Commercial banks occupy a predominant place in the financial system and the payment system. Banks are 'special'; as financial intermediaries critical for mobilising public savings and for deploying them to provide safety and return to the savers[11]. The deployment of funds mobilised through deposits involves banks in financing economic activity and providing the lifeline for the payment system[12]. Given the overwhelming dominance of banks in the financial system and their systemic importance, reform measures were first introduced for commercial banks and subsequently extended to other financial intermediaries such as DFIs, Non-banking Financial Companies (NBFCs), co-operative banks and the insurance sector.

7.10 The reform agenda for the banking and financial sector has been driven mainly by the Reports of two Committees set up by the Government of India, the Committee on the Financial System, 1991 (Chairman: Shri M. Narasimham)[13] and the Committee on Banking Sector, 1998 (Chairman: Shri M. Narasimham)[14]. Several Committees, Advisory Groups, Working Groups, and Technical Groups set up by the Government of India and the Reserve Bank have facilitated the reform process through their various recommendations and suggestions (Annex VII.2). The reform of banking sector has encompassed measures pertaining to competition, development of prudential norms, markets, institutions and the legal environment, and improvements in supervisory process[15]. The major stance of the policy environment is to create an enabling environment with greater operational flexibility and functional autonomy for banks with a view to enhancing their efficiency, productivity and profitability[16].

Competition

7.11 It is generally agreed that a competitive financial system facilitates mobilisation of savings and allocation of resources consistent with market forces and thus, enhances efficiency of institutions. In a competitive financial market characterised by lower barriers to entry, financial intermediaries benefit from the economies of scale and scope due to financial innovations and the lower cost of production of financial services[17]. Furthermore, a competitive financial system limits the problems of adverse selection and moral hazard, which affect efficiencies of financial intermediaries.

10 Reddy, Y.V., (2002), 'Monetary and Financial Sector Reforms: A Practitioner's Perspective', RBI Bulletin, May.
Reddy, Y.V., (2004), 'Financial Stability in India', RBI Bulletin, October.

11 Chapter II of the Report, Box II.10: Special Nature of Banks.

12 Mohan, R., (2004), 'Ownership and Governance of Private Sector Banks in India', RBI Bulletin, October.

13 Government of India, (1991), Report of the Committee on the Financial System (Chairman : M. Narasimham).

14 Government of India, (1998), Report of the Committee on Banking Sector, (Chairman : M. Narasimham).

15 Mohan, R., (2004), 'Financial Sector Reforms', RBI Bulletin, October.
Reserve Bank of India, Report on Currency and Finance, 2001-02.

16 Reddy,Y.V., (2002), 'Monetary and Financial Sector Reforms in India: A Practitioner's Perspective', RBI Bulletin, May.

17 Canoy, M.; Dijk, M. van.; Lemmen, J.; Mooij, R. de and Weigand, J., (2001), 'Competition and Financial Stability', CPB Netherlands Bureau for Economic Policy Analysis, CPB Document, No. 015, December.

7.12 In India, concerted efforts have been made towards the development of a multi-institutional structure in the financial sector and the emphasis has been on the increased efficiency of institutions through competition, irrespective of ownership. Competition has been infused into the financial system principally through deregulation in interest rates, granting of functional autonomy to banks and allowing greater participation of private sector and foreign banks[18]. As part of the deregulation process, there has been a significant easing of control over the credit market. The statutory pre-emption of banks' funds has eased with the lowering of CRR and SLR. All interest rates with the exception of savings deposit rates and Non-resident external deposits have been deregulated.

7.13 The enabling environment for inducing competitiveness in the banking industry has taken two major forms. With the amendment to Banking Companies (Acquisitions and Transfer of Undertakings) Act 1970/1980, public sector banks have been allowed to access the capital market to augment their capital base. The shareholding of Government in public sector banks has been substantially reduced. At present Government shareholding in public sector banks cannot be reduced beyond a minimum of 51 per cent so that the Government remains the dominant majority shareholder. Within the current provisions of the Banking Regulation Act, barriers to entry have been relaxed[19]. New private banks and foreign banks have been granted licenses in order to allow the financial system to benefit from better technology, specialised skills, better risk management practices, greater portfolio diversification and deepening of the financial market[20]. Keeping in view the rigours of intensifying competition on the one hand, and tightening of prudential regulations on the other, the Reserve Bank revised the entry norms for new private sector banks in January 2001. Guidelines were set out to ensure an arm's-length relationship between investing companies and promoter groups to prevent connected lending. Guidelines were also issued for the conversion of NBFCs to scheduled banks.

7.14 The Union Budget 2002-03 announced the intention to permit foreign banks, depending on their size, strategies and objectives, to choose to operate either as branches of their overseas parent, or, as subsidiaries in India. In March 2004, the Government of India issued notification while raising foreign direct investment (FDI) limit in the private banks up to a maximum of 74 per cent under the automatic route, including the investment made by foreign institutional investors (FIIs). According to the Government's notification, foreign banks are permitted to have either branches or subsidiaries only. They may operate in India through one of the three channels *viz.*, (i) branch/es; (ii) a wholly owned subsidiary; or (iii) a subsidiary with aggregate foreign investment up to a maximum of 74 per cent in a private bank.

4. Prudential Norms

7.15 A strong and resilient financial system and orderly evolution of financial markets are key prerequisites for financial stability and rapid economic progress on sustainable basis[21]. It is recognised that increased competition in the financial system heightens the need for prudential regulation and supervision to ensure financial stability[22]. In a highly competitive financial market, banks may engage in riskier operations due to the pressure of profit margins. The higher level of risks may fuel bank failures and impinge on the confidence of the public in the financial system. In this context, the need for prudential regulation and supervision arises in various ways; to allow only viable banks to operate, to limit excessive risk taking by owners and managers of banks, to establish appropriate accounting, valuation, and reporting rules to achieve market discipline, and to provide corrective measures and restrictions on activities of weak institutions[23].

18 Reserve Bank of India, Report on Currency and Finance, 1999-2000.
19 Reserve Bank of India, Report on Trend and Progress of Banking in India, 1998-99.
20 Reddy, Y.V., (2004), 'Financial Stability: Indian Experience', RBI Bulletin, July.
21 Report on Currency and Finance, 1999-2000, Reserve Bank of India.
22 Jalan, B., (1999), 'Towards a more Vibrant Banking System', RBI Bulletin, January.
23 International Monetary Fund, (1998), 'Toward a Framework for Financial Stability', World Economic and Financial Surveys, January.

7.16 In the Indian context, a major element of financial sector reforms has been the adoption of a set of prudential measures relating to capital adequacy, income recognition, asset classification and provisioning, exposure norms, disclosures, investment and risk management as well as asset-liability management aimed at imparting strength to the banking system as well as ensuring safety and soundness through greater transparency, accountability and credibility. In keeping with the vision of developing an internationally competitive and sound domestic banking system, the deepening and broadening of prudential norms have been the core of the approach to financial sector reforms. The calibration of the convergence with international standards is conditioned by the specific realities of the domestic situation[24].

7.17 Prudential norms are being continuously monitored and refined keeping in view the financial innovations, the maturity and development of financial markets and the emerging challenges to financial stability. In this regard, banks have been encouraged to build risk-weighted components of their subsidiaries into their own balance sheets and to assign additional capital. Risk weights are being constantly refined to take cognisance of additional sources of risk, including market risks. The concept of 'past due' in the identification of non-performing assets (NPAs) has been dispensed with, and the 90-day delinquency norm has been adopted for the classification of NPAs with effect from March 2004. Taking cognisance of increasing exposure of banks arising out of high growth of credit in the retail segment, including housing and consumer sectors in the recent years, the Reserve Bank in its mid-term Review of annual policy Statement for 2004-05 announced higher risk containment measures. A comparative position of prudential norms as applicable to different segments of financial sector is provided in Annex VII.3.

Capital Adequacy

7.18 A strong capital base of banks is essential for ensuring sustained growth of banks' business and for absorbing unexpected losses[25]. The capital to risk weighted assets ratio (CRAR) based on Basel Capital Accord I has evolved as the widely accepted method of measuring soundness and solvency of banks. The CRAR system requires banks to hold different categories (tiers) of capital against assets and off-balance sheet items with different risk weights. With a view to adopting the Basel norms, the Reserve Bank decided in April 1992 to introduce the CRAR system for banks (including foreign banks). Initially, the CRAR was fixed at 8 per cent at par with the international benchmark. With greater deepening of the financial sector in the 1990s, the focus shifted to having tighter prudential norms, and the CRAR was raised to 9 per cent in March 2000.

Recapitalisation of Banks

7.19 As part of the prudential regulation and supervision, banks were required to meet the capital adequacy norms to avoid sudden pressures on their balance sheets. However, due to past bad lending, some banks found it difficult to maintain adequate capital. Drawing upon lessons from the recapitalisation practices in various other countries, the Government of India contributed over Rs.22,000 crore over the period 1992-93 to 2002-03 towards recapitalisation of nationalised banks to help them meet capital adequacy norms in line with the international standards. Due to improvements in profits, some of the public sector banks have returned the capital to the Government[26].

7.20 With the amendment to the Banking Companies (Acquisition and Transfer of Undertakings) Act in 1994, several PSBs have raised capital both in India and abroad through Global Depository Receipts. Several public sector banks have also raised subordinated debt through the private placement route for inclusion under tier-II capital. Government of India in the 'Common Minimum Programme' (May 2004) has announced that competition in the financial sector will be expanded and the public sector banks will be given full managerial autonomy.

[24] Reddy, Y.V., (2001), 'Financial Sector Reforms: An Update', RBI Bulletin, April.

[25] International Monetary Fund, (1998), 'Toward a Framework for Financial Stability', World Economic and Financial Surveys, January.

[26] Reserve Bank of India, Report on Trend and Progress of Banking in India, 2002-03.

Ownership of Financial Institutions

7.21 The approach of various regulatory regimes in addressing the issue of ownership in banks, both its nature as well as concentration, has been largely consistent in thrust and direction (Box VII.1). The criticality of the ownership structure of banks for financial stability arises in the context of the concentrated shareholding in banks controlling huge public funds, and the risk of concentration of ownership leading to potential problems of moral hazard and linkages of owners with businesses. For a developing economy, there is also much less tolerance for downside risks among depositors many of whom place their life savings in the banks. Hence from a moral, social, political and human angle, there is a more onerous responsibility on the regulator[27].

7.22 In India, the objective of promoting diversified ownership has been pursued for all types of banks. Government ownership has been reduced for several public sector banks. In order to promote diversified ownership of private sector banks, guidelines were issued by the Reserve Bank in February 2004 in regard to acquisition/transfer of shares of a private sector bank which would take the aggregate shareholding of an individual or a group to an equivalent of five percent or more of the paid up capital of the bank. While this requirement already existed, transparency was imparted by the guidelines. In July 2004, a comprehensive policy framework for ownership and governance in private sector banks has been placed in the public domain by the Reserve Bank in the form of draft guidelines, for wider public debate. The draft guidelines focuses on 'fit and proper' status of owners and directors[28], corporate governance, and professional management, which form important concerns for regulators entrusted with the tasks

Box VII.1: Regulatory Guidelines on Ownership in Banks – International Experience

Most of the countries with the exception of a few smaller developing ones, do not have an explicit statutory cap on the maximum shareholding by a single person/entity in a bank. The case of Canada is unique in the sense that there are differential criteria for smaller and bigger banks; while banks with less than Canadian $ 5 billion in assets do not have a limit, those with a bigger asset size have the maximum cap of 20 per cent (voting) and 30 per cent (non-voting). In the absence of an explicit cap, ownership concentration is regulated through a layered threshold structure. Any person/entity wishing to acquire shareholding in a bank beyond the specified thresholds would be required to seek regulatory notification/approval for the same. The minimum thresholds vary across a wide scale from one per cent to even 25 per cent in certain cases. Further, beyond the minimum thresholds a set of qualifying thresholds (indicatively 5 per cent, 10 per cent, 15 per cent, 20 per cent, 33 per cent and 50 per cent) are prescribed. The breach of the said thresholds triggers regulatory notifications/approvals.

The thresholds for a majority of the countries are measured in terms of absolute holding percentages. For a few countries like Singapore, Switzerland, New Zealand, these are in terms of voting rights.

The above structure applies to direct as well as indirect control by a person singly or jointly through a group of associates or related parties. For acquisition of shares beyond the specified thresholds, acquirers need to provide comprehensive information to the authorities, including the intent of purchase, terms and conditions, if any, manner of acquisition, source of funds, and the like. Additionally, in case of body corporates, they may also be required to provide details of their promoters, shareholding pattern and other group entities.

The regulators make an assessment on a case to case basis subject to a number of considerations including the overall sectoral impact of the transaction and the satisfaction of 'fit and proper' principles by the person(s) acquiring the stake. An indicative list of criteria considered by the approving authority includes:

- The nature and sufficiency of the financial resources of the applicant(s) as a source of continuing financial support for the bank;
- The soundness and feasibility of the plans of the applicant or applicants for the future conduct and development of the business of the bank;
- The business record and experience of the applicant or applicants or, if the applicant or any of the applicants is a body corporate, its reputation for being operated in a manner that is consistent with the standards of good character and integrity;
- The impact of any integration of the businesses and operations of the applicant or applicants with those of the bank on the conduct of those businesses and operations; and
- Overall impact on the sectoral competitiveness.

Reference:

Barth, J.R. and Levine, R., (2001), '*Regulations and Supervision Around the World, A New Database*', World Bank Working Paper 2588, World Bank, Washington D.C.

World Bank Database 2003.

27 Mohan, R., (2004), 'Ownership and Governance in Private Sector Banks in India', RBI Bulletin, October.

28 Chapter II on Policy Developments: Recommendations of the Consultative Group of Directors of Banks and FIs (Chairman: A.S. Ganguly).

of protecting depositors' interest and safeguarding institutions for ensuring stability of the financial system. Based on the feedback received, a second draft of the guidelines would be prepared and put in public domain for further discussion.

Management of Non-Performing Assets

7.23 Banks provide loans and advances subject to borrowers' promise for payment of the principal and interest in the future. In this process, banks are exposed to various types of risks including credit risk arising from non-performing loans and defaults of borrowers[29]. Moreover, with increasing globalisation and diversified ownership where credit rating agencies constantly review the strength of banks, managing the level of NPAs assumes importance[30].

7.24 The Reserve Bank along with the Government, has initiated several institutional measures to contain the levels of NPAs. Notable among these include Debt Recovery Tribunals, *Lok Adalats* (people's courts) and Asset Reconstruction Companies (ARCs). Settlement Advisory Committees were formed at regional and head office level of commercial banks. Corporate Debt Restructuring (CDR) mechanism was institutionalised in 2001 to provide a timely and transparent system for restructuring of large corporate debts with the banks and financial institutions. The CDR mechanism has been revised based on the announcement in the Union Budget 2002-03. While several measures, as mentioned above, have been undertaken towards preventing the accumulation of NPAs, in the absence of creditor rights, the problem tended to persist. In order to address this aspect, the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act was enacted in April 2002. The Act empowers secured creditors to enforce any security interest credited in its favour without any intervention of court or tribunal. A set of guidelines has been issued to financial entities, so that the process of instituting ARCs proceeds on smooth lines. Several institutions have initiated steps towards establishment of ARCs. The Reserve Bank has given license to three ARCs out of which one has started functioning[31].

Asset Classification and Provisioning

7.25 In India, the asset classification for provisioning against NPAs is based on a four-tier system; standard assets, substandard assets, doubtful assets and loss assets. Appropriate provisioning norms have been stipulated for all these categories of assets. During 2002-03 and 2003-04, there has been a concerted endeavour to align provisioning norms to the international best practices as well as to respond to emerging trends in the portfolio structure of banks. The most notable development was implementation of the 90 day delinquency norm effective March 2004. In regard to other major developments, as a major step toward tightening prudential norms, banks were advised in May 2002, that effective March 2005, an asset would be classified as doubtful if it remained in the sub-standard category for 12 months as against the prevailing norm of 18 months. Banks have been permitted to phase the additional provisioning consequent upon the reduction in the transition period from sub-standard to doubtful assets from 18 months to 12 months over a four year period, commencing from the year ending March 2005, with a minimum of 20 per cent each year. In another initiative toward tightening provisioning norms, banks have been advised to make 100 per cent provision for the net debit position in their inter-branch accounts in respect of unreconciled entries outstanding for more than six months, with effect from March 31, 2004, as against the existing period of one year.

7.26 In June 2004, the Reserve Bank took a major decision of encouraging banks to adopt graded higher provisioning[32]. The Reserve Bank

29 (a) Chapter III; Box III.7: Determinants of Non-Performing loans of Indian Banks.
(b) Report on Trend and Progress of Banking in India, 2002-03.

30 (a) G-20 (2003), 'Globalisation: The Role of Institution Building in the Financial Sector'.
(b) Mohan, R., (2004), 'Globalisation : The Role of Instititution Building in the Financial Sector : The Indian Case', RBI Bulletin, February.

31 Chapter V; Box V.4: Regulatory Environment for ARCs in India.

32 Mid-term Review of annual policy Statement 2004-05, Reserve Bank of India.

introduced a graded higher provisioning on secured portion of NPAs as on March 31, 2004, ranging from 60 per cent to 100 per cent over a period of three years in a phased manner, with effect from March 31, 2005. However, in respect of all advances classified as 'doubtful for more than three years' on or after April 1, 2004, the provisioning requirement would be 100 per cent. The provisioning requirement for unsecured portion of NPAs under the above category will continue to be 100 per cent as hitherto.

7.27 In an open economy environment, several banks have witnessed significant internationalisation of their balance sheets arising from cross border capital flows and international banking operations. In order to guard against the risks associated with country exposures, banks have been advised to make provisions, with effect from March 31, 2003, on the net funded country exposures on a graded scale ranging from 0.25 to 100 per cent, depending upon the risk categories prescribed in the country risk management (CRM) guidelines. They are also required to disclose, as a part of the 'Notes on Accounts' to the balance sheet as on March 31 each year, their category-wise country risk exposures and the extent of aggregate provisions held against them.

7.28 A significant feature of the changing financial landscape has been the increased blurring of the distinction between banks and development finance institutions due to deregulation of the financial sector and wide ranging financial innovations. Banks have shown increasing interest in providing long-term finance to the corporate sector through project financing. Such changes in the structure of banks' credit portfolio necessitated alignment of income recognition and provisioning norms. Accordingly, banks were advised in May 2002 that they should not recognise income on accrual basis in respect of (a) the projects where financial closure had been achieved and formally documented, (b) projects sanctioned before 1997 with original project cost of Rs.100 crore or more, where financial closure was not formally documented and (c) projects sanctioned before 1997 with original project cost of less than Rs.100 crore, where financial closure was not formally documented. In February 2003, banks have been advised to recognise income on accrual basis in respect of these three categories of projects under implementation, which are classified as 'standard'.

7.29 The Reserve Bank's thrust on adequate level of provisions is reflected in the fact that the cumulative level of provisioning for the scheduled commercial banks works out to 70.6 per cent of gross NPAs as at end-March 2004. This achievement is notable in comparison with the internationally prescribed benchmark of 50 per cent provisioning against NPAs.

Valuation of Investments

7.30 In order to make the valuation of the banks' investment portfolio reflective of the purpose, commercial banks have been urged to classify their entire investment portfolio, with effect from September 30, 2000 (from March 31, 2001, in the case of select FIs) under three categories, *viz.*, 'Held to Maturity (HTM)', 'Available for Sale (AFS)' and 'Held for Trading (HFT)'. Investments under AFS are to be marked to market at the year-end or at more frequent intervals. Investments under HFT category are to be marked to market monthly or at more frequent intervals. Guidelines were also issued for the classification of investments, shifting of investments among the three categories, valuation of the investments, methodology for booking profit/ loss on sale of investments and providing for depreciation.

7.31 Amidst the concerns of rising trends in interest rates in the recent times, with their implications for banks' investment portfolio, the Reserve Bank allowed banks, as a one-time measure, to exceed the ceiling of 25 per cent of investments under HTM category by shifting some of their investments in SLR securities from the HFT/AFS categories to HTM category at the lowest of the acquisition cost or prevailing market value or book value subject to a maximum of 25 per cent of SLR securities to be held in HTM[33]. Consistent with international standards that do not place any cap on HTM category, such a move was considered advisable taking into account the statutory nature of the 25 per cent SLR while ensuring prudence and transparency in valuation on transfer to HTM.

[33] Mid-term Review of annual policy Statement 2004-05, Reserve Bank of India.

Capital Charge for Market Risk

7.32 Banks hold broadly two major types of assets: loans and advances, and investment in SLR and non-SLR securities. While loans and advances involve credit risk, investments primarily involve market risk due to changes in interest rates and yields. In 1997, the Basel Committee on Banking Supervision (BCBS) issued the 'Amendment to the Capital Accord to incorporate Market Risks' containing comprehensive guidelines to provide explicit capital charge for market risks, *i.e.*, the risk of losses in on-balance sheet and off-balance sheet positions arising from movements in market prices. The market risk positions subject to capital charge requirement are the risks pertaining to interest rate related instruments and equities in the trading book; and foreign exchange risk (including open position) throughout the bank (both banking and trading books).

7.33 In the Indian context, banks hold a sizeable portion of investment in SLR and non-SLR securities, which are sensitive to changes in interest rates. The market risk of banks' portfolio emerged as an important concern of the regulatory process in the wake of the soft interest rates in 2002-03 and 2003-04. In the annual policy Statement of April 2002, the Reserve Bank advised banks to adopt the Basel norm for capital charge for market risk and issued draft guidelines in June 2004 on computing capital charge for market risk to select banks, seeking their comments. With a view to ensuring smooth transition to Basel II norms, the annual policy Statement 2004-05 proposed to phase the implementation of capital charge for market risk over a two year period: banks would be required to maintain capital charge for market risk in respect of their trading book exposures (including derivatives) by March 31, 2005 and banks would be required to maintain capital charge for market risk in respect of the securities included under AFS category by March 31, 2006.

7.34 Furthermore, in order to provide a cushion for managing the market risk, the Reserve Bank introduced a system of Investment Fluctuation Reserve (IFR) in 2002. Banks have been advised to ensure that the building up of the IFR of 5 per cent of their investments in HFT and AFS categories is achieved earlier, though they have time up to March 2007. The Reserve Bank in the annual policy Statement 2004-05 allowed banks to build up higher percentage of IFR upto 10 per cent of portfolio depending on the size and composition of their portfolio, and the concurrence of their Boards.

7.35 Banks have been urged to prepare themselves to comply with the prudential requirements in regard to their investment in non-SLR securities by the end-December 2004 (mid-term Review of annual policy Statement 2004-05).

Market Discipline

Accounting Standards

7.36 The need for high quality accounting standards is to ensure that information contained in the financial statements is accurate, timely and comprehensive, so that it is particularly useful for markets and stakeholders. The endeavour of the Reserve Bank is to eliminate/reduce gaps in compliance by banks, FIs and NBFCs with the accounting standards issued by the Institute of Chartered Accountants of India (ICAI). Detailed guidelines have been issued from time to time to ensure banks' compliance with these accounting standards, as also to operationalise consolidated accounting practices.

7.37 The Reserve Bank has been making continuous efforts to ensure convergence of its supervisory norms and practices with the international best practices. In regard to Accounting Standards (AS), a Working Group (Chairman: Shri N.D. Gupta) was constituted to recommend steps to eliminate/reduce gaps in compliance by banks with AS as issued by ICAI. The Working Group examined compliance by banks with the AS 1 to 22, which were already in force for the accounting period commencing from April 1, 2001, as also AS 23 to 28, which were to come into force for subsequent periods. The Working Group observed, that out of Accounting Standards which are already in force, *viz*., AS 1 to 22, banks in India were generally complying with most of the AS, with an exception of eight AS resulting in qualifications in the financial statements. These pertain to AS 5 (net profit or loss for the period, prior period items and changes in accounting policies), AS 9 (revenue recognition), AS 11 (accounting for the effect of changes in foreign exchange rates), AS 15 (accounting for retirement benefits in the financial statements of employers), AS 17 (segment reporting), AS 18 (related-party disclosures), AS 21 (consolidated financial statements), and AS 22 (accounting for taxes on income). In view of the above and also with a view to eliminate gaps in compliance with the AS, the Working Group made certain recommendations for compliance by banks with the concerned accounting standards. In March 2003, the Reserve Bank issued detailed guidelines on the basis of the Group's recommendations for the guidance of banks.

7.38 The Reserve Bank constituted a Standing Committee on Procedures and Performance Audit on Public Services (Chairman: S. S. Tarapore)[34] in November 2003. The Committee submitted four Reports, *viz.*, Foreign Exchange Transactions, Government Transactions Relating to Individuals, Banking Operations and Currency Management. The Reserve Bank has implemented some of the recommendations of the Standing Committee in the areas of foreign exchange, Government transactions, banking operations, and the currency management[35].

Transparency and Disclosure

7.39 The stability of a financial system can be achieved only when institutions and markets function on the basis of informed decisions. Minimising the adverse selection and moral hazard problem of banks and other financial intermediaries requires production and reporting of adequate information. Adequate disclosure of information should act as a deterrent to excessive risk-taking since it enables the market to discipline banks. The disclosure also acts to protect borrowers and lenders from abusive practices and make them more aware of the costs and commitments in financial contracts.

7.40 In India, the banking system has witnessed greater levels of transparency and standards of disclosure. The range of disclosures have gradually been expanded over the years and presently includes a host of indicators relating to capital adequacy (Tier I and Tier II capital separately), NPAs, Government shareholding, movements in NPAs, exposure to sensitive sectors (capital market, real estate and commodities), movements in provisions for NPAs and investments as also information on corporate debt restructuring. These are being further enhanced to incorporate asset-liability management, risk management policies, concentrations, connected lending, evaluation of investment in subsidiaries, various performance measures and indicators thereof. Banks are providing information on various indicators in the form of notes to accounts and schedules in their balance sheets.

7.41 Guidelines in regard to Fair Practices Code for Lenders were framed and the banks/ all-India FIs have been advised to adopt these guidelines[36]. Banks and FIs have the freedom of enhancing the scope of the guidelines without sacrificing the spirit underlying them. The Board of Directors should also lay down the appropriate grievance redressal mechanisms within the organisation to resolve disputes arising in this regard. A periodical review of the compliance of the Fair Practices Code and the functioning of the grievances redressal mechanism may be submitted to the Board at regular intervals.

7.42 The Reserve Bank has been taking several steps from time to time to enhance the transparency in banks' operations by prescribing comprehensive requirements for disclosure in tune with the international best practices. The Reserve Bank is empowered to impose penalties on a commercial bank under the provision of Section 46(4) of the Banking Regulation Act, 1949, for contraventions of any of the provisions or non-compliance with any other requirements of the Act; order, rule or condition specified by the Reserve Bank under the Act. The imposition of penalty on a bank is decided after a due process of advising the bank and seeking its explanation so as to afford a reasonable opportunity to the bank for being heard. In view of the added emphasis on the role of market discipline under Basel II and with a view to enhancing further transparency, banks have been advised on October 19, 2004 that all cases of penalty imposed by the Reserve Bank as also strictures/directions on specific matters

[34] Chapter II; Box II.15: Standing Committee on Procedures and Performance Audit on Public Services.

[35] The details of recommendations implemented are provided in the mid-term Review of annual policy Statement 2004-05.

[36] Annual Report 2002-03, Box X.7.

including those arising out of inspection will be placed in the public domain with effect from November 1, 2004.

Corporate Governance

7.43 Corporate governance is becoming crucial for banks and FIs to promote effective risk management and financial stability. In the financial system, corporate governance assumes importance in order to determine the health of the system and its ability to survive economic shocks. The health of the financial sector largely depends on the capacity of individual institutions to identify, measure, monitor and control their respective risks. Under corporate governance, banks articulate corporate values, codes of conduct and standards of appropriate behaviour, *etc.* and have systems and controls to ensure compliance with them. The Board sets the strategic objectives and corporate values of banks and specify transparent lines of responsibility and accountability, which are communicated throughout the organisation. The Board and the top management meet at specified intervals for timely exchange of information on the bank's financial condition and management practices. It is, therefore, possible to identify different sets of players in the corporate governance system. There is a dynamic balance among them that determines the prevailing corporate governance system depending on the stage of institutional development and the historical development.

7.44 The governance of banks is an outcome of a complex of legal, regulatory, and supervisory policies. It is necessary to promote effective systems of internal management and risk control with strict accountability of owners, directors and senior management, including prevention of insider abuse and financial crime and control of connected lending. The Reserve Bank has responsibility for corporate governance in the banking sector. As part of the on going financial sector reforms, the Boards of banks and FIs have been given greater autonomy to lay down guidelines and procedures to enhance transparency and disclosure, to contain risk and for asset-liability management. Further, interaction with market participants has been intensified both at informal level and formal fora, like advisory committees.

7.45 The Reserve Bank constituted a Consultative Group of Directors of Banks and Financial Institutions (Chairman: Dr. A. S. Ganguly) in October 2001 to address the issues relating to corporate governance. The Group recommended various measures, benchmarked against international best practices as enunciated by the Basel Committee on Banking Supervision, to make the supervisory role of the Boards of banks and FIs more effective. The report of the Group was examined by the Board for Financial Supervision (BFS) and based on its recommendations, action to be taken by public and private sector banks were grouped separately and advised to the banks in June 2002. These included due diligence procedures for appointment of directors on the boards of private sector banks, and role and responsibilities of independent/non-executive directors.

7.46 The Securities and Exchange Board of India (SEBI) had constituted a Committee on Corporate Governance (Chairman: Shri Kumar Mangalam Birla), which submitted its Report in May 1999. The recommendations of the Committee were forwarded to the Reserve Bank with a request to consider issuing appropriate guidelines to banks with a view to harmonising the existing requirements with the SEBI Committee requirements. Banks, which have issued shares to the public and are listed on stock exchanges, have been advised to form committees to look into redressal of shareholders' complaints and to provide un-audited financial results on a half yearly basis to their shareholders with a summary of significant developments. It was observed that the procedures in regard to appointment and removal of external auditors are more stringent in banks than those recommended by the SEBI Committee.

7.47 The Joint Parliamentary Committee (JPC) on Stock Market Scam observed that it is imperative for the banks to follow strategies and techniques basic to the tenets of sound corporate governance. These include inducting capable and experienced directors, efficient management, coherent strategy and business plan, and clear lines of responsibility and accountability. The JPC also endorsed the recommendations of the Advisory Group on Banking Supervision (Chairman: Shri M. S. Verma) submitted in January 2001 and desired that the same be implemented expeditiously. Banks have to assign priority to strengthen their Management Information System (MIS) and internal control mechanisms to comply with these requirements.

5. Development of Markets

7.48 The financial system serves the economy, *inter alia*, by providing liquidity for easy exchange of assets, a mechanism for risk sharing while allowing savers to hold varied assets. Borrowers in the system have a wider choice for raising funds suited to their productive activities. Thus, the economic function of financial markets can be seen in three dimensions: time, risk and information[37]. Financial markets and institutions work together to achieve these core functions of the financial system. Financial markets provide a direct mechanism while financial intermediaries provide an indirect mechanism for matching the needs of savers and borrowers[38].

7.49 In India, development of financial markets has been pursued essentially for bringing about a transformation in the structure, efficiency, and stability of markets as also facilitating integration of markets. The emphasis has been put on strengthening price discovery, easing of restrictions on flows or transactions, lowering of transaction costs, and enhancing liquidity. During post-reform period, the structure of financial market has witnessed a remarkable change in terms of the types, the number and the spectrum of maturity of financial instruments traded in various segments of money, gilts and foreign exchange markets.

Money Market

7.50 The money market is generally expected to perform three broad functions: providing an equilibrating mechanism to even out demand for and supply of short-term funds, a focal point for central bank's intervention for influencing liquidity and general level of interest rates in the economy, and reasonable access to providers and users of short-term funds to fulfil their borrowing and investment requirements at an efficient market clearing price. The money market instruments mainly comprise call money, certificates of deposit (CDs), Treasury Bills, other short-term Government securities transactions, such as, repos, bankers' acceptances/ commercial bills, commercial papers (CPs), and inter-corporate funds. While inter-bank money markets and central bank lending *via* repo operations or discounting provide liquidity to banks, other money market instruments, such as, commercial bills and CPs provide liquidity to the commercial sector. In India, as in many other developing countries, the evolution of the money market and its structure has been integrated into the overall deregulation process of the financial sector.

7.51 The Reserve Bank is the most important constituent in the money market. By virtue of implications for the conduct of monetary policy, the money market comes within the direct purview of the Reserve Bank's regulation. The primary aim of the Reserve Bank's operations in the money market is to ensure that the liquidity and short-term interest rates are maintained at levels consistent with the monetary policy objectives. The Reserve Bank influences liquidity and interest rates through a number of operating instruments, *viz*., cash reserve requirements of banks, conduct of open market operations (OMOs), repo transactions, changes in the Bank Rate, and at times through foreign exchange swap operations[39].

7.52 The evolution of the money market in India could be traced to the late 1980s when the Working Group on Money Market (Chairman: Shri N.Vaghul) made a series of recommendations for developing various segments of the money market[40]. Initially, under the reform process, the changes in the money

37 Merton, R., (1990), 'Continous Time Finance', Blackwell, Cambridge.

38 Canoy, M, M. van Dijk, J. Lemmen, R. de Mooij and J. Weigand, (2001), 'Competition and Financial Stability', CPB Netherlands Bureau for Economic Policy Analysis, CPB Document, No. 015, December.

39 Reddy, Y.V., (2002), 'Developing Bond Markets in Emerging Economies: Issues and Indian Experience', Keynote Address at the Asian Conference, jointly hosted by FIMMDA, PDAI, and Thai BDC at Bangkok on March 11, 2002.

40 Reserve Bank of India, Annual Report, 2003-04, Box V.1: Evolution of Money Markets.

market structure were brought in through a gradual shift from a regime of administered interest rates to a market-based pricing of assets and liabilities, development of infrastructure, and introduction of new instruments. The reform of money market also focused on greater and wider participation of other financial institutions for deepening of the market. Accordingly, primary/satellite dealers, mutual funds and other participants in the bills rediscounting market and corporates (through primary dealers) besides banks, LIC and UTI, were allowed to participate in the call money market. While banks and primary dealers were allowed two-way operations, other non-bank entities participated only as lenders.

7.53 In recent years, the Reserve Bank's approach has been to foster balanced development of different segments of the money market, introduce new instruments, reduce dependence of participants on uncollateralised exposures, facilitate price discovery in the short-end and upgrade the payment system infrastructure[41]. Accordingly, the Reserve Bank's strategy has focused on developing pure call/notice money market, instituting full-fledged Liquidity Adjustment Facility, developing infrastructure, promoting transparency, and various measures pertaining to instruments for non-bank participants.

7.54 With a view to transforming the call/notice money market into a pure inter-bank market with participation of banks and primary dealers (PDs) only, a phased exit of non-banks from the call/notice money market was started in May 2001. Accordingly, the average daily lending in a reporting fortnight in call/notice money market has been reduced from 75 per cent in June 2003 to 30 per cent of their average daily lending in call/notice money market during 2000-01, with effect from January 8, 2005. With effect from February 7, 2004, PDs have been permitted to borrow up to 200 per cent of their net owned funds (NOFs), as at end-March of the preceding financial year, on average, in a reporting fortnight. Any PD facing genuine difficulty in adhering to the limit was permitted to approach the Reserve Bank for extension of period of compliance.

7.55 The traditional refinance support on fixed terms has been replaced while moving to a full-fledged Liquidity Adjustment Facility (LAF) since 2000. The LAF has been in operation, comprising repo and reverse repo operations through auctions. It has emerged as a primary instrument for modulating day-to-day liquidity conditions with a view to equilibrating the liquidity and keeping the short-term interest rates within an informal corridor. The repo market is being developed with lending as well as borrowing operations. A revised LAF scheme was operationalised in April 2004. The LAF scheme has been operated with overnight fixed rate repo and reverse repo from November 1, 2004. From October 29, 2004, a switchover to the international usage of the terms 'repo' and 'reverse repo' has been effected.

7.56 The development of the payment system infrastructure was strengthened with the introduction of the Negotiated Dealing System (NDS) in February 2002, formation of the Clearing Corporation of India Ltd. (CCIL) in 2001, and the implementation of real time gross settlement (RTGS) system in March 2004. The NDS enables screen-based electronic dealing and reporting of transactions in money market instruments, secondary market transactions in Government securities and facilitates dissemination of information on trades with a minimum time lag. It also permits paperless settlement of transactions in Government securities given the electronic connectivity with CCIL and the delivery *verses* payment settlement system at the Public Debt Office (PDO) of the Reserve Bank. The CCIL acts as a central counterparty through novation and provides guaranteed settlement with risk management systems put in place to limit settlement risks. The RTGS system embodies instantaneous settlement of transactions on a gross basis thereby completely obviating the need for any clearing arrangement in the transaction.

7.57 Large exposures to call/notice money borrowings, which are uncollateralised by nature, carry potential danger of systemic instability arising out of defaults. It also impedes the development of other segments of the money market and constrains the Reserve Bank's ability

[41] Reserve Bank of India, Report on Currency and Finance, 1999-2000.

to influence short-term interest rates. In this regard, the Reserve Bank instituted prudential limits of exposure to the call/notice money market for banks from October 2002 keeping in view the potential risk of systemic instability arising out of defaults due to large recourse to the uncollateralised money market segment. Rupee funds raised under the Reciprocal Line Facility were exempted from these limits. This exemption was phased out from the fortnight beginning February 7, 2004.

7.58 In order to achieve transparency, effective the fortnight beginning May 3, 2003, reporting of call/notice money market transactions on the NDS was made mandatory, irrespective of whether executed on the NDS or outside and whether the counterparty is a member of the NDS or not. Necessary changes in the software and dissemination of data to NDS members was executed in July 2003.

7.59 Measures have also been taken to make various other money market instruments (such as CDs, CPs, *etc.*) freely accessible to non-bank participants. These measures were intended to improve depth, efficiency and transparency in money market operations.

7.60 As part of developing new instruments, a major initiative pertains to Collateralised Borrowing and Lending Obligation (CBLO), which was operationalised as a money market instrument through CCIL on January 20, 2003. With a view to developing the market for the CBLO, the Reserve Bank allowed certain exemptions in the form of CRR. Furthermore, securities lodged in the gilt accounts of the bank maintained with the CCIL under the Constituents' Subsidiary General Ledger (CSGL) facility and remaining unencumbered at the end of any day can be reckoned for SLR purposes. The wider usage of the instrument is expected to receive impetus from the establishment of real time connectivity between the PDO and the CCIL and value-free transfer of securities between market participants and the CCIL.

Government Securities Market

7.61 The role of Government securities market in promoting stability of financial systems derives from stable prices and stable markets. As a debt manager to the Government, the development of a deep and liquid market for Government securities is of critical importance to the Reserve Bank in facilitating price discovery and reducing the cost of Government debt. Such markets also provide an effective transmission mechanism for monetary policy, facilitate the introduction and pricing of hedging products and serve as benchmarks for other debt instruments. As the monetary authority, the Reserve Bank has a stake in the development of debt markets. Liquid markets imply a more transparent and correct valuation of financial assets, facilitate better risk management and are, therefore, extremely useful for the Reserve Bank as a regulator of the financial system.

7.62 Efforts towards development of the Government securities market have focused on three areas: institutional measures, innovations through instruments, and enabling measures[42]. During the 1990s, the approach to development of Government securities market focussed on removal of structural bottlenecks, introduction of new players and instruments, free pricing of financial assets, relaxation of quantitative restrictions, and improvement in trading, clearing and settlement practices. Reforms also encompassed regulatory and legal changes, technological upgradation and refinement of the market microstructure.

7.63 In recent years, the approach to development of Government securities market has focused more on financial stability aspects: greater transparency, risk free settlement, deep liquidity, and broad-based participation. Significant steps taken by the Reserve Bank in the recent period pertain to elongation of maturity, development of new benchmark Government securities by consolidating new issuances in key maturities, enhancing fungibility and liquidity by reissuances of existing loans, promoting retailing of Government securities, introduction of floating rate bonds, announcement of a core calendar and enhanced transparency of the central Government's borrowing programme.

[42] Mohan, R., (2004), 'Financial Sector Reforms in India, Policies and Performance Analysis', RBI Bulletin, October.

Mohan, R., (2004), 'A Decade of Reform in the Government Securities Market and the Agenda for the Future, Key note Address, FIMMDA-PDAI Conference, Dubai, RBI Bulletin, November.

7.64 The NDS system was established in February 2002 for ensuring greater efficiency and transparency in operations as well as facility risk free settlement. This paved the way for establishment of the CCIL and compulsory dematerialisation of Government securities. Almost all market participants have joined NDS and Subsidiary General Ledger (SGL) transactions at the PDO, Mumbai are now on electronic mode through NDS. Similarly, bids in LAF, Treasury Bills and Central Government dated securities auctions are being received electronically through NDS, which have resulted in reducing auction bid processing time. Measures were introduced on May 20, 2002 to accelerate the process of holding of securities in the dematerialised mode and to reduce the scope for trading in government securities in physical form and possible irregularities through non-delivery. In connection with dematerialisation of securities through CSGL and to eliminate possibility of 'excess' securities being created, specific action points were drawn up for a system of more frequent and effective reconciliation of Government loans.

7.65 As part of developing a vibrant Government securities market, Treasury Bills of varying maturities, *viz*., 14-day, 91-day, 182-day, 364-day have been introduced. The 14-day Treasury Bills are designed to enable State Governments to park their excess liquidity. At present, auctions are held only for 91-day and 364 day Treasury Bills. Innovations have been introduced with respect to long-term bonds as well. These include zero coupon bonds, capital indexed bonds and floating rate bonds. For the first time, a 10-year bond was issued (on July 17, 2002) with put and call option exercisable on or after 5 years from the date of issue. The issuance of two 30-year Government bonds in August and October 2002 provided additional flexibility to market participants. Operational and prudential guidelines on Separate Trading for Registered Interest and Principal of Securities (STRIPS) were formulated. PDs which meet certain laid down financial criteria were authorised to undertake stripping and reconstitution of securities. Since April 1, 2003, all transactions in Government securities in the PDO, Mumbai are now being settled through CCIL, which has resulted in significantly reduced funding requirement for every member and mitigation of liquidity risk.

7.66 Buying and selling of Government securities through the stock exchanges, *viz*., National Stock Exchange (NSE), Mumbai Stock Exchange (BSE) and Over the Counter Exchange of India (OTCEI) was allowed with effect from January 16, 2003 on an anonymous screen-based order-driven basis to facilitate countrywide access and wider participation in the Government securities markets. This measure was aimed at reducing time and cost in trade execution by matching orders on a strict price and time priority, and enhancing the operational and informational efficiency of the market as well as its transparency, depth and liquidity.

7.67 During 2003-04, various efforts have been made in the areas of retailing, widening of the market, hedging market risk, consolidation of debt market and reduction of payment risks in Government securities segment. A Working Group (Chairman: Dr. R.H. Patil) reviewed the performance of NDS in the context of its operational efficiency and recommended an anonymous electronic screen based order matching trading system on the NDS. The Report of the Group has been placed in the public domain for wider discussion. In order to evaluate the role of PDs in the Government securities market with particular emphasis on their obligation and the ability to cope with emerging risks and possible diversification of their balance sheets, a Working Group (Chairman: Dr. R.H. Patil) was constituted. The Report of the Group is being placed before the Technical Advisory Committee for advice to enable further action. With the withdrawal of the Reserve Bank's participation in primary issues of Government securities by April 2006 as stipulated in the Fiscal Responsibility and Budget Management Act, the OMOs would warrant a review of processes and technological infrastructure consistent with market developments. The Reserve Bank's intervention directly in the market or with PDs on real time basis may become necessary. In view of this, the Reserve Bank in its mid-term Review of annual policy Statement for 2004-05 proposed to set up a Study Group for strengthening open market operations framework to address the emerging needs and equip the Reserve Bank as well as market participants in the light of the enactment of Fiscal Responsibility and Budget Management (FRBM) Act.

Foreign Exchange Market

7.68 In an open economy environment, the foreign exchange market has assumed critical importance for stability of the financial system since banks' balance sheets are being influenced by the foreign capital inflows and various other external transactions. The Indian forex market has widened and deepened such the 1990s on account of implementation of various measures recommended by the High Level Committee on Balance of Payments in 1993 (Chairman: Dr. C.Rangarajan), the Expert Group on Foreign Exchange Markets in India in 1995 (Chairman: Shri O.P.Sodhani) and the Committee on Capital Account Convertibility in 1997 (Chairman: Shri S.S.Tarapore). With the transition to a market determined exchange rate system in March 1993 and the subsequent gradual liberalisation of restrictions on various external transactions, ensuring orderly conditions in the forex market in India has become one of the key objectives. The Reserve Bank has undertaken various measures towards development of spot as well as forward segments of foreign exchange market.

7.69 The CCIL was allowed operations with transactions in Rupee/US dollar foreign exchange spot and forward deals in November 2002, with a view to provide authorised dealers a transparent dealing system while allowing them to access to the automatic foreign exchange order matching system and helping to significantly improve the efficiency and transparency of the foreign exchange market in India.

7.70 In recent years, forex flows, especially due to increasing capital flows, have posed various challenges for liquidity management since these have implications for the conduct of domestic monetary policy and exchange rate management. The impact of such a domestic monetary policy depends largely on the kind of exchange rate regime that the authorities follow. In the context of large forex inflows that India has been experiencing, the Reserve Bank has been reviewing the operational aspects of inflow of forex, *i.e.*, the extent of forex market intervention and consequent build up of reserves, and the need for and extent of sterilisation required. The Reserve Bank's policy measures and operational practices have ensured that appropriate liquidity is maintained in the system consistent with the objective of price stability.

7.71 The Reserve Bank's approach towards ensuring stability of forex market has been evident on various occasions. During the late 1990s, in particular, 1997-98, the forex market remained stable despite the Asian crisis. The forex market exhibited orderly conditions during 2001-02 and 2002-03 despite the September 11 development in the US, international oil price movement in the external front and various domestic developments arising from border tensions, natural calamities such as cyclone and earthquake, and monsoon failure. During 2002-03 and 2003-04, forex market again attested to stability and orderly conditions in the wake of redemption of Resurgent India Bonds (RIBs) and the surge in capital flows. The capital account recorded sustained inflows despite large outflows in the form of policy-induced pre-payments of multilateral debts as well as the one-shot redemption of RIBs. The Reserve Bank put in place an appropriate mechanism to ensure the smooth redemption of RIBs in close consultation with the State Bank of India (SBI), which floated the instrument in 1998. Finally, the payments obligation on account of redemption of RIBs of US dollar 5.5 billion was discharged on October 1, 2003 without any adverse impact either on Indian financial market or on foreign exchange reserves. While the Reserve Bank made available the foreign currency requirements of SBI on the date of redemption, SBI had built up adequate rupee resources to fund foreign currency purchases from the Reserve Bank. In order to smoothen the impact of the redemption over time, Reserve Bank had contracted forward foreign currency assets which took care of a major portion of the requirements. The balance requirements were met out of the foreign exchange reserves.

7.72 During 2003-04, the net inflows were the highest ever, and posed challenges for the Reserve Bank's monetary management, especially, sterilised intervention. In this context, the Reserve Bank, in consultation with the Government of India, introduced the Market Stabilisation Scheme (MSS) as an additional instrument for liquidity and monetary management. A Memorandum of Understanding

(MoU) detailing the rationale and operational modalities of the MSS was signed between the Government of India and the Reserve Bank on March 25, 2004. In order to enable the Reserve Bank to address the overhang of liquidity, the Government raised the ceiling of MSS from Rs. 60,000 crore to Rs. 80,000 crore. The intention of MSS has been essentially to differentiate the liquidity absorption of a more enduring nature by way of sterilisation from the day-to-day normal liquidity management operations. In order to provide transparency and stability to the financial markets, to begin with, an indicative schedule for issuance of Treasury Bills / dated securities for Rs.35,500 crore under MSS for the quarter April-June 2004 was released on March 25, 2004. Keeping in view the emerging liquidity situation, the auctioning of both 91-day and 364-day Treasury Bills under the MSS was discontinued from November 10, 2004. The outstanding amount of securities comprising 91-day and 364-day Treasury Bills and dated securities issued under MSS as on November 13, 2004 amounted to Rs. 55,686 crore (face value).

7.73 As the volume under MSS rose, the visible liquidity under LAF declined. The reduction of liquidity under LAF helped in stabilising the yield curve at the shorter end. This was evident from the CBLO rates, market repo rates and overnight call money rates inching closer to the LAF repo rate. It was, however, noticed that there was some bunching of liquidity due to the 7-day minimum tenor of LAF repo which imparted volatility to short-term rates, particularly around the time of primary auctions of Government securities. Accordingly, overnight fixed rate repo under LAF was introduced in August 2004, in place of overnight variable rate repo which was discontinued in April 2004. While the excess liquidity has come down with the combined effect of slowdown in capital inflows and better domestic absorption on account of higher credit demand, it still remains substantial at around Rs. 69,466 crore as on November 16, 2004.

6. Payment System and Technology

7.74 Payment and settlement systems constitute the backbone of the financial economy. The objective of an efficient payment system is to minimise systemic risk. Moreover, operating in a globally competitive environment requires a high level of technological development. The oversight of payment system is an essential function of central banks, aiming to ensure the smooth functioning of payment system and seeking to contribute to financial stability. The payment system is also important for the integration of financial markets, which in turn facilitates transmission of monetary policy impulses. The payment system influences the speed, financial risk, reliability and cost of domestic and international transactions.

7.75 The Reserve Bank has made concerted efforts at developing a safe, secure and efficient payment and settlement system to enhance financial stability. In the process of improving the overall efficiency of the payment and settlement systems in the country, the Reserve Bank, apart from performing the regulatory and oversight functions, has also undertaken promotional and institutional activities.

7.76 Information technology (IT) has made a major presence in the Indian banking sector. IT has changed the contours of three major functions of financial intermediaries: access to liquidity, transformation of assets and monitoring of risks. While the driving force behind all the initiatives towards development of the payment system has been technology, it has been ensured that all the other major covenants of a safe, efficient and secure payment and settlement systems are fully met with.

7.77 A holistic approach has been adopted towards designing and development of a modern, robust, efficient, secure and integrated payment and settlement system taking into account certain aspects relating to potential risks, legal framework and the impact on the operational framework of monetary policy. The approach to the modernisation of the payment and settlement system in India has been three-pronged: (a) consolidation, (b) development, and (c) integration. The consolidation of the existing payment systems revolves around strengthening computerised cheque clearing, expanding the reach of Electronic Clearing Services (ECS) and Electronic Funds Transfer (EFT) by providing for systems with the latest levels of technology. The critical elements in the developmental strategy are the opening of new clearing houses, interconnection of clearing houses through the INFINET; optimising the deployment of resources by banks through RTGS System, NDS, Centralised Funds Management

System (CFMS); and the Structured Financial Messaging System (SFMS). While integration of the various payment products with the systems of individual banks is the thrust area, it requires a high degree of standardisation within a bank and seamless interfaces across banks.

7.78 Recognising the need for providing a safe, sound and robust platform to facilitate the absorption of technology by banks, the Reserve Bank set up the Institute for Development and Research in Banking Technology (IDRBT) in 1996, which is an autonomous centre for providing essential core networking functions for banks. The IDRBT has set up the country's financial communication backbone called the INFINET (INdian FInancial NETwork) – which is a Wide Area Network based on Satellite communication (using VSATs) and terrestrial lines. The network has been in operation since 1999 and is available for the exclusive use of banks and financial institutions, as a Closed User Group. With the benefits ushered in by the INFINET, more products have been introduced by the Reserve Bank, using the INFINET backbone. The National Payments Council (NPC), constituted in May 1999, is entrusted with the task of laying down the broad policy parameters for designing and developing an integrated state-of-the-art, robust payment and settlement systems for the country.

7.79 The Payment systems can be subject to various types of risks, *e.g.*, credit risk, liquidity risk, legal risk, operational risk and systemic risk. To reduce risks in Deferred Net Settlement System (DNSS), the RTGS has been operationalised by the Reserve Bank. RTGS is a large value funds transfer system whereby financial intermediaries can settle inter-bank transfers for their own account as well as for their clients[43]. The final settlement of inter-bank funds transfers on a continuous, transaction-by-transaction basis takes place throughout the processing day. It is a fully secure system using digital signature, and public key infrastructure (PKI) based encryption for safe and secure message transmission. More than 75 per cent of the value of inter-bank settlements, which were earlier settled through the multilateral DNSS based inter-bank clearing is now settled under the RTGS. DNSS was an alternative followed in many places for managing large value payment. Under DNSS, the participant banks' individual payment messages are netted and the net amount is settled at a specified time, typically at the end of the day. There were two major drawbacks in such a system: (i) the settlement risk was carried by the counter parties till the end of the day until the settlement was completed, and (ii) there was a systemic risk in the sense that if a party defaulted, the transactions needed to be unwound, and recalculated and/or reverted to gross obligations. Even though DNSS is less demanding in terms of liquidity needs as the final net obligations are smaller than the underlying gross obligations, large payments are preferred to be made *via* RTGS mechanism because of the lower risk.

7.80 The stand-alone version of RTGS system, after elaborate testing was put under a trial run. An external group of experts evaluated the policies, procedures, accounting and technology aspects of the system. The Reserve Bank commenced implementation of the RTGS system in a phased manner. As a first stage, a demonstrable version of the RTGS system was implemented in June 2003, and hands-on practice was given to the officials of 104 banks. The live operations of RTGS system commenced on March 26, 2004 with the participation of 4 select banks. This system is fully linked with the integrated accounting system of the Reserve Bank. As RTGS services will be offered by banks through their branch network, it is essential that banks should put in place necessary connectivity between their branches and the payment system gateway through which banks will interact with the RTGS system.

7.81 As on November 19, 2004, there were a total of 94 direct participants including banks, with 1,451 branches located in 152 cities and towns, conducting transactions on the RTGS. The coverage is expected to increase to 3,000 branches in 275 centers by December 2004. With a view to helping banks to efficiently manage their funds and to eliminate avoidable movements of funds around various centers for settlement purpose, the Reserve

[43] Chapter II, Box II.16: RTGS in India

Bank is likely to introduce a National Settlement System (NSS) in a phased manner. It will link up different clearing houses managed by the Reserve Bank and other banks at one centralised place. It is likely to be operationalised in early 2005. The RTGS arrangement also enables banks to ensure transfer of funds instantaneously among the member banks of the system all over the country through electronic transfer mechanism availing the benefit of pooling of funds at different centres for optimum utilisation. Recognising the critical importance of the back-up/disaster recovery management systems, two geographically dispersed sites were identified as back up/disaster recovery during 2003-04 and data centres are being set up at these locations. The RTGS system provides for an electronic based settlement of inter-bank and customer-based transactions, with intra-day collateralised liquidity (IDL) support from the Reserve Bank to the participants of the system. The RTGS system has also been enabled for straight through processing (STP) of customer transaction without manual transaction.

7.82 At present, all retail payment systems, both paper-based and electronic-based, are settled on a deferred net settlement basis. Such settlement has credit, liquidity and operational risks that could lead to settlement failures. In order to put in place an appropriate risk mitigation mechanism for the retail payment systems as also to examine the operational implications of such a mechanism, a Working Group with representatives from the Reserve Bank, Indian Banks' Association (IBA) and banks has been constituted by the Reserve Bank.

7.83 It was indicated in the annual policy Statement 2004-05 that the Reserve Bank would set up a Board for Payment and Settlement Systems (BPSS) that would lay down the policies for the regulation and supervision of the payment and settlement systems encompassing the domestic and cross-border systems. The constitution of the Board will ensure more effective regulation and supervision of the various payment and settlement systems in the country. The draft regulation to set up the BPSS has been transmitted to the Government for notification in the Gazette.

7.84 In order to facilitate large scale usage of ECS and EFT schemes for large value money transfers and to meet the requirements of various segments of the financial sector including the securities markets, the existing per transaction limits for ECS and EFT have been dispensed with effective November 1, 2004.

7.85 In recent years, plastic cards (credit, debit and smart cards) have gained greater acceptance and momentum as a medium of financial transactions[44]. Banks are issuing either their own cards or cards under affiliation with international card issuing institutions. The volume and value of transactions undertaken using these cards have increased significantly. While recognising the popularity of cards, regulatory and customer protection measures assume importance. Accordingly, it has been proposed to constitute a Working Group to look into the regulatory and customer protection aspects and suggest measures for card usage in a safe, secure and customer friendly manner.

7. Architecture of Regulation and Supervision

7.86 The Reserve Bank is entrusted with the supervision of India's banking system under the provisions of the Banking Regulation Act, 1949 and the Reserve Bank of India Act, 1934. The Reserve Bank regulates select FIs and NBFCs under Chapter III-B of the Reserve Bank of India Act. Consequent upon amendments to Chapters III-B, III-C and V, through the Reserve Bank of India (Amendment) Act in 1997, the Reserve Bank introduced a comprehensive regulatory framework in respect of NBFCs, including compulsory registration in terms of the amended Section 45-IA[45].

7.87 Under the provisions of the Reserve Bank of India Act, 1934, and the Banking Regulation Act, 1949, the Reserve Bank enjoys a range of powers to direct banks to submit quarterly Monitorable Action Plans, to call for progress reports on targets pertaining to various indicators of banks' balance sheet and profit and loss accounts such as capital, profitability, NPAs, inter-branch, inter-bank and *nostro* accounts, borrowal accounts, *etc.* The Reserve Bank is

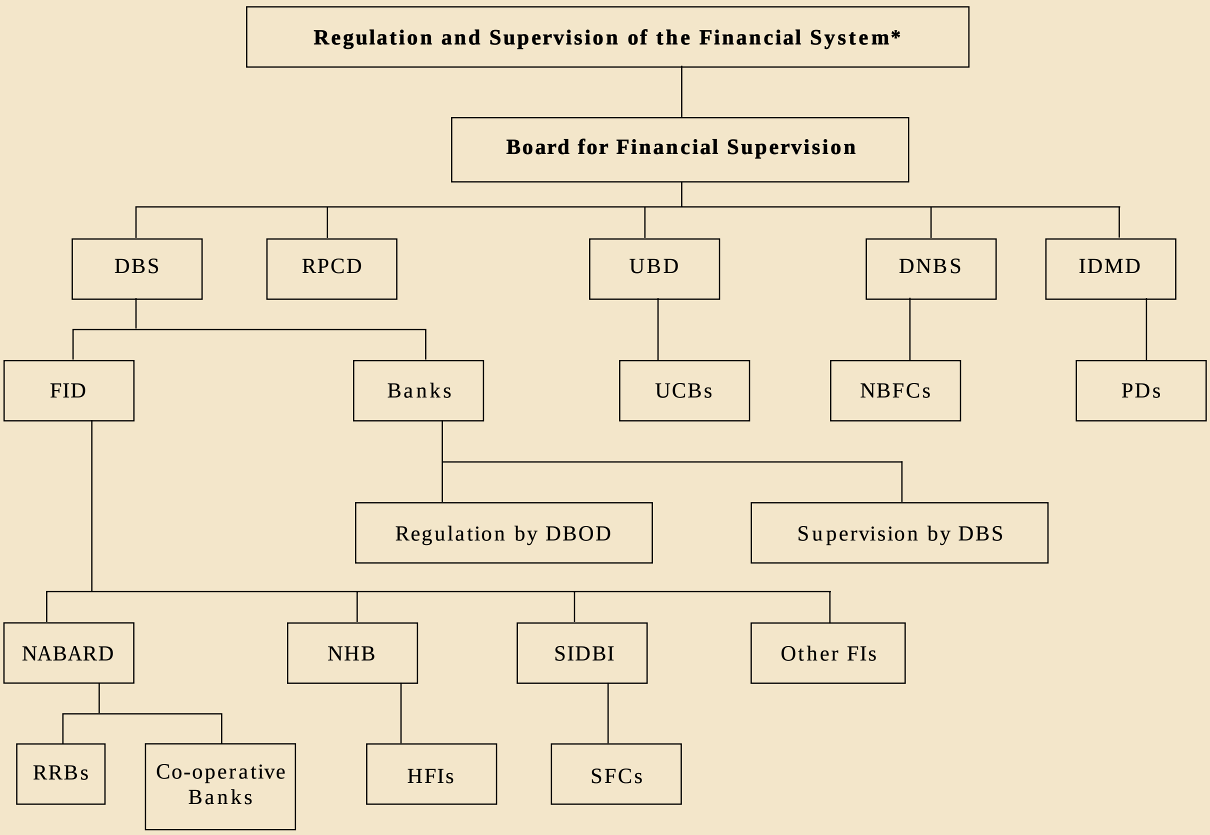
44 Also see Chapter II, Box II.7: Credit Cards in India.
45 Reserve Bank of India, Annual Report, 2000-01.

empowered to put caps on allocation of credit to certain sectors including the priority sector for promoting broad-based development, and to put restrictions on lending to the sensitive sectors. The Reserve Bank is vested with the power of control over banks' management by way of ban on recruitment and opening of branches, and changes in the management of banks by removal of the Chief Executive Officer or Directors of the Board. In addition, the Reserve Bank appoints additional Directors/Observers to oversee the functioning of private sector banks so as to prevent its affairs from being conducted in a manner detrimental to the interest of depositors. The Reserve Bank also exercises powers in extreme cases to place private sector banks under moratorium or initiate winding up proceedings. The architecture of regulation and supervisory process is set out in Chart VII.1.

Board for Financial Supervision

7.88 The Board for Financial Supervision (BFS) was constituted in November 1994, as a committee of the Central Board of Directors of the Reserve Bank of India[46]. The primary objective of BFS is to undertake supervision of the financial sector comprising commercial banks, financial institutions, non-banking financial companies, co-operative banks, and primary dealers. The Board is chaired by the Governor and the Deputy Governors of the Reserve Bank are ex-officio Members. One of the Deputy Governors is nominated as Vice-Chairman. Further, four Directors from the Central Board are co-opted as Members generally for a term of two years. The Board is required to meet normally once in a month. During the meetings, it deliberates upon inspection reports and other supervisory

Chart VII.1: Architecture of Regulation and Supervision



* The chart outlines the supervisory purview of the Reserve Bank of India.
Note: DBS, RPCD, UBD, DNBS, IDMD and FID are the respective regulating/supervising Departments of the Reserve Bank.

[46] Chapter II: Policy Developments

issues placed before it by the supervisory departments. The BFS is assisted by the Department of Banking Supervision (DBS) of the Reserve Bank and it gives directions on the regulatory and supervisory issues of various supervised entities. Some of the initiatives taken by BFS include restructuring of the system of bank inspections, introduction of off-site surveillance, strengthening of the role of statutory auditors, and strengthening of the internal defence mechanism of supervised institutions.

Surveillance and Monitoring

7.89 During the pre-reform era, the regulatory /supervisory framework in India bordered on micro management of banks through on-site annual inspection of banks. The only off-site data that were being collected were the published balance sheets and profit and loss accounts of commercial banks. The Committee on the Financial System (Chairman: M. Narasimham) and other committees, which examined the supervisory practices followed by the Reserve Bank and recommended setting up of an off-site monitoring function to strengthen the financial sector supervision. In its very first meeting, the BFS approved a new system of Surveillance and Monitoring based on a combination of on-site inspection and off-site surveillance system. Under the new approach, the off-site surveillance system was incorporated for (i) establishing a system for in-house monitoring of banks and other credit institutions based on a prudential supervisory reporting framework; (ii) building a 'Memory' on all supervised institutions and setting up a market intelligence and surveillance unit (MISU); (iii) restructuring the system of bank inspections in terms of focus, process, reporting and follow up, strengthening the statutory audit of banks and enlarging the role of auditors in the supervisory process including using them as agents; and (iv) strengthening the internal defences within the supervised institutions such as corporate governance, internal control and audit functions, and management information and risk control systems, as an extension of the task of supervision.

On-site Supervision

7.90 Prior to 1992, there were financial inspections once in four years and annual financial reviews for the public sector banks. In case of private sector banks and foreign banks, financial inspections were carried out once in 18 months to 24 months. In order to obviate the long interval between two actual inspections, the two streams of inspections were synthesised into one annual financial inspection (AFI) applicable to all banks, which was implemented in 1992. The scope of AFI was broadened and CAMELS/CALCS model (Capital adequacy, Asset quality, Management, Earnings appraisal, Liquidity and Systems and controls) was introduced for inspection of banks. A system of rating the performance of banks on the basis of on-site inspection has been introduced. Banks are awarded a scale of 'A' through 'D' in descending order of performance.

7.91 While inspection of the overseas operations of branches of Indian banks is left largely to the parent banks, a system of evaluation visits covering all branches functioning at different financial centres has been instituted as a part of the initiatives taken to strengthen cross border supervision. Besides periodical visits and meetings with overseas supervisors, formal MOUs for exchange of supervisory information are being worked out as, part of the process of implementation of Basel Committee's core principles on cross border supervisory co-operation. Portfolio appraisals of the International Divisions of Indian banks having foreign branches are also conducted by the DBS annually. In these appraisal exercises conducted at the banks' corporate offices and controlling divisions of foreign operations, asset quality, operating results, *etc.* of the foreign branches and the host country regulators' perceptions are also assessed and periodically discussed with the banks' International Divisions for rectification of the functional gaps, if any.

Consolidated Supervision

7.92 The *Core Principles for Effective Banking Supervision* issued by the Basel Committee on Banking Supervision (BCBS) have underscored this requirement of consolidated supervision as an independent principle. Keeping in view the development of the financial sector, there has been an increased focus on empowering supervisors to undertake consolidated supervision of bank groups and monitoring of systemically important institutions during 2002-03 and 2003-04. The Reserve Bank set up a multi-disciplinary Working Group in November 2000 (Chairman: Shri Vipin Malik) to examine the feasibility of introducing consolidated accounting and other quantitative methods to facilitate consolidated supervision. On the basis of the recommendations of the Working Group, guidelines on consolidated supervision were issued to banks for implementation with effect from the year ended March 2003. Banks were advised to ensure strict compliance commencing from the year ended March 31, 2003. The components of consolidated supervision to be implemented by the Reserve Bank include Consolidated Financial Statements (CFSs) for public disclosure and Consolidated Prudential Reports (CPRs) for supervisory assessment of risks which may be transmitted to banks or other supervised entities by other Group members. Moreover, there would be application of certain prudential regulations like capital adequacy and large exposures/risk concentration on group basis. Initially, consolidated supervision has been mandated for all groups where the controlling entity is a bank.

7.93 Supervision at consolidated level for banks having subsidiaries/associates/joint ventures have been introduced, under which banks are expected to submit half-yearly consolidated prudential returns and annual consolidated financial statements including consolidated balance sheets and profits and loss accounts. There has also been a move towards Risk Based Supervision (RBS), following international best practices and recommendations of the BCBS[47]. Alongside on-site AFI, 8 banks were identified last year for RBS on a pilot basis and based on the experience gained from the pilot study, 15 more banks have been identified for RBS during the current inspection cycle.

7.94 The financial landscape in India has been increasingly witnessing the entry of some of the bigger banks into other financial segments like merchant banking, insurance, *etc.* which has made them financial 'conglomerates'. Financial liberalisation has also led to emergence of several new players with diversified presence across major segments and possibility of some of the non-banking institutions in the financial sector acquiring large enough proportions to have a systemic impact. From a regulatory perspective, the above developments have led to an appreciation of the limitations of the segmental approach to supervision in addressing the following potential risks associated with conglomeration. The risks could be on account of the moral hazard associated with the 'Too-Big-To-Fail' position of many financial conglomerates, contagion or reputation effects on account of the 'holding out' phenomenon and concerns about regulatory arbitrage, non-arm's length dealings, *etc.* arising out of intra-group transactions and exposures, both financial and non-financial. Therefore, as a proactive stance to address these issues so that the gains on financial stability are further strengthened, the Reserve Bank in the mid-term Review of monetary and credit policy 2003-04 announced the setting up of a Working Group on Financial Conglomerates (Convenor: Smt. Shyamala Gopinath), in consultation with the Chairman, Securities and Exchange Board of India (SEBI) and Chairman, Insurance Regulatory and Development Authority (IRDA), to have a special monitoring system for Systemically Important Financial Intermediaries (SIFIs). The Group, in its Report submitted in June 2004, suggested criteria for identifying financial conglomerates, a monitoring system for capturing intra-group transactions and exposures amongst such conglomerates and a mechanism for inter-regulatory exchange of information in respect of conglomerates. Twenty four conglomerates have been identified for the purpose and the first Report based on the format recommended by the Group is under compilation. A nodal cell has been established at the Reserve Bank for smooth implementation of the framework. A Technical Committee with representatives from all three regulators has been interacting and addressing issues arising out of the reporting requirements.

Off-site Monitoring and Surveillance System (OSMOS)

7.95 The objectives of setting up an off-site supervision process are to provide information about the health of banks on regular basis to the supervisory authority, to build a database for analysis and monitoring of institutions, to capture systemic trends in banking and to

[47] Also see Chapter II, Box II.12: Basel II: A Revised Framework.

support policy initiatives. For a large banking sector, on-site monitoring and inspections entail substantial cost and supervisory resources. In this regard, off-site monitoring is useful for saving cost and optimum allocation of supervisory resources. As part of crisis management, off-site supervision is used as a framework for Early Warning System (EWS) and as a trigger for on-site inspections of vulnerable institutions. The Reserve Bank instituted a computerised off-site prudential supervisory reporting system for banks in 1995. Since then, the scope and coverage of off-site surveillance has widened while evolving as a powerful tool of the supervisory process for capturing various facets of efficiency and risk management of banks.

7.96 In 1995, when off-site prudential supervisory returns were first introduced, these returns were christened 'DSB' returns. Initially, seven returns for Indian banks and five returns for foreign banks were prescribed. Over the years, with a view to enhancing market discipline through increased disclosure and transparency, the list of returns has expanded. At present, there are 23 returns submitted by banks. These returns cover, *inter alia*, the areas of assets, liabilities, exposures, capital adequacy, operating results, asset quality, large credits, connected lending, ownership and control, consolidated prudential reports, risk based supervision reports, balance sheet analysis, report of operations of subsidiaries / associates / joint ventures, as also returns on liquidity and interest rates sensitivity both for Indian and foreign currencies. The coverage of these returns is modified periodically so as to capture the relevant data on emerging supervisory concerns. A time span of 21 days from the end of the period for technologically advanced new private and foreign banks and one-month time from the end of the period for public sector banks and old private sector banks was prescribed for submission of the returns. The OSMOS system has stabilised over a period of time and provided various benefits. As the OSMOS database has the geographical reach and technical capacity, it is envisaged that the work relating to preparation of risk profile under risk-based supervision would be greatly facilitated.

7.97 This macro approach to financial supervision has helped policy makers to refine their regulatory as well as monetary policy stance so as to achieve the fine balance between growth and financial stability. For instance, over the last couple of years, the major supervisory concern has been to deal with the potential interest rate risk of the banking sector. Based on the data collected on the maturity patterns of banks' assets and liabilities, the book and market value of the investments, the impact of rising bond yields on the banks' balance sheets after taking in to account the cushion available both for the system as a whole, and for the individual banks could be compiled regularly. Outliers in the system on the basis of their capacity to withstand interest rate shock were sensitised to take corrective actions.

Urban Co-operative Banks

7.98 The Urban Co-operative Banks (UCBs) form an important constituent of the co-operative credit system[48]. The UCBs meet the financing needs of the urban sector, particularly, non-agricultural small borrowers. Co-operative banks perform all the main banking functions of deposit mobilisation, supply of credit and provision of remittance facilities. The UCBs come under multiple regulatory structure comprising Registrar of Co-operative Societies of States, Central Government and the Reserve Bank. The Reserve Bank has regulatory and supervisory authority for bank-related operations under certain provisions of the Banking Regulation Act, 1949 (as applicable to the Co-operative Societies). UCBs are included in the Second Schedule of the Reserve Bank of India Act, 1934, provided their net demand and time liabilities are at least Rs.100 crore and subject to certain other related criteria.

7.99 Keeping in view the challenges arising from the functioning of UCBs for the financial system, the Reserve Bank appointed a High Power Committee (Chairman: Shri K. Madhava Rao) in May 1999 to review the performance of UCBs and to suggest necessary measures to strengthen this sector. The Committee emphasised the need for preserving the co-operative character of UCBs, reducing the

[48] Also see 'Chapter IV: Developments in Co-operative Banking' of the Report.

systemic risks to the financial system, ensuring depositors' interest and putting in place strong regulatory norms at the entry level so as to sustain the operational efficiency of UCBs in a competitive environment. Based on the recommendations, various measures have been undertaken to strengthen the existing UCB structure particularly in the experience of an increasing number of weak banks and alignment of urban banking sector with the other segments of banking sector for the application of prudential norms and removing the irritants of a dual control regime.

7.100 To safeguard the interest of depositors, in the light of developments in the urban co-operative banking sector in 2001-02, the Reserve Bank has undertaken a series of measures directed towards strengthening the financial position of the UCBs during 2002-03 and 2003-04. These measures include applying capital adequacy standards, prescribing an asset-liability management framework, enhancing the proportion of holding of Government and other approved securities for the purpose of SLR stipulation, and restriction on bank finance against the security of corporate shares and debentures[49].

7.101 In June 2002, the UCBs were advised that it was mandatory for them to hold a proportion of their SLR assets in the form of Government and other approved securities. UCBs were advised to effect purchase/sale transactions in Government securities necessarily through the SGL account with the Reserve Bank or CSGL accounts with the designated agencies or dematerialised accounts with other banks/ depositories. They are required to route such transactions through the NDS/CCIL system. They are also required to make fresh investments in permitted instruments such as PSU bonds, bonds/equity of specified All-India Financial Institutions, infrastructure bonds issued by FIs, and units of UTI only in dematerialised form. UCBs have been prohibited from dealing with brokers as counter-parties, and advised to have their transactions in Government securities subjected to concurrent audit every quarter, and confirm to the Reserve Bank that the investments as reported by the UCB are, in fact, owned by it.

7.102 To strengthen the supervisory system, the Reserve Bank extended the Off-site Surveillance System (OSS) to all non-scheduled UCBs having deposit size of Rs.100 crore and above. A supervisory reporting system was introduced for the scheduled primary (urban) co-operatives banks with effect from March 31, 2001, as a first step towards setting up of a system for OSS of all UCBs. The OSS reporting system comprises a set of eight returns as against the earlier set of 10 returns. As the reporting system has stabilised in respect of the scheduled UCBs, the same has been extended to all non-scheduled UCBs having deposit size of Rs.100 crore and above. In order to facilitate smooth transition/operationalisation of the new set of returns for the non-scheduled UCBs covered under the OSS reporting system, the period of one month for submission of the returns would be implemented gradually from the quarter ended December 2004 onwards. Prudential concerns monitored through these returns include aspects relating to solvency, liquidity, capital adequacy, asset quality/ portfolio risk profile, connected or related lending and concentration of exposures of the supervised institutions. A collateral objective of the reporting system is to sensitise the management of banks to concerns of the supervisory authority and thereby also help in self-regulation.

7.103 The overall ceiling on loans and advances (both secured and unsecured) to all directors of UCBs, their relatives and concerns in which they are interested was brought down from the earlier ceiling of 10 per cent of the bank's demand and time liabilities to 5 per cent. Following recommendations of the Joint Parliamentary Committee and with a view to preventing certain irregularities which surfaced in the case of some UCBs, a total ban has been imposed with effect from October 1, 2003, on grant of loans and advances to directors of UCBs, their relatives and concerns in which they have interest.

7.104 The Reserve Bank has also directed that UCBs should undertake usual due diligence in respect of investments in non-SLR securities. Presently, regulations of the Reserve Bank preclude banks from extending credit facilities for certain purposes. Banks should ensure that

[49] Reserve Bank of India, Report on Trend and Progress of Banking in India, 2000-01.

such activities are not financed by way of funds raised through the non-SLR securities. UCBs must not invest in un-rated debt securities except bonds of nationalised banks, unlisted securities, unlisted shares of AIFIs and privately placed debt securities. The debt securities shall carry a credit rating of not less than investment grade from a credit rating agency registered with the SEBI. UCBs should not invest in non-SLR debt securities of original maturity of less than one year.

7.105 The Reserve Bank introduced a new system of grading of co-operative banks in April 2003. The new system of grading is based on their CRAR, level of net NPAs, record of losses and compliance with regulatory environment. Similarly, a system of supervisory rating for UCBs under the CAMELS model has been introduced. Initially it was implemented in the context of scheduled UCBs but subsequently its simplified version was made applicable to non-scheduled UCBs since March 2004.

7.106 A vision document for the future role of UCBs is being evolved to ensure depositors' interests and avoid contagion while providing useful service to the local communities. In regard to structural issues, the Reserve Bank would be encouraging growth of strong and viable entities within the sector through consolidation. Further, the Reserve Bank would continue to pursue with the Central and State Governments regarding the issues that arise in their jurisdiction.

Development Finance Institutions (DFIs)

7.107 Along with the changed operating environment for banks in the globalised scenario, the regulatory framework for DFIs has undergone a significant change[50]. On the one hand, the access of DFIs to low-cost long-term funds, particularly non-SLR bonds, has been withdrawn, whereas on the other hand, they have to compete with banks for long-term lending. With the removal of control on interest rate structure, it has become a challenging task for the DFIs to raise long-term funds. DFIs have reacted to these developments by raising funds at competitive rates from the market through public issues and increasingly, through private placements, resulting in an overall increase in their cost of funds. Faced with rising resource cost, increased competition and decline in asset quality, DFIs have responded by diversifying into para-banking activities (*i.e.*, merchant banking, advisory services). As a consequence, there was general decline in their term-lending operations, while their short-term lending and non-fund based operations have increased. A major restructuring in the financial sector is evident in the recent conversion of two DFIs into banks, *viz.*, ICICI and IDBI. Consequently, these two banks have come under the purview of the Reserve Bank's regulatory and supervisory process as commercial banks.

7.108 All India financial institutions are being covered by on-site supervisory process (CAMELS standards) on the lines in vogue for banks since 1995[51]. Taking into account the developmental functions and supervisory function exercised by some of these institutions – NABARD supervises State/Central Co-operative Banks and Regional Rural Banks, National Housing Bank (NHB) regulates and inspects housing finance companies, and IDBI inspects state financial corporations-a modified approach for supervisory assessment of these institutions has been introduced. The Working Group (Chairman: Shri Y.H. Malegham) has recommended measures in this regard.

7.109 On a review of the credit exposures of the term lending institutions in 1997, the Reserve Bank prescribed credit exposure limits for them in respect of their lending to individual/group borrowers. Accordingly, credit exposure norms as a prudential measure were prescribed for all-India term-lending and refinancing institutions. The norms aimed at better risk management and avoidance of concentration of credit risks, and limit a term lending institution's exposures to an individual borrower and group borrowers. The credit exposure to single borrower shall not exceed 15 per cent of capital funds of the FIs. However, the exposure may exceed by additional five percentage points (*i.e.*, up to 20 per cent) provided the additional credit exposure is on account of infrastructure projects. The credit exposure to the borrowers belonging to a group

[50] Also refer Chapter V: Financial Institutions of the Report.

[51] Reserve Bank of India,Report on Trend and Progress of Banking in India, 2000-01.

shall not exceed 40 per cent of capital funds of the FI. However, the exposure may exceed by an additional 10 percentage points (*i.e.*, up to 50 per cent) provided the additional credit exposure is on account of infrastructure projects.

Non-Banking Financial Companies (NBFCs)

7.110 With regard to NBFCs, the Reserve Bank had limited powers to regulate the asset side of the balance sheet of these entities until 1997. In order to strengthen the regulatory framework, the Reserve Bank of India (Amendment) Act, was promulgated in 1997. The legislative focus was primarily aimed at moderating their deposit mobilisation activity by linking the quantum of deposit acceptance to their net owned funds. The salient features of the amended provisions pertain to the revised entry point norms, compulsory registration with the Reserve Bank, maintenance of certain percentage of liquid assets in the form of unencumbered approved securities, creation of a reserve policy and transferring certain proportion (not less than 20 per cent) of profits every year. In order to buttress the regulatory measures, the supervisory framework consists of a four-pronged mechanism comprising (i) on-site inspection on the CAMELS pattern, *viz.*, capital adequacy, assets, management, earnings, liquidity, systems and procedures; (ii) off-site monitoring through periodic control returns from NBFCs using state-of-the-art information technology; (iii) an effective market intelligence network; and (iv) a system of submission of exception reports by statutory auditors of NBFCs. For NBFCs, the system of on-site examination is structured on the basis of CAMELS approach and the same is akin to the supervisory model adopted for the banking system. A comprehensive Inspection Manual has been brought out for the use of Inspecting Officers. Appropriate supervisory framework, wherever necessary with the assistance of external chartered accountant firms, has been evolved for on-site inspection of all NBFCs holding public deposits. In order to bring NBFCs in line with international practices, the Reserve Bank intends to initiate a consultative process with the NBFCs with regard to their plan of action for voluntariliy phasing out of their acceptance of public deposits[52].

7.111 Recently, the Reserve Bank has envisaged a road map for Residuary Non-Banking Companies (RNBCs) with a view to smoothening the process of transition of these institutions to compliance with the Reserve Bank's directions[53]. In order to ensure that the depositors are served appropriately and systemic risks are avoided, the Reserve Bank intends to focus on improvements in the functioning of RNBCs, including transparency of operations, corporate governance, 'Know Your Customer', *etc.*[54]

8. Crisis Prevention

7.112 In order to ensure that banks' financial position does not deteriorate beyond redemption, it is essential that corrective actions must be taken when banks have adequate cushion of capital and their financial position is still satisfactory. This is important since low or negative capital base and adverse financial conditions may induce banks to try measures such as, offering very high interest rates on deposits to fund high risk borrowers. The Basel Committee had also endorsed the need of supervisors taking timely corrective action when banks fail to meet CRAR or other prudential requirements.

Prompt Corrective Action

7.113 The Reserve Bank issued draft guidelines in 2003 on a scheme of Prompt Corrective Action (PCA) towards building a safe and sound banking system, backed by a strong supervisory regime[55]. The response has been dictated by two major considerations, *i.e.*, to identify problem banks at an early stage and to monitor the behaviour of troubled banks in an attempt to prevent failure or to limit losses or contagion. The PCA measures ensure that regulators are properly equipped to anticipate problems in complex and integrated financial systems, detect fragilities, take prompt corrective action to deal with distressed institutions, and minimise opportunities for regulatory arbitrage by financial intermediaries.

[52] Also see Chapter VI: Non-Banking Financial Companies
[53] Reserve Bank's annual policy Statement 2004-05, and the mid-term Review of annual policy Statement 2004-05.
[54] Also see Chapter VI, Box VI.1: Maintenance of Directed Investments by RNBCs.
[55] Reserve Bank of India, 'Discussion Paper on Prompt Corrective Action', available at www.rbi.org.in.

7.114 The system of PCA is based on various trigger points and mandatory and discretionary responses by the supervisors. A schedule of corrective actions has been worked out based on three parameters *i.e.*, CRAR, asset quality (Net NPAs) and profitability (Return on Assets-RoA). Trigger points have been proposed under each of the three parameters, taking into account the practicality of implementation of certain measures in the Indian context. For CRAR, three trigger points have been proposed-CRAR of greater than or equal to 6 per cent, but less than 9 per cent; greater than or equal to 3 per cent but less than 6 per cent; and less than 3 per cent. For Net NPAs, two trigger points have been proposed - greater than 10 per cent but less than 15 per cent; and 15 per cent and above. For RoA, the trigger point has been set at less than 0.25 per cent. For every trigger point, a set of mandatory and discretionary PCAs has been laid down. A discussion paper on PCA has been put on the Reserve Bank's web-site for wider circulation, inviting suggestions and comments from banks and others. On a review of the PCA scheme, the BFS decided to continue the scheme in its present form. A few banks coming under the trigger zones were advised to take necessary corrective actions. Thereafter, some of these banks have recorded improvements in their functioning.

Exposure Norms

7.115 Safeguarding against excessive risk exposures to firms, sectors, or countries is an important concern of regulators. Depositors' confidence and thus the stability of the banking system are closely tied to the quality and liquidity of the banks' assets. As a prudential measure aimed at better risk management and avoidance of concentration of credit risks, the Reserve Bank has advised the banks to fix limits on their exposure to specific industry or sectors and has prescribed regulatory limits on banks' exposure to individual and group borrowers in India.

7.116 Taking into account international best practices, the exposure ceiling has been fixed in relation to bank's capital funds as defined under capital adequacy standards (Tier I and Tier II Capital) since April 2002. The exposure ceiling is applicable for both domestic and foreign banks. The exposure ceiling limits applicable from April 1, 2002, as computed above would be 15 per cent of capital funds in case of single borrower and 40 per cent in the case of a borrower group. Banks may in exceptional circumstances, with the approval of their Boards, consider the enhancement of the exposure to a borrower upto a further 5 per cent of capital funds (20 per cent of capital funds for single borrower and 45 per cent of capital funds for group borrowers) subject to the borrower consenting to the banks making appropriate disclosures in their respective annual reports. In respect of exposure to infrastructure, banks may consider additional sanctions upto 5 per cent and 10 per cent over and above the limits of 20 per cent and 45 per cent, respectively. In addition, banks are also required to observe certain statutory and regulatory exposure limits in respect of advances against/investments in shares, debentures and bonds.

Credit Exposure on Derivative Products

7.117 Credit exposures on derivative products have important ramifications for banks. Therefore, it is crucial that these are measured appropriately. As per the instructions, prior to March 31, 2003, exposures by way of non-funded credit limits were captured at 50 per cent of such limits or outstandings, whichever is higher. Besides, the exposure of banks on derivative products, such as, Forward Rate Agreements (FRAs) and Interest Rate Swaps (IRS) was captured for computing exposure by applying the conversion factors to notional principal amounts as per the original exposure method. With effect from April 1, 2003, in addition to reckoning non-fund based limits at 100 per cent, banks have been advised to include forward contracts in foreign exchange and other derivative products at their replacement cost value in determining individual / group borrower exposure. As per the paper of the Basel Committee on Banking Supervision on International Convergence of Capital Measurement and Capital Standards, 1988, there are two methods to assess the exposure on account of credit risk in derivative products, *viz.*, (i) Original Exposure Method and (ii) Current Exposure Method. Banks and FIs have been encouraged to follow the Current Exposure Method, which is more accurate in measuring credit exposure of a derivative product. In case a bank is not in a position to adopt the Current Exposure Method, it may follow the Original Exposure Method. However, banks have been advised that their endeavour should be to move over to the Current Exposure Method in course of time. Banks have been advised to adopt, effective from April 1, 2003, either of the above two methods, consistently for all derivative products, in determining individual/group borrower exposure. Banks would not be required to calculate potential credit exposure for single currency floating/ floating interest rate swaps. The credit exposure on single currency floating/floating interest rate swaps are to be evaluated solely on the basis of their marked-to-market value.

Frauds

7.118 In order to prevent frauds in banks, the Reserve Bank has been advising banks, from time to time, about the major fraud prone areas and the safeguards necessary for prevention of frauds. The Reserve Bank has also been circulating to banks, the details of frauds of an ingenious nature not reported earlier so that banks could introduce necessary safeguards by way of appropriate procedures and internal checks. Banks have also been advised about the details of unscrupulous borrowers and related parties who have perpetrated frauds on banks so that banks could exercise caution while dealing with them. To facilitate this ongoing process, the Reserve Bank has devised a reporting system for banks to provide full information about frauds and the follow-up action taken thereon on time on a quarterly basis. A software on 'Frauds Reporting and Monitoring System' has since been developed and the banks have been imparted requisite training to use the module for reporting. Reserve Bank has also notified banks that the failure in this regard is subject to penal action as prescribed under provisions of the Banking Regulation Act, 1949.

Know Your Customer

7.119 As per the guidelines on 'Know Your Customer' (KYC), banks are required to carry out due diligence of customers before opening any deposit account. This is a measure taken to combat money laundering and financing of terrorism in the country. In August 2002, the Reserve Bank advised urban co-operative banks to complete an appropriate KYC procedure by December 2004 for establishing identity by means of suitable documents and to ensure that adoption of such a procedure does not lead to denial of access to banking services for the general public. Banks have been directed to limit the application of KYC procedures to existing accounts where the credit or debit summation for the financial year ended March 31, 2003 is more than Rs.10 lakh or where unusual transactions are suspected. KYC procedures are applied to all existing accounts of trusts, companies, firms, religious, charitable organisations and other institutions or where the accounts are opened through a mandate or power of attorney. In December 2002, banks were advised to review the accounts opened prior to August 2002, for compliance with the KYC norms and take necessary steps to complete the work in respect of all accounts in a phased manner by December 2004[56]. Recently, the Reserve Bank imposed penalty on a foreign bank for violating KYC norms.

Credit Information Bureau (India) Ltd.

7.120 Credit Information Bureau (India) Ltd. (CIBIL) was set up in 2001 to compile and disseminate credit information. An efficient credit information system enhances the quality of credit decisions and improves the asset quality of banks apart from facilitating faster credit delivery. Banks/FIs have been advised to obtain the consent of all their borrowers for dissemination of credit information to enable CIBIL to compile and disseminate credit information. It was reported by a major nationalised bank that they had submitted credit information relating to 80 per cent of their eligible borrowers after obtaining necessary consents. Banks have been urged to make persistent efforts in obtaining consent from all of their borrowers, in order to establish an efficient credit information system, which would help in enhancing the quality of credit decisions and improving the asset quality of banks, apart from facilitating faster credit delivery.

[56] Reserve Bank of India (2004), ' Guidelines on Know Your Customers', Master Circulars.

Managing Troubled Banks

7.121 Over the years, the banking sector in India has weathered several changes in the domestic as well as external environment. The banking sector has shown significant resilience in the face of adverse shocks given the concerted efforts of the regulatory and supervisory authorities. Internationally, mergers and amalgamations is a common strategy adopted to restructure/strengthen banks. Mergers and amalgamations are not new to the Indian banking system too. However, it is pertinent to note that a majority of such mergers have been undertaken by banks voluntarily for strategic purposes (Box VII.2).

7.122 During 2002-03 and 2003-04, the Reserve Bank's approach to successfully averting possible crises arising from certain troubled private sector banks, *viz.*, the Centurion Bank and the Global Trust Bank (GTB) has been noteworthy. Centurion Bank Ltd. was set up in 1995 under the revised guidelines for entry of new banks in private sector and was promoted by a non-banking financial company and its associates, in association with Keppel Bank of Singapore, Asian Development Bank (ADB) and International Finance Corporation (IFC). The reverse merger of the promoting non-banking financial company with the bank in 1998 failed to strengthen the bank as was expected. Deterioration in the asset quality and adverse developments due to high capital market exposure led to poor financial results and the bank reported losses in 2002 and the bank's capital adequacy slipped to 1.95 per cent as on March 31, 2003. It was clear that the bank's fragile solvency needed augmentation with fresh capital infusion which was proving difficult with the erosion in the bank's net worth. Realising that a successful programme of capital restructuring would revive the bank the Reserve Bank sought to assure all the stakeholders in the interim through a press release that the bank had ability to earn operating profits but the net loss was on account of the additional requirements for provisions towards NPAs. The release which mentioned that the Reserve Bank

Box VII.2: Banks Amalgamated since Nationalisation of Banks in India

Sr. No.	Name of Transferor Bank	Name of Transferee Bank	Date of Amalgamation
1.	Bank of Bihar Ltd.	State Bank of India	November 8, 1969
2.	National Bank of Lahore Ltd.	State Bank of India	February 20, 1970
3.	Miraj State Bank Ltd.	Union Bank of India	July 29, 1985
4.	Lakshmi Commercial Bank Ltd.	Canara Bank	August 24, 1985
5.	Bank of Cochin Ltd.	State Bank of India	August 26, 1985
6.	Hindustan Commercial Bank Ltd.	Punjab National Bank	December 19, 1986
7.	Traders Bank Ltd.	Bank of Baroda	May 13, 1988
8.	United Industrial Bank Ltd.	Allahabad Bank	October 31, 1989
9.	Bank of Tamilnadu Ltd.	Indian Overseas Bank	February 20, 1990
10.	Bank of Thanjavur Ltd.	Indian Bank	February 20, 1990
11.	Parur Central Bank Ltd.	Bank of India	February 20, 1990
12.	Purbanchal Bank Ltd.	Central Bank of India	August 29, 1990
13.	New Bank of India	Punjab National Bank	September 4, 1993
14.	Kashi Nath Seth Bank Ltd.	State Bank of India	January 1, 1996
15.	Bari Doab Bank Ltd.	Oriental Bank of Commerce	April 8, 1997
16.	Punjab Co-operative Bank Ltd.	Oriental Bank of Commerce	April 8, 1997
17.	Bareilly Corporation Bank Ltd.	Bank of Baroda	June 3, 1999
18.	Sikkim Bank Ltd.	Union Bank of India	December 22, 1999
19.	Times Bank Ltd.	HDFC Bank Ltd.	February 26, 2000
20.	Bank of Madura Ltd.	ICICI Bank Ltd.	March 10, 2001
21.	Benares State Bank Ltd.	Bank of Baroda	June 20, 2002
22.	Nedungadi Bank Ltd.	Punjab National Bank	February 1, 2003
23.	South Gujarat Local Area Bank Ltd.	Bank of Baroda	June 25, 2004
24.	Global Trust Bank Ltd.	Oriental Bank of Commerce	August 14, 2004

encourages the bank to make due provisions to clean its balance sheet and was issued simultaneously with the publication of the annual results of the bank for 2001-02 showing a net loss, had a sobering effect which helped the bank to carry on with efforts to secure fresh capital.

7.123 In April 2003, the bank received a proposal from a group of investors for restructuring of capital through a combination of writing down of the capital to reckon the erosion, fresh subscription through rights issue and additional investment from a bank which was exiting Indian operations. The proposal was examined carefully to weigh the resultant benefits and to ensure complete regulatory compliance and was found acceptable. The restructuring programme went through smoothly and the bank was able to achieve CRAR of 9 per cent by September 2004 and report a net profit of Rs.8.41crore.

7.124 The Reserve Bank had granted licence to Global Trust Bank (GTB) Ltd. in September 1994 as a part of the policy to set up new private sector banks. The bank was promoted by a group of professionals led by Dr. Jayanta Madhab and Shri Ramesh Gelli, the then Chairman of Vysya Bank Ltd. with the participation of International Finance Corporation (IFC) and Asian Development Bank (ADB) as associates. The financial position of GTB started weakening in 2002 due to very high exposure to capital market which had turned into problem assets. After it came to the notice of the Reserve Bank that the bank had incurred huge net loss in 2002, it was put under close monitoring. The bank was instructed to adopt a prudential policy of containing growth of risk weighted assets, to make maximum recoveries of NPAs, to reduce its high capital market exposure to the prudential limit, provide against impairment of assets out of the operating profits and to take immediate steps to augment the capital.

7.125 The bank reported some progress in making recoveries and also the attempts underway to have equity infusion. However, it was not able to finalise a programme of capital augmentation till June 2004 through domestic sources as advised. Later, the bank submitted in July 2004, a proposal received from an overseas equity investor fund for recapitalisation of the bank. The proposal was not found acceptable by Reserve Bank on prudential and other considerations.

7.126 As the financial position of the bank was deteriorating progressively and the solvency of the bank was being seriously affected, the Reserve Bank had to place the bank under moratorium on July 24, 2004 to protect the interests of the large body of small depositors of the bank and in the interest of the banking system. A firm proposal for merger of the bank was received from Oriental Bank of Commerce (OBC). OBC's perception on the issue was examined by the Reserve Bank, keeping in view, its financial parameters, its retail network and synergies as well as strategic advantages. Taking into account the interests of OBC and depositors of GTB, as well as the bank's strengths and weaknesses, GTB was merged with OBC with effect from August 14, 2004 under the powers vested with the Reserve Bank under the Banking Regulations Act, 1949 through a scheme sanctioned by the Government of India.

Mitigating Conflicts of Interest

7.127 There is an increasing concern internationally about the impact of the conflicts of interest in the financial sector. Legislative and regulatory measures have been adopted by different countries to ensure that conflicts of interest are not allowed to compromise the interest of stakeholders and public at large. These measures are intended to have positive impact on investors' confidence, efficacy of the regulatory framework and, above all, the credibility of those associated with the financial services. Accordingly, in consultation with Chairman, SEBI and Chairman, IRDA, the Reserve Bank has proposed to constitute a Working Group on avoidance of conflicts of interest. The Working Group will identify the sources and nature of potential conflicts of interest, the international practices to mitigate this problem, the existing mechanisms in India in this regard and make recommendations for avoidance of such conflicts of interest.

Deposit Insurance

7.128 There is international recognition of deposit insurance system as a component of a sound financial safety net for protecting less financially sophisticated depositors from the loss of their deposits when banks fail and thus, its contribution of financial stability. According to a World Bank Study, almost all countries have either explicit or implicit deposit insurance system.[57]

7.129 India is the second country to institute a Deposit Insurance Scheme way back in 1961 in the wake of failure of a few banks. The deposit insurance system is designed to provide protection to small depositors who lack adequate financial skills and do not have the wherewithal to monitor banks. Since such depositors can cause run on banks on the basis of even unsubstantiated rumours, the deposit insurance also contributes to the stability of the banks and the financial system. In India, the Deposit Insurance System is mandatory and covers all commercial banks and all 'eligible' cooperative banks, with the exception of certain co-operative banks in some States, which do not comply with the provisions of the DICGC Act, 1961 relating to 'eligible banks'. Some co-operative banks have become ineligible for deposit insurance cover due to their opting to get registered under certain Acts which have been enacted in the context of the new policy on co-operatives (which envisages more autonomy to the co-operative banks) but do not comply with the 'eligibility' criteria laid down in the DICGC Act, 1961. Deposit Insurance cover has not yet been extended to the co-operative banks in certain States *viz.*, Meghalaya, Mizoram, Arunachal Pradesh, Chhattisgarh and Nagaland and three Union Territories *viz*, Lakshadweep, Chandigarh, and Dadra and Nagar Haveli for reasons including the inadequate legal framework and other formalities.

7.130 Under the deposit insurance system, all deposits with the exceptions of deposits of foreign Governments, deposits of State/Central Governments, inter-bank deposits, and deposits held abroad, are insured by DICGC. The insurance cover is provided to deposits held in the same right and in the same capacity, and presently, the limit is Rs.1 lakh. Banks are charged premium on total assessable deposits. The premium is payable half yearly and is currently eight paise per Rs.100 of assessable deposits and is slated to increase to 10 paise per Rs.100 of assessable deposits from the year 2005-06. With the existing limit, there is a high degree of protection available to small depositors; 95.4 per cent of deposit accounts (up from 79 per cent in 1961) and 66 per cent of assessable deposits (up from 25 per cent in 1961) are fully protected. This is way ahead of the IMF's recommended limits of 80-90 per cent and 20 per cent respectively.

7.131 With a view to educating the small depositors, DICGC has taken steps to increase public awareness of the deposit insurance scheme by sending relevant written material to the insured banks for them to display in all branches at all places where depositor interaction is involved. DICGC has also hosted its own website (www.dicgc.org.in) for providing information to the public. The Corporation is working on a new law to replace the existing DICGC Act 1961 so as to make it an effective instrument for dealing with distressed banks in the Indian financial set up.

9. Assessment of Financial Stability

7.132 Since financial stability is a much broader concept, there is no common framework for the empirical analysis. Several central banks and international financial institutions have attempted compilation of a set of Financial Soundness Indicators (FSIs) to monitor the health and soundness of financial institutions and markets, and of their corporate and household counterparts. Under the FSIs, two sets of indicators have been identified by the IMF *viz.*, core set and encouraged set. This avoids a one-size-fits-all approach, and provides a degree of flexibility in the selection of indicators that are most relevant to assessing vulnerabilities in country-specific circumstances. Aggregated micro-prudential indicators and other indicators notably macroeconomic indicators that support the assessment and monitoring of the strengths and vulnerabilities of financial systems form a major component of FSIs.

7.133 As part of the initiatives in adopting best international practices for monitoring the stability of financial system in India, the Reserve Bank has been compiling Macro-Prudential

[57] Barth, J.R. and Levine, R. (2001),' *Regulations and Supervision Around the World, A New Database*', World Bank Working Paper 2588, World Bank, Washington, D.C.

Indicators (MPIs) since March 2000[58]. The review of MPIs covers the areas of capital adequacy, asset quality, risk management, management soundness, earnings and profitability, liquidity, interest rate, maturity structure of assets and liabilities, and various indicators pertaining to major segments of financial markets such as debt, forex, capital market segments, besides macroeconomic indicators such as growth, inflation, interest rate, exchange rate, *etc.* The MPI review is accompanied by a review of developments in the global environment.

7.134 The MPI review is prepared on a half-yearly basis. The review of MPIs covers commercial banks, financial institutions and co-operatives. The MPIs comprise both aggregated micro-prudential indicators (AMPIs) of the health of individual financial institutions and macroeconomic indicators (MEIs) associated with financial system soundness. As part of the efforts to disseminate these FSIs, the Reserve Bank has started publishing the core set of indicators in its various publications. The empirical approach to AMPIs encompasses analysis of the indicators during the period under review as compared with the previous/ comparable periods and trend analysis for providing a balance of short-term and medium term perspectives. It may be noted that several indicators, which form a part of the review of MPIs, have already been discussed in the earlier Chapters.[59] Accordingly, an empirical assessment of financial stability in India based on a synoptic view of the institutional structure of financial markets (Appendix Table VII.1) and select MPIs, accompanied by a backdrop of global financial environment is set out below.

Financial Stability Review in India

7.135 Global growth is gaining momentum and most of the macroeconomic risks which could pose a threat to financial stability are receding. As per the IMF forecast, world GDP growth in 2004 is likely to be the highest in 30 years. Despite this, there are certain global risks which need to be managed. As the prospects for the global economy depend to a great extent on the US economy's performance, persistent twin deficits in the US continue to be a cause for concern for global financial stability. A major part of the US Government debt is held by the central banks of the Asian economies, particularly, China and Japan. Therefore, increased inter-dependence between US and the Asian economies may have serious implications for the global financial stability. Beside this, uncertainty about the quality of assets of banks in the UK and Japan and the sustainability of the current pattern of global capital flows to emerging markets pose potential risks to the global financial stability (Box VII.3)[60].

Indian Context

Macro Economic Environment

7.136 During 2003-04, the domestic economic outlook remained bright with the real GDP growth rate surpassing the 8 per cent level, and the growth being broad-based across agriculture, industry and services. Industrial growth also recorded a better performance across all sub sectors. The inflation rate has remained under control. A cause for concern, however, was the persistence of high fiscal deficit. The external sector exhibited sustained improvement in terms of external trade, reserve accumulation and stability in external debt indicators. However, the accumulation of forex reserves remained a matter of concern for the monetary and exchange rate management. In this context, the operationalisation of MSS enabled the Reserve Bank to manage liquidity.

Financial Markets

7.137 Financial markets witnessed easy liquidity conditions generated by persistent capital inflows. Interest rates continued to soften

[58] The methodology for the compilation of MPIs is broadly in line with the IMF Occasional paper on Macro-prudential Indicators of Financial System Soundness (No.192, April 2000). The scope and coverage of MPIs were enhanced in the review from the half-year ended March 2002 onwards with the introduction of certain additional indicators in line with the approach outlined in the IMF paper on 'Financial Soundness Indicators: Analytical Aspects and Country Practices' (Occasional Paper No.212 of 2002).

[59] Also see Chapter III, Chapter IV, Chapter V and Chapter VI.

[60] International Monetary Fund,(2004), 'Global Financial Stability Report', June.

Box VII.3: Global Financial Stability Report, September 2004

As per the Global Financial Stability Report released by the IMF in September 2004, the global financial system, especially the health of financial intermediaries, has been further strengthened by the broadening economic recovery over the past six months. Financial intermediaries, banks and non-banks alike, have strengthened their balance sheets and are capable of absorbing considerable shocks in the future. The Report positively assesses that in the short run there does not seem to be any major systemic threat to the global financial system. In the recent years, two major positive developments, *viz.*, a strong capital base going into the recession and a paradigm shift in risk management among the major banks have taken place. This has made the market players well prepared to face long expected tightening of monetary policy. Further, the global financial system is capable of absorbing the financial shocks. In the recent period, the gradually strengthening recovery of the world economy, as well as a steep yield curve, has sharply increased profitability within the financial sector and thus enhanced financial stability. As a result of economic recovery, there are robust increases in revenues accompanied by a sharp fall in corporate default rates and in non-performing loans which provide a strong cushion of comfort for the financial sector. Presently, financial markets are adjusting with equanimity to the on going tightening of interest rate.

The Report however foresees some medium term risks. The most immediate risk is that market participants may develop a sense of complacency, seeing how smoothly financial markets have adjusted to the initial moves to higher policy rates. This may be reflected in the low volatility observed in major stock and bond markets. Therefore in search for yield, market participants may tend to engage in indiscriminate risk behaviour. Secondly, since the correlation between the US treasury yield and the bond yield in Euro and emerging markets is high, the spillover effect of any spike in U.S. yields may be widely felt in these regions. This raises doubts whether other regions are ready to absorb higher market interest rates. Global current account imbalances pose a continued risk, even though it is difficult to forecast how or when the financing of the current account deficits or the adjustment of the imbalances could become disorderly. Global geopolitical risks continue to exist and could quickly heighten risk aversion among international investors to the detriment of asset markets especially those with weak credit quality or limited liquidity. Oil prices may increase further contributing to inflation concerns and potentially hurting financial markets and the economic recovery.

Since the Federal Reserve and other central banks have managed the initial phase of transition towards high interest rate successfully, the Report suggests that the role of these banks is to guide market expectations in executing planned adjustment program. The countries should use current comfortable conjectural situation to address the weaknesses in their respective financial systems. The countries where loss making banking sector exists, consolidation process should be facilitated to run it profitably. The Report also highlights the long term issues such as challenge being faced by many countries, of improving the adequacy of pension provisions to cope with rising dependency ratio. Since pension funds are long-term institutional investors, the growing size of pension funds and focus on their asset liability management should strengthen their role in supporting financial stability. Any change in the asset allocation of the pension funds may have a large impact on different asset classes and financial markets particularly of smaller size.

across the various segments of the financial markets. Money market rates were stable, ruling essentially at sub-repo levels. The yield curve flattened during the first half of the year but steepened later in the wake of rising inflation, hardening of international interest rates and profit booking by investors. Excess supply conditions in the foreign exchange market put upward pressure on the Indian rupee *vis-à-vis* the US dollar, pushing down forward *premia* across the board. Equity markets revived during 2003-04, attracting large foreign institutional investor inflows especially as valuations remained attractive *vis-à-vis* other Asian countries. The growing integration of domestic markets with international markets posed interest rate risks as several leading central banks reversed their easy monetary policy stance of the last two years. A second set of concerns emanated from the exchange rate risks, which could result from possible currency realignments, necessitated by the correction of the US macroeconomic imbalances.

Corporate Profitability and Credit Off-take

7.138 With close to 6.5 per cent growth in industrial production, corporate sector reported robust growth in sales and profits during March 2004. Buoyed by the falling interest rates, bottom lines of listed companies for manufacturing companies improved during 2003-04. Interest cost accounted for about 50 per cent of gross profits of manufacturing companies till December 2002. Since then, this ratio has fallen steeply and in March 2004, it stood at 39 per cent. An indicator of the falling interest burden is the fact that total interest outgo of the corporate sector actually declined in absolute terms by 7 per cent in 2003-04 despite the fact that sales grew by 16 per cent. Also, this growth was on top of the 23 per cent growth in sales recorded in 2002-03. Better cost management and rising productivity coincided with demand spurt in almost all the sectors of the industry. Rising income levels, aided by good monsoons led to a buying spree in consumer products, which created a backward flow of demand. Reflecting this uptrend, credit off-take from the banking system by commerce and industry remained stronger in 2003-04.

7.139 Further, there was an increase in non-bank sources of commercial finance. Firstly, subscription by mutual funds to commercial paper and debentures accelerated during 2003-04. Secondly, there was an increasing recourse to external sources by companies in view of the lower offshore interest rates prevailing and the strength of the rupee against the US dollar.

Aggregated Micro-Prudential Indicators (AMPIs)

Capital Adequacy

7.140 The analysis of capital adequacy in the MPI review covers trends in aggregated CRAR of commercial banks, UCBs, FIs, and NBFCs complemented with frequency distribution of CRAR, the CRAR of five largest banks, and the CRAR of banks not complying with the regulatory minimum, and aggregate analysis of risk profile of assets of various institutions.

7.141 Other than the scheduled UCBs the financial sector was well placed with respect to the capital requirements. The aggregated capital ratios of scheduled commercial banks at 12.9 per cent as at end-March 2004 (12.7 per cent as at end-March 2003) witnessed an increasing trend for the fourth year in succession. This would enable banks to meet the requirements under the new guidelines related to capital charge for market risk. The CRAR of the majority of the scheduled commercial banks, with an exception of two banks, were well above the regulatory stipulation.

7.142 At an aggregate level, growth in capital of SCBs continued to outstrip the growth in risk-weighted assets of banks for the seventh consecutive half-year, ending March 2004. The share of risk weighted assets (RWAs) with high-risk weight declined to 40.2 per cent of the total risk weighted assets as at March 2004 from 41.7 per cent as at March 2003. The details of risk profile of assets and off-balance sheet of SCBs are provided in Appendix Tables VII.2, VII.3 and VII.4.

7.143 The CRAR of the scheduled UCBs is a cause for concern. As against the stipulated ratio of nine per cent, the CRAR of scheduled UCBs declined to 3.0 per cent as at end-March 2004 from 5.3 per cent as at end-March 2003. As regards the FIs, the aggregated CRAR stood at a high of 22.0 per cent as at the end of March 2004, almost at the same level of 22.4 per cent as at end-March 2003. The erosion of capital for two large term lending institutions (IIBI, and IFCI) due to high level of NPAs coupled with persistent financial loss is a matter of concern.

7.144 For the NBFCs (having asset size more than Rs.10 crore), the CRAR as at September 2003 was 19.2 per cent, well above the regulatory minimum of 12.0 per cent. The CRAR at this level was somewhat lower than 21.9 per cent as at March 2003 but higher than 14.8 per cent as at September 2002. The CRAR of PDs showed an increasing trend and stood at 42.7 per cent as at March 2004 as against 29.8 per cent as at March 2003.

Asset Quality

7.145 The asset quality is analysed in terms of range of indicators including sectoral and industrial credit concentration, credit utilisation ratio, exposure to sensitive sectors, retail credit, currency denomination of credit, non-performing loans, credit to sick and weak industries, connected lending, leverage ratios, off-balance sheet exposure, and corporate profitability.

7.146 Gross NPAs of the commercial banks recorded a decline of 2.6 per cent in 2003-04 as against a decline of 3.3 per cent in 2002-03. The net NPAs fell by 12.8 per in 2003-04 as against a decline of 9.3 per cent in 2002-03. The decline in the gross and net NPAs of scheduled commercial banks was witnessed despite the changeover to 90 days norm reflecting the impact of several initiatives undertaken. This is also indicative of higher profits resulting in higher provisioning and write-offs.

7.147 Gross NPAs to assets ratio of SCBs declined to 7.6 per cent as at end-March 2004 from 9.3 per cent as at end March 2003. The net NPAs to assets ratio of SCBs declined to 3.0 per cent as at end-March 2004 from 4.6 per cent as at end March 2003. The gross and net NPAs ratios of the scheduled urban co-operative banks declined to

27.4 per cent and 16 per cent, respectively as at end March 2004 from 30.5 per cent and 24 per cent, respectively, as at end March 2003. The cause for concern, however, was the poor and deteriorating asset quality of FIs. While gross NPAs stood at 16.4 per cent as at end March 2004 increasing from 14.3 per cent as at March 2003 and, net NPAs ratio rose to 10.5 per cent as at end March 2004 from 9.7 per cent as at end March 2003. The poor asset quality was driven by very high NPA ratios of the term lending institutions. Gross NPAs ratio of NBFCs declined to 8.8 per cent as at March 2003 from 10.6 per cent as at end March 2002. Gross NPAs ratio of NBFCs showed a further decline to 8.2 per cent as at September 2003. The net NPAs ratio of NBFCs declined to 2.7 per cent as at end March 2003 from 3.9 per cent as at end March 2002. The net NPAs ratio of NBFCs showed a further decline to 2.6 per cent as at September 2003.

Leverage Ratio

7.148 Leverage Ratio (*i.e.*, assets to equity ratio) of SCBs declined to 16.9 per cent in 2003-04 as against 17.4 per cent in 2002-03. The leverage ratio of FIs showed an increase to 5.2 per cent as at end March 2004 from 4.7 per cent as at end March 2003; the increase was mainly due to erosion of the capital and reserves coupled with increase in asset base in respect of certain FIs. The leverage ratio of NBFCs came down to 9.5 per cent as at end March 2003 from 10.0 per cent as at September 2002 before increasing marginally to 10.1 per cent as at the end of September 2003. The leverage ratio of the PDs decreased marginally to 2.5 per cent as at end March 2004 as compared to 2.9 per cent as at end March 2003.

Earnings and Profitability

7.149 In the analysis of earnings and profitability, the MPI review covers return on assets, return on equity, profit margin, operating costs, and structural profitability indicators such as interest spread. The earnings and profitability indicators showed positive developments for the financial system as a whole except in the case of FIs and scheduled UCBs. The return on total assets of SCBs improved to 1.2 per cent as at end March 2004 from 1 per cent as at end-March 2003. The return on equity (RoE) of the commercial banking system at 19.8 per cent as at end March 2004 was higher than 17.6 per cent as at end-March 2003. The return on total assets of UCBs was negative at 3.6 per cent as at end March 2004 as against a negative 0.1 per cent as at end March 2003. Continued negative returns for term lending institutions, with limited recourse to low cost funds, has brought the return on total assets for FIs down to the negative level. The return on total assets was negative at 0.2 per cent as at end March 2004 as against a positive performance at 0.8 per cent as at end March 2003. The RoE was also negative at 1.2 per cent as at end March 2004 as against a positive performance of 3.8 per cent as at end March 2003. The return on total assets of the PDs declined to 5.9 per cent as at end March 2004 from 6.6 per cent as at end March 2003 due to increased volatility in securities market.

Risk Management

7.150 The analysis of market risks reflects on interest rate risks, foreign exchange risks, and the risks arising from the exposure of banks and financial institutions to commodities and capital market.

Interest Rate Risk

7.151 Given the significant share of investments especially in Government securities in the assets portfolio of commercial banks, the interest rate sensitivity of their balance sheets is critical. The Reserve Bank conducts periodic sensitivity analysis of banks' investment portfolio, based on the Standardised Duration Approach suggested by the BIS. Along with this, the Reserve Bank also estimates the cushion available in terms of unrealised gains on banks' investments portfolio and assesses their ability to withstand the impact of rising yields on their balance sheets. Banks have been sensitised about the need to take adequate measures to address the interest rate sensitivity of their portfolio.

Currency Risk

7.152 The annual policy Statements and mid-term Reviews of the Reserve Bank continue to express concern over unhedged foreign currency borrowings by corporates, which could impact their overall financial status leading to instability in the financial system under severe uncertainties. Recognising such potential risks, the Reserve Bank in its mid-term Review of monetary and credit policy in October 2001 stressed the importance of banks' monitoring of large unhedged foreign currency exposures of corporates. Further, in the mid-term Review of monetary and credit policy in November 2003, banks have been advised to adopt a policy, which explicitly recognises and takes account of risks arising out of foreign exposures of their clients. Accordingly, banks have been advised that all foreign currency loans above US dollar 10 million or such lower limits as may be deemed appropriate *vis-à-vis* the banks' portfolio of such exposures could be extended by them on the basis of a well laid out policy of their Boards except in cases of export finance and loans extended for meeting forex expenditure. Banks were advised to ensure hedging of significant but avoidable risks to corporate balance sheets on account of their forex exposures, which might also possibly impact the quality of banks' assets.

7.153 During 2003-04, an appreciation of the rupee *vis-à-vis* US dollar coupled with soft global interest rates resulted in increased recourse to external commercial borrowings by the Indian corporate sector. Also, the excess supply conditions and related expectations in the foreign exchange market pushed down rupee dollar forward premia. In this scenario, the foreign currency positions of the importers and other corporates going in for external commercial borrowings (ECBs), has remained largely unhedged. In the current scenario of hardening of overseas interest rates and the consequent effect on the exchange rate, the corporate balance sheets may be affected rendering the banking sector vulnerable to credit risk on account of the unhedged exposure of their clients. Further, in view of the systemic risk, banks have been encouraged to obtain information from their large borrowers on their unhedged forex exposures, so that the banks, in turn, can assess the risk of their own exposure to such corporates on an on-going basis.

Commodity Risk

7.154 Banks in India generally do not actively trade in commodities. However, certain banks have been allowed to trade in precious metals subject to fulfilment of specified prudential norms. The exposure of the banking system to precious metals is miniscule and is not a cause for systemic concern.

Equity Risk

7.155 The exposure of banks to capital market was at 1.8 per cent of total advances, well below the stipulated five per cent limit. However, the developments in the stock market on May 17, 2004, particularly the sharp decline in the banking sector indices, had induced regulatory actions. On May 17, 2004, the stock market in India witnessed turbulent conditions on account of uncertainties related to the formation of new Government at the Centre. Rising international oil prices and apprehensions of rise in international interest rates also contributed to the sudden reversal in market sentiment. The market ended the day with a net loss of 11 per cent in market capitalisation compared with the previous day's close. However, orderly conditions were restored quickly and the Reserve Bank actively monitored the situation such that there is no transmission of panic from equity market to other markets. The Reserve Bank operated by intervening in forex market. Once it was clear that there was no spillover into other markets, it was ensured that the payment and settlement systems were not affected. The Reserve Bank operated at three different levels. First, the Reserve Bank assured a backstop facility to settlement banks. Second, the Reserve Bank issued a statement indicating adequate availability of liquidity both in Rupee and foreign exchange market. Third, the margin requirement on all advances against shares/financing of IPOs/issue of guarantees by banks was reduced from 50 per cent to 40 per cent. These measures had a soothing effect on the markets and financial stability was maintained.

Liquidity

7.156 The existence of excess liquidity in the financial system as a whole can be seen from the high absorption of liquidity under LAF through repos throughout 2003-04. The average level of daily repos was Rs.36,235 crore during 2003-04. The ratio of liquid assets to total assets of banks increased to 42.7 per cent as at end-March 2004 from 41.6 per cent as at end-March 2003. In the case of FIs, the proportion of short term borrowings to total borrowings for the FIs declined to 5.9 per cent as at end-March 2004 from 6.9 per cent as at end-March 2003, indicating the comfortable liquidity position.

10. Conclusion

7.157 Financial sector reforms adopted in the 1990s have enhanced the strength of banks and financial institutions in India. The reform measures adopted have ensured that their asset quality and profitability have improved. A striking feature of these institutions has been their improved resilience to the domestic and the external environment.

7.158 Developing countries differ so much in size, nature and structure of the economy, level of development and socio-political conditions that there may not be a set of well defined structured issues in respect of financial stability. In India the vulnerability to real sector shocks has potential to significantly affect financial stability. The major sources of such shocks in India are very sharp increases in oil prices and extraordinary monsoon failures with consequent impact on the agriculture sector. In sum, it needs to be appreciated that the weight to financial stability in India appears to be higher than in many other countries.

Annex VII.1: Reports on Financial Stability by Various Central Banks and International Financial Institutions *(Contd.)*

Name of the Bank	Periodicity	Broad Issue Covered
Bank of England	Biannual, Started in 1997.	Financial stability conjuncture and outlook, strengthening financial infrastructure, financial stability and macroeconomy, issues in emerging market economies, financial market developments in UK, accounting and financial stability, assessing operational risks, various theme-based articles.
Sveriges Riksbank, Sweden	Biannual, Started in 1997.	Assessment of the international financial stability, performance of major banking groups, analysis of developments in the financial infrastructure - the system of instruments and technical and administrative systems, research articles on various themes or issues related to financial stability where the Riksbank wishes to clarify its policy.
Norges Bank, Norway	Biannual, Started in 2002, published together with the Inflation Report.	International developments and Norwegian securities markets, macroeconomic developments, households and enterprises, financial institutions, statistics, current research at Norges Bank on financial stability.
Oesterreichische Nationalbank (OeNB), Austria	Biannual, Started in 2000.	Regular analysis of developments in Austrian financial system and international developments with an impact on financial stability, studies offering in-depth insights into specific topics related to financial stability.
Banco de España, Spain	Biannual, Started in 2002.	Banking risks, profitability of deposit institutions, solvency, and research articles on financial stability.
Banco Central do Brasil, Brazil	Annual, Started in 2002.	Financial market evolution (analysis of developments in both national and international financial markets), national financial system supervision, payment system, financial system organization, prudential regulation and selected studies.
Bank of Israel, Israel	Annual, Started in 2003.	Future challenges and risks, developments in the environment in which the financial system operates in Israel and world wide, developments relating to the stability of the major components of the financial system-the financial markets, the banking system and institutional investors-and the developments in credit and the public's financial assets, central features of the financial system: the structure of the financial sector-banks and institutional investors-and the main changes to the financial infrastructure.
Swiss National Bank, Switzerland	Annual, Started in June 2003.	Focuses on various issues pertaining to two vital elements in the system, the banking sector and the financial market infrastructure.

Annex VII.1: Reports on Financial Stability by Various Central Banks and International Financial Institutions *(Concld.)*

Name of the Bank	Periodicity	Broad Issue Covered
South African Reserve Bank	Biannual, Started in 2003.	Focuses on a range of issues pertaining to banking sector and regulatory and supervisory process against the backdrop of international developments.
Bank de France	Biannual, Started in 2003.	Reviews developments affecting financial institutions, markets, and their infrastructure from cyclical and structural perspective, theme-based research articles on financial stability.
National Bank of Poland	Started in 2001.	Analysis of functions of banks and financial institutions, developments in markets, select articles.
National Bank of Belgium	Annual, Started in 2002.	Macro-prudential review is complimented with some thematic articles on domestic and international financial stability.
Reserve Bank of Australia	Biannual, Started in 2002.	Assesses current conditions of financial system and potential risks to financial stability, theme-based articles.
Hong Kong Monetary Authority	Biannual, Started in 2003.	Analyses factors affecting Hong Kong's financial and monetary stability.
Denmark's Nationalbank	Annual, Started in 2002.	The two-part report: first part analyses the development in financial stability, with emphasis on the banking institutions and the second part of the report includes articles on current topics.
Central Bank and Financial Services Authority of Ireland	A separate chapter in Annual Report until 2004, First Report on Financial Stability in September 2004.	Analyses financial stability issues and developments theme based research articles.
Bank of Canada	Annual, Started in 2002.	Developments in financial system and analysis of policy directions, articles on select issues.
Latvia National bank	Biannual, Started in 2003.	Analyses and assesses the performance of Latvian financial system.
Central Bank of the Russian Federation	Annual, Started in 2001.	Monitoring macroeconomic, markets, and other imbalances, analysis of financial state and economic performance of principal institutions.
IMF	Biannual, Started in 2001.	Issues in global financial stability, macroeconomic policies and stability, international financial architecture, financial systems of developed and emerging economies, research articles as Box item.
BIS-FSI	Biannual, Started in 2001.	Issues in global financial stability, international banking, international financial architecture, banking sectors of developed and emerging economies, research articles as Box item.

Annex VII.2: List of Select Committees/Working Groups Set up by the Reserve Bank and Government of India *(Contd.)*

Reports	Year of Submission
Working Group on the Banking Arrangements for Implementation of Value Added Tax	September 2004
Advisory Committee to Advise on the Administered Interest Rates and Rationalisation of Saving Instruments	July 2004
Advisory Committee on Flow of Credit to Agriculture and Related Activities from the Banking System	June 2004
Recommendations and Action Taken for Report of the Advisory Committee on Flow of Credit to Agriculture and Related Activities From the Banking System	June 2004
Working Group on Monitoring of Financial Conglomerates	June 2004
Working Group on Development Financial Institutions	May 2004
Committee on Procedures and Performance Audit on Public Services	2004
Internal Group on External Liabilities of Scheduled Commercial Banks	May 2004
Advisory Committee on Flow of Credit to Agriculture	May 2004
Working Group on Flow of Credit to SSI Sector	May 2004
Working Group on Instruments of Sterilisation	December 2003
Internal Group on Liquidity Adjustment Facility	December 2003
Working Group on Cheque Truncation and E-cheques	July 2003
Technical Monitoring Group on Foreign Direct Investment: First Action Taken Report	June 2003
Working Group on Introduction of Credit Derivatives in India	March 2003
Advisory Committee on Ways and Means Advances to State Governments	January 2003
Working Group on Rupee Derivatives	November 2002
Committee on Computer Audit	December 2002
Committee on Payment Systems	October 2002
Review Group on the Working of the Local Area Bank Scheme	September 2002
Working Group for Suggesting Operational and Prudential Guidelines on STRIPS (Separately Traded Registered Interest and Principal of Securities)	July 2002
Technical Group on Statistics of International Trade in Services	March 2002

Annex VII.2: List of Select Committees/Working Groups Set up by the Reserve Bank and Government of India *(Contd.)*

Reports	Year of Submission
Working Group on Electronic Money	July 2002
Working Group on Economic Indicators	June 2002
Consultative Group of Directors of Banks / Financial Institutions	April 2002
Working Group to Examine the Role of Credit Information Bureaus in Collection and Dissemination on Suit-Filed Accounts and Defaulters	January 2002
Working Group on Consolidated Accounting and Other Quantitative Methods to Facilitate Consolidated Supervision	December 2001
Expert Committee to Review the System of Administered Interest Rates and Other Related Issues	September 2001
Committee on Banking Sector Reforms (Narasimham Committee II)-Action taken on the Recommendations	October 2001
Informal Group on STRIPS	October 2001
Inter-Departmental Group to Study the Rationalisation of Current Account Facility with Reserve Bank of India	May 2001
Expert Committee on Legal Aspects of Bank Frauds	August 2001
Standing Committee on International Financial Standards and Codes	May 2002
Technical Group on Market Integrity	May 2002
Advisory Group on Fiscal Transparency	July 2001
Advisory Group on Data Dissemination	May 2001
Advisory Group on Bankruptcy Laws	May 2001
Advisory Group on Securities Market Regulation	May 2001
Advisory Group on Corporate Governance	March 2001
Internet Banking	June 2001
Standing Technical Committee of RBI and SEBI on Review of the RBI Guidelines on Bank Financing of Equities	April 2001
Technical Group on Phasing Out of Non-banks from Call/Notice Money Market	March 2001
Core Group on Voluntary Disclosure Norms for State Governments	January 2001
Interim Report of the Advisory Group on Bankruptcy Laws	January 2001
Advisory Group on International Accounting and Auditing	January 2001

Annex VII.2: List of Select Committees/Working Groups Set up by the Reserve Bank and Government of India *(Concld.)*

Reports	Year of Submission
Advisory Group on Payment and Settlement Systems	September 2000
Advisory Group on Insurance Regulation	September 2000
Advisory Group on Banking Supervision	September 2000
Advisory Group on Transparency in Monetary and Financial Policies	September 2000
Working Group on Discounting of Bills by Banks	September 2000
Task Force to Study the Co-operative Credit System and Suggest Measures for its Strengthening	August 2000
Internal Group to Review the Guidelines Relating to Commercial Paper	March 2000
Expert Committee for Recommending changes in the Legal frame work concerning Banking System	February 2000
In-house Working Group On Asset Securitisation	December 1999
High Power Committee on Urban Co-operative Banks	December 1999
Working Group on Reforms in Deposit Insurance in India	November 1999
Informal Group on Valuation of Banks Investments Portfolio	November 1999
Working Group for setting up Credit Information Bureau in India	November 1999
Committee for Redesigning of Financial Statements of Non-Banking Financial Companies	October 1999
Working Group on Restructuring Weak Public Sector Banks	October 1999
Working Group for Working Out Modalities on Dissemination of Information in Electronic Form	September 1999
Sub-group on Repurchase Agreements (Repos)	August 1999
Committee on Technology Upgradation in the Banking Sector	July 1999
Technical Committee on State Government Guarantees	May 1999
Working Group for Harmonising the Role and Operations of DFIs and Banks	January 1999
Working Group of EURO	November 1998
Working Group on Money Supply: Analytics and Methodology of Compilation.	June 1998
Committee on Banking Sector	1998
Committee on Capital Account Convertibility	June 1997
Expert Group on Foreign Exchange Markets in India	1995
High Level Committee on Balance of Payments	April 1993
Committee on the Financial System	December 1991

Annex VII.3: Prudential Norms - A Comparative Statement as on 30 June 2004 *(Contd.)*

Sr. No.	Norms as applicable to commercial banks, *viz.*, public sector, private sector and foreign banks	As applicable to UCBs	As applicable to RRBs	As applicable to StCBs/ DCCBs
1.	**Advances**			
	A. Non Performing Advances			
	Identification of NPAs	Same as commercial banks, except Gold loans, small loans both up to Rs. 1 lakh and State Government guaranteed accounts.	Same as commercial banks, except State Government guaranteed accounts.	Relaxed payment delinquency norm at present, would be on par with commercial banks by March 2006.
	B. Income Recognition			
	Not recognizing income on NPA unless realised .	Same as commercial banks.	Same as commercial banks.	Same as commercial banks, except where State Co-operative Act provides for recognition of income on NPA, matching provision is to be made.
	C. Asset Classification			
	All advances have to be classified into four asset classification categories.	Same as commercial banks.	Same as commercial banks.	Same as commercial banks.
	D. Provisioning			
	i. Provisioning norms for standard assets and NPAs in all categories.	Same as commercial banks.	Same as commercial banks.	Same as commercial banks, except no provisions for standard assets. Lower provisioning requirements for doubtful assets. Entire loss asset to be written off.
	ii. Provisioning norms for sale of financial assets to Securitisation Company (SC)/ Reconstruction Company (RC).	Same as commercial banks. However, the write off will be as per provisions of Co-operative Societies Act.	Not applicable.	Not applicable.
2.	**Investments**			
	(i) Classification The entire investment portfolio of the banks (including SLR securities and non-SLR securities) should be classified under three categories, *viz.*, 'Held to Maturity' (HTM), 'Available for Sale' (AFS), and 'Held for Trading' (HFT).	Same as commercial banks.	Three-Tier classification of investment portfolio has not been extended to RRBs.	Investments in approved securities bifurcated into two categories : (i) Permanent (ii) Current

Annex VII.3: Prudential Norms - A Comparative Statement as on 30 June 2004 *(Contd.)*

Sr. No.	Norms as applicable to commercial banks, *viz.*, public sector, private sector and foreign banks	As applicable to UCBs	As applicable to RRBs	As applicable to StCBs/ DCCBs
	(ii) Valuation			
	(a) HTM : ● Marking to market not necessary, unless book value is more than face value, where premium is to be amortised over the period remaining to maturity. ● provision for diminution in value, which is not temporary.	(a) Same as commercial banks.	(a) The SLR investments are required to be categorized under HTM category.	Approved securities : (i) Permanent depreciation : No (ii) Current : Valued at lower of cost or market value and depreciation to be provided for. Other investments : Same as current investments.
	(b) AFS : ● Marking to market, at least at quarterly intervals. ● Net appreciation in each classification to be ignored, net depreciation to be provided for.	(b) At year end or more frequent intervals.	(b) Not applicable	
	(c) HFT : ● Marking to market at monthly or more frequent. Net appreciation in each classification to be ignored, net depreciation to be provided for.	(c) Same as commercial banks.	(c) Not applicable.	
	(iii) Non Performing Investments Identification of Non-performing investment	Same as commercial banks.	Not applicable.	Relaxed norm at present, would be on par with commercial banks by March 2006.
	(iv) Income Recognition Not reckoning income on non-performing investment	Same as commercial banks.	Not applicable.	RBI has not issued any guidelines to StCBs/ DCCBs in this regard.
	(v) Provisions on Investments			
	(a) Where the interest/ principal is in arrears, the banks should make appropriate provisions for the depreciation in the value of the investment.	(a) Same as commercial banks.	(a) Not applicable.	(a) RBI has not issued any guidelines to StCBs/ DCCBs in this regard.

Annex VII.3: Prudential Norms - A Comparative Statement as on 30 June 2004 *(Contd.)*

Sr. No.	Norms as applicable to commercial banks, *viz.*, public sector, private sector and foreign banks	As applicable to UCBs	As applicable to RRBs	As applicable to StCBs/ DCCBs
	(b) Banks to build up an Investment Fluctuation Reserve of a minimum of 5 per cent *viz.*, "Held for Trading" and "Available for Sale", within a period of 5 years ending March 31, 2006.	(b) UCBs with deposits of Rs. 100 crore and above, are required to build up IFR of a minimum of 5 per cent of their portfolio. Building up of IFR for banks with deposits less than Rs. 100 crore is optional.	(b) Not applicable.	(b) Not applicable.
3.	**Capital to Risk-Weighted Assets Ratio (CRAR)**			
	(i) *Minimum of 9 per cent of Risk Weighted Assets on an on- going basis*	Minimum of 9 per cent of Risk Weighted Assets on an on- going basis.	CRAR has not been made applicable to RRBs as yet.	CRAR has not been made applicable to StCBs/ DCCBs as yet.
	(ii) *Capital for Market Risks* Banks are required to maintain capital for market risks in respect trading book.	UCBs provide for market risk on all Government and other approved securities at an uniform rate.	Not applicable.	RBI has not issued any guidelines to StCBs/ DCCBs in this regard.
	(iii) *Capital Adequacy for Subsidiaries* Required to maintain capital for subsidiaries.	UCBs as co-operative societies, are not permitted by the Co-operative Societies Act, to set up subsidiaries. Therefore, CRAR norms for subsidiaries have not been made applicable to them.	Not applicable.	StCBs/ DCCBs are not allowed to float subsidiaries.
4.	**Exposure Norms**			
	(i) *Exposures to :* (a) Individual borrowers : • 15 per cent of the capital funds. • 20 per cent, if exposure is on infrastructure sector.	20 per cent of capital funds.	15 per cent of owned funds.	RBI has not issued any guidelines to StCBs/ DCCBs in this regard.
	(b) Group of borrowers : • 40 per cent of the capital funds. • 50 per cent, if exposure is on infrastructure sector.	50 per cent of capital funds. Infrastructure sub ceiling has not been made applicable to UCBs (since the banks are expected to meet credit needs of small borrowers).	40 per cent of owned funds.	

Annex VII.3: Prudential Norms - A Comparative Statement as on 30 June 2004 *(Contd.)*

Sr. No.	Norms as applicable to commercial banks, *viz.*, public sector, private sector and foreign banks	As applicable to UCBs	As applicable to RRBs	As applicable to StCBs/ DCCBs
	In addition to the above, in exceptional circumstances, banks may assume an additional exposure up to 5 per cent of capital funds with the approval of Board.			
	ii) Components of Exposure	Same as commercial banks, except instructions on underwriting, *etc.*	Same as commercial banks.	RBI has not issued any guidelines to StCBs/ DCCBs in this regard.
	(iii) Sensitive Sector Exposure			
	(a) Ceiling for capital market exposure With sub-ceiling on convertible bonds and debentures and units of equity oriented mutual funds.	(a) The instructions issued to commercial banks are not made applicable to UCBs since they are not allowed to invest in corporate shares and debentures.	Same as commercial banks.	RBI has not issued any guidelines to StCBs/ DCCBs in this regard.
	(b) Unsecured Exposures No limit.	(b) Limit prescribed on unsecured advances and guarantees.		
5.	**Asset Liability Management**			
	Limits on mismatches (negative gap) in cash flows during 1-14 days and 15-28 days buckets.	Same as commercial banks applicable to scheduled UCBs.	Not applicable.	RBI has not issued any guidelines to StCBs/ DCCBs in this regard.
6.	**Call Money Operations**			
	(i) Lendings of Scheduled Commercial Banks (StCBs) in the call/ notice money market, subject to a limit. (ii) Limits prescribed on borrowings by StCBs.	(i) UCBs are free to lend in the call/ notice money market without any limit. (ii) Limits prescribed on the borrowings of UCBs in call/ notice money market.	(i) Not applicable. ii) Not applicable.	RBI has not issued any guidelines to StCBs/ DCCBs in this regard.
7.	**Consolidated Supervision**			
	Required to prepare consolidated financial statements and adhere to certain prudential regulations on group basis.	UCBs are not permitted by RBI/ Co-operative Societies Act to set up subsidiaries.	Not applicable, since RRBs do not have subsidiaries.	RBI has not issued any guidelines to StCBs/ DCCBs in this regard.

Annex VII.3: Prudential Norms - A Comparative Statement as on 30 June 2004 *(Concld.)*

Sr. No.	Norms as applicable to commercial banks, *viz.*, public sector, private sector and foreign banks	As applicable to UCBs	As applicable to RRBs	As applicable to StCBs/ DCCBs
8.	**Provisioning For Country Risk Exposure**			
	Provisioning requirement on bank's net funded exposure on any country exceeding 1 per cent of its total assets. In accordance with country risk rating.	Not applicable.	Not applicable.	StCBs/ DCCBs are not operating outside their respective area of operations.
9.	**Disclosure Requirements**			
	Banks are required to disclose information relating to the following areas in the "Notes on Accounts" to the Balance Sheet. i. Capital Adequacy ii. Asset Quality iii. Profitability Ratios iv. Maturity pattern of certain Assets & Liabilities and Lending to Sensitive Sector.	The UCBs having deposits in excess of Rs. 100 crore are required to make disclosures in their balance sheets similar to commercial banks except Maturity pattern of certain assets and liabilities.	Same as commercial banks, except capital adequacy. However, the details of disclosure vary.	Banks are required to disclose information relating to the following areas in the "Notes on Accounts" to the Balance Sheet. i. Non –SLR investments.