Chapter VIII

Perspectives

8.1 The reform process in the financial sector has been taken forward with the primary objective of having a strong and resilient banking system. Considerable progress has been made in strengthening the regulatory and supervisory norms with a view to inducing greater accountability and market discipline amongst the participants. This has enabled the Indian banking system to acquire strength, efficiency, and vibrancy necessary to meet global competition. The most significant achievement in the banking sector has been the marked improvement in financial health of banks in terms of capital adequacy, profitability and asset quality with an increasing focus on risk management. The Reserve Bank has made persistent efforts towards adoption of international benchmarks as appropriate to Indian conditions, improvement in management practices and corporate governance, and upgradation of technological infrastructure. While certain changes in the legal infrastructure are yet to be effected, the developments so far have brought the Indian financial system closer to global standards. From the mid-1990s, public sector banks had to face competition from the more customer-focused private sector entrants. This, competitive pressure induced public sector banks to revitalize their operations. After almost a decade of financial reforms, the banking sector in India is distinctly better placed in terms of its strength, efficiency and modernisation.

8.2 The reform process has changed the relationship between the Reserve Bank and commercial banks from one of micro regulation to that of macro management. With the focus on deregulation and liberalisation coupled with enhanced responsibilities for banks, the banking sector is faced with several challenges. Consistent with the shift to functioning in a competitive economy and to the adoption of prudential best practices, the major challenges facing the banking sector are the deployment of funds in quality assets and the management of revenues and costs. Concurrently, the issues of corporate governance and appropriate disclosures for enhancing market discipline have received regulatory attention for ensuring increased transparency and greater accountability.

8.3 Credit growth during the first half of 2004-05, traditionally a slack season for credit off-take, has been one of the highest in recent years. Inspite of a rapid acceleration in non-food credit growth caused by lending to the retail segment, the pick up in non-food credit appears to be broad-based. Improvement in credit delivery mechanisms has been the focus of recent policy measures. In the Union Budget 2004-05, the Central Government announced a broad outline of programmes for doubling the flow of credit to agriculture in three years with a credit growth of 30 per cent for 2004-05. The flow of credit to agriculture may lead to greater credit penetration by replacing non-institutional sources of finance.

8.4 Over the past few years there has been a steady decline in interest rates largely reflecting sustained reduction in inflation rates and inflationary expectations. Such reductions in interest rates occurred in an environment where credit growth remained sluggish. Consequently, there was a favourable impact on banks' balance sheets in terms of increased operating profits from treasury operations given the asset concentration in favour of Government securities in excess of the requirement of statutory liquidity ratio (SLR). For example, treasury income of the banking sector increased from Rs.9,541 crore in 2001-02 to Rs.19,532 crore in 2003-04 and constituted 32.0 per cent and 37.1 per cent of operating profit in the corresponding years. This in turn enabled banks to make larger loan loss provisions. Consequently, the net NPA ratio has declined from 5.5 per cent in 2001-02 to 2.9 per cent by 2003-04. While a declining interest rate scenario has positive spin offs for the banking sector, given that interest rates had touched historically low levels by 2003-04, there does not appear to be any further scope for similar trends to be observed during 2004-05. In future, therefore, an increasing proportion of banks' income would emanate from the traditional business of lending. Banks now have a diversified credit portfolio with increasing shares of lending to housing, consumer credit and credit to other priority sectors such as small transport operators. The flow of credit to agriculture also continues to remain robust given the enabling policy environment which has emphasised credit delivery. In this direction, vehicles of rural credit delivery through Kisan Credit Cards (KCC) and increasing linkage of bank credit and self help groups (SHGs), have proved effective. As regards industrial credit, greater thrust is placed on lending to small and medium enterprises (SMEs), especially the small scale industries (SSIs).

8.5 In order to enable the banks to determine appropriate pricing of loans to small and medium enterprises, development of a system of proper credit records would be very helpful. For this purpose, the Credit Information Bureau of India Ltd. (CIBIL) would work out appropriate mechanisms in consultation with the Reserve Bank, SIDBI and IBA. The Reserve Bank has also exhorted banks to make persistent efforts in obtaining consent from all their borrowers, in order to establish an efficient credit information system. This would help in enhancing the quality of credit decisions and improving the asset quality of banks, apart from facilitating faster credit delivery. As the risk profile of bank lending is more diversified and banks are expanding their loan books, it is essential that banks pay adequate attention to quality of lending so that credit expansion could be on a sustained trajectory building upon higher profitability while ensuring financial stability.

8.6 Keeping in view these requirements, as well as the increasing focus on credit delivery mechanisms, the Reserve Bank initiated various measures in its mid-term Review of annual policy for 2004-05. These measures include raising of limits for direct finance to the housing sector, raising of the composite loan limit for small-scale industries, removal of the restrictive provisions of service area approach, enhancing limits on advances under the priority sector for dealers in agricultural machinery and distribution of inputs for allied activities and allowing banks to extend finance to Non-Banking Financial Companies (NBFCs) against second hand assets financed by them subject to the approval of the policies by the banks' Boards.

Infrastructure Financing

8.7 The Reserve Bank has announced several policy measures in the recent years to facilitate infrastructure financing. These measures included enlarging the scope of the definition of infrastructure lending, permitting banks to raise long-term bonds with a minimum maturity of five years to the extent of their exposure of residual maturity of more than five years to the infrastructure sector, *etc.* It is intended that banks should first provide assistance to such infrastructure projects before raising resources through bonds. The Reserve Bank has already set up a Working Group to examine the instruments for credit enhancement which the State Governments can offer to improve creditworthiness and borrowing capability of State Public Sector Undertakings (PSUs)/Special Purpose Vehicles (SPVs) to attract institutional financing for infrastructure projects.

Risk Management

8.8 Growth in the economy has been leading to a natural expansion of the credit portfolio to fund the increasing demand for industrial growth and new plans of corporate expansion. The demand for higher levels of infrastructure financing has also followed this growth. In this context, to ensure a healthy growth in the credit portfolio, integrated risk management systems to address all relevant risks need to be evolved alongside selection of appropriate risk management models.

8.9 With a view to building up of adequate reserves to guard against any possible reversal of interest rate environment in future due to unexpected developments, the Reserve Bank advised banks in January 2002, to build up an Investment Fluctuation Reserve of a minimum of 5.0 per cent of the investment in held for trading and available for sale categories within a period of 5 years. Taking cognisance of hardening of inflation and an environment subject to unanticipated changes because of unforeseen domestic and external developments, the banking system, in particular, has to recognise interest rate cycles and strengthen risk management processes to cope with eventualities so that financial stability could be maintained and interest rate movements could be passed in a non-disruptive manner.

Basel II Developments

8.10 The process of benchmarking prudential norms applicable to Indian banks with international best practices has been carried forward. The Basel Committee on Banking Supervision, after a protracted consultative process, issued the framework of New Capital Accord (Basel II) in June 2004, which is expected to be implemented in many jurisdictions by end-2006. An important pre-requisite for implementation of advanced approaches under Basel II is a well-established risk management system in banks. Risk management comprises various risks that a financial institution has to manage *viz*., credit risk, operational risk, market risk, including interest rate risk and forex risk. Basel II aligns the capital measurement framework with sound contemporary practices in banking, promotes improvements in risk management, and is intended to enhance financial stability.

8.11 As Indian banks gear up for migration to Basel II, the progress made by banks in this direction is being monitored by the Reserve Bank with reviews at quarterly intervals. However, as a logical step before migration to capital adequacy norms under Basel II, banks have been mandated to maintain capital charge for market risk. Banks would need to chalk out development strategies to ensure full compliance with capital requirements arising out of implementation of Basel II. The Reserve Bank on its part is making efforts to formulate policies to deal with risks arising on account of operations of large and complex financial institutions and issues relating to the adoption of Basel II in the form of supervisory and regulatory challenges. Banks have also been advised to undertake a self assessment of their existing risk management systems taking into account the three major risks covered under Basel II and to concurrently initiate appropriate measures to upgrade them to meet the minimum standards prescribed under Basel II. In view of complexities involved in migrating to Basel II, a Steering Committee comprising members from banks, Indian Banks' Association and the Reserve Bank has been constituted to prepare guidelines for implementation of Basel II.

Corporate Governance in Banking Sector

8.12 New private banks and foreign banks have been granted licences in order to allow the financial system to benefit from greater competition through better technology, specialised skills, better risk management practices, greater portfolio diversification relating to treasury operations and deepening of the financial markets. The concentrated shareholding in banks controlling substantial amount of public funds poses the risk of concentration of ownership given the moral hazard problem and linkages of owners with businesses. Corporate governance in banks has therefore, become a major issue. Diversified ownership becomes a necessary postulate so as to provide balancing stakes. As the ownership of banks gets broad-based, the importance of institutional and individual shareholders will increase. In such a scenario, banks will need to put in place a proper code for corporate governance for benefiting all stakeholders of a corporate entity.

8.13 Simultaneously, in the interest of diversified ownership of banks, the Reserve Bank intends to ensure that no single entity or group of related entities have shareholding or control, directly or indirectly, in any bank in excess of 10 per cent of the paid up capital of the private sector banks. Any higher levels of acquisition will be with the prior approval of the Reserve Bank and in accordance with the guidelines notified on February 3, 2004. In the draft guidelines circulated in July 2004, the Reserve Bank has proposed for discussion and feedback a comprehensive framework of policy relating to ownership and governance in Indian private sector banks. The broad principles underlying the framework of policy relating to ownership and governance of private sector banks would have to ensure that the ultimate ownership and control of private sector banks is well diversified. A revised discussion paper is being issued after consideration of comments and feedback received. Further, Banks have to ensure that important shareholders (*i.e.*, shareholding of 5 per cent and above) are 'fit and proper', as laid down in the guidelines dated February 3, 2004 on acknowledgement for allotment and transfer of shares and the directors and the CEO who manage the affairs of the bank are 'fit and proper' and observe sound corporate governance principles. To ensure that shareholders and directors on Board are 'fit and proper', banks in the private sector should undertake a process of due diligence to determine the suitability of the person for appointment / continuing to hold appointment as a director on the Board, based upon qualification, expertise, track record, integrity and other 'fit and proper' criteria.

Risk-Based Supervision

8.14 With increased deregulation, globalisation and greater competition from within the country, cross border dealings have exposed banks to greater risk. Diversification into non-traditional products like insurance, derivatives, *etc*., has added to the complexity of banking business. Internet banking, e-commerce, e-money, *etc*., have added new dimensions to risks in the banking sector. Accordingly, there is a need for enlarged focus on risk-based supervision in order to improve risk sensitivity of the supervisory approach. However, stabilising risk-based supervision, as an effective supervisory mechanism, may be a challenging task and long-term drawn out process. A significant development during 2003-04 was a successful pilot programme run for risk-based supervision, aimed at allocating supervisory resources in accordance with the risk profile of banks.

8.15 In order to sensitise banks to explicitly recognise and take into account the risks arising out of forex exposures of their clients, banks were advised that henceforth, foreign currency loans of US $ 10 million and above, or such lower limits as may be deemed appropriate *vis-à-vis* the banks' portfolio of such exposures, can be extended only on the basis of a well laid down policy of their Boards with regard to hedging of such loans. The country risk management guidelines have also been reviewed to encompass country exposures of more than one per cent of a bank's assets. The information on the total exposure of the corporate clients is not readily available with banks. The banks are being 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.

8.16 With a view to containing risks arising out of non-SLR investment portfolio of banks, in particular through the private placement route, the guidelines, *inter alia*, addressing the aspects of coverage, regulatory listing as well as rating requirements, fixing prudential limits, internal assessments, role of the Boards, disclosures and trading and settlement were issued to banks. The guidelines on non-SLR investments were issued to banks giving a transition period up to end-December 2004 for compliance. However, a study of select banks revealed that banks continue to have significant share of unlisted and unrated investments in their non-SLR portfolio. Therefore, banks have been urged to prepare themselves to comply with the prudential requirements within the prescribed timeframe.

8.17 The prudential norms on income recognition, asset classification and provisioning thereon were introduced first during 1992-93, as per the recommendations of the Narasimham Committee. The norms have placed the identification of non-performing assets (NPAs) and provisioning for them on an objective platform and the endeavour has since been to make them comparable with the international norms. The enactment of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002 would help in the recovery of NPAs. Since the chances/ extent of recovery of an asset reduces over a period of time, it is essential that banks expedite recovery of NPAs. With effect from March 31, 2005, the Reserve Bank would introduce a graded higher provisioning requirement according to the age of NPAs, which are included under 'doubtful for more than three years' category.

Technology in Banking

8.18 Technology has been the key driver of the revolutionary changes in the Indian financial sector with the increasing demand for interconnectivity, internet banking and Automated Teller Machine (ATM) centres. Net banking, phone banking, mobile banking, ATMs and bill payments are the new facilities that banks are using not only to attract customers but also to help them reduce their total operating costs. The introduction of computerisation in the banking sector has led to considerable improvements in the functioning of clearing house mechanism, which facilitates the exchange of instruments, and processing of payment instructions at a central point among the participating banks. Clearing houses have gradually extended their range of activities to automate by electronic means the settlement of payment transactions. The Reserve Bank framed a set of guidelines known as Uniform Regulations and Rules for the bankers' clearing houses to provide a uniform framework for the conduct of clearing throughout the country and have been adopted individually by the general body of each clearing house in the country. The momentum achieved needs to be sustained.

8.19 Most public sector banks with their extensive branch networks are still in the process of making a shift over from the ledger book accounting practices to computer-balanced spreadsheets and from cashier-dispensed currency to ATMs. However, the transformation towards computerised functioning in public sector banks is beginning to set in and the response is becoming evident. The Reserve Bank has been playing a key role in the development of a modern, state-of-the-art payment and settlement system in India. Accordingly, the modernisation of the system has been accorded high priority in the financial sector reforms. The thrust of these reforms has been towards greater consolidation, development and integration of the payment and settlement systems in India. In view of the substantial progress made in payments and settlement system as envisioned in the 'Payments System Vision Document 2001-04,' the Reserve Bank has initiated measures to draft a document on 'Payments System Vision Document 2005-08' under the guidance of the National Payments Council.

8.20 Technology has become a strategic and integral part of banking, driving banks to acquire and implement world-class systems that enable them to provide products and services in large volumes at a competitive cost with better risk management practices. There is a need to undertake extensive computerisation across bank branches as banks that adopt the latest in technology would have an edge over others in terms of productivity. Customers' awareness has necessitated banks to deliver tailor-made products through multiple channels, allowing customers access to the bank round the clock.

8.21 In accordance with the recommendations of the Working Group on Cheque Truncation and E-cheques, the Reserve Bank decided that an Image based Cheque Truncation Pilot Project should be initiated for the Bankers' Clearing House of the National Capital Region of Delhi and its nearby areas. The pilot project is expected to be made operational in the early part of 2005. In this context, some steps need to be taken by the banks relating primarily to the procurement and/or outsourcing of truncation capabilities and adopting related changes in systems and procedures. Banks may also form a Policy Group, Implementation Group and nominate Nodal Officers for the purpose. In order to further promote other types of electronic modes of funds transfer *viz.*, Electronic Clearing Service (ECS) and Electronic Fund Transfer (EFT), the Reserve Bank announced that the service charges on banks for ECS and EFT transactions would be waived for the period up to March 31, 2006. In order to facilitate large scale usage of the 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 Reserve Bank, in mid-term Review of annual policy for 2004-05, has dispensed with the existing per transaction limits for ECS and EFT effective November 1, 2004.

Payment and Settlement System

8.22 A significant development during 2003-04 was the commencement of Real Time Gross Settlement (RTGS) System as a facility for quick, safe and secure electronic mode of funds transfer. The technological infrastructure for the smooth and secure functioning of the payment system was strengthened with the implementation of RTGS system, the Special Electronic Funds Transfer system and the Online Tax Accounting System. RTGS System has also enabled 'Straight Through Processing' at the banks' end for putting through customer transactions. The Negotiated Dealing System (NDS) enabled an improvement in Liquidity Adjustment Facility (LAF) auctions by providing in a timely fashion, all the parameters such as issue, duration, type of auctions, the opening and closing time, *etc.* To improve the performance of NDS as a trading platform in Government securities, a new order matching system (NDS-OM) has been recommended by the Working Group on Screen Based Trading in Government Securities. NDS-OM would have substantial advantages like anonymity, better access, quicker trade execution, improved pre and post trade transparency, reduction in trading costs, more efficient price discovery, straight through processing and improved market liquidity. Currently trial runs of the new module are being conducted. The Clearing Corporation of India

Limited (CCIL), which offers a multilateral netting mechanism, has provided time and cost benefits to banks.

8.23 The Reserve Bank of India has made several efforts in setting up a safe, secure and efficient communications network for the exclusive use of the banking sector. INFINET is already being used by a large number of banks for funds and non-funds based message transfers. INFINET is one of the few networks in the world which use the latest in technology and security called ‘Public Key Infrastructure’. For such communication systems to be effective, there is a need for an effective security policy which offers a shared vision of how the controls in workplace should be implemented with the objective of protecting data, information and eventually, the economic value of the organisation. There is a need for creating a culture of security by launching training programmes in these areas. These efforts need to be supported by surveillance, monitoring, auditing to detect unusual usage patterns and deficiencies. As the connectivity expands, there is a greater need for security features that guard against the spread of e-contagions.

Transparency

8.24 The relationship between the Reserve Bank and market participants has changed through the expansion and reinforcement of the consultative processes for formulating prudential regulations. To further this consultative process and with the specific goal of making the regulatory guidelines more user friendly, a Users’ Consultative Panel has been constituted comprising representatives of select banks and market participants. The panel provides feedback on regulatory instructions at formulation stage to avoid ambiguities and operational glitches. The Reserve Bank has operationalised a mailbox in October 2004, where the clarifications issued to individual banks on various prudential aspects would be posted for benefit of all users. This mailbox can be accessed on the Reserve Bank website. Further, to strengthen the consultative process and to place such a process on a continuing basis, a Standing Technical Advisory Committee on Financial Regulation was constituted in November 2003. The Committee consists of experts drawn from academia, financial markets, banks, non-bank financial institutions and credit rating agencies. The purview of the Committee includes examination of the issues referred to it and advising the Reserve Bank on regulations on an on-going basis covering banks and non-bank financial institutions and other market participants.

Issues in Co-operative Banking

8.25 Issues arising out of multiplicity of supervisory authorities continue to pose challenges in the co-operative banking sector. The Reserve Bank has repeatedly drawn the attention of the Government to the impact of multiple supervisory authorities on the performance of the co-operative banks. Co-operative banks are also subject to other difficulties ranging from members’ apathy, imprudent investment decisions, low recovery rates, weak financial position and failure to modernise systems and procedures. Beside these, reconciling democratic character and financial discipline among these institutions is a challenge. Failure of a few co-operative banks has adverse implications for rest of the co-operative banks. A vision document is being evolved for the future role of Urban Co-operative Banks (UCBs) which must ensure depositors’ interests and avoid contagion while providing useful service to the local communities. The Reserve Bank would be encouraging growth of strong and viable entities through consolidation in the co-operative sector and sensitising the State and Central Governments regarding the issues that arise in their jurisdiction.

8.26 The Reserve Bank has initiated several measures to mitigate the systemic implications of various risks prevailing in the co-operative sector. In its annual policy Statement 2004-05, the Reserve Bank announced that it would consider issuance of fresh licences only after a comprehensive policy on UCBs, including an appropriate legal and regulatory framework for the sector, is put in place. The Reserve Bank advised UCBs to classify an asset as doubtful with effect from March 31, 2005 if it remained in the sub-standard category for 12 months. Banks were however permitted to phase the consequent additional provisioning over a four-year period commencing from the year ending March 2005 with a minimum of 20 per cent each year.

8.27 The Reserve Bank has received requests from banks and Federations/ Associations of UCBs for giving some more time to restructure the accounts of UCBs and progressively meet the stricter prudential norms. In response, the Reserve Bank allowed the phasing of additional provisioning over a five-year period commencing from the year ending March 2005 instead of four years. Further, the banks have been permitted to make a minimum of 10 per cent of the required provision in each of the first two years and the balance in equal instalments over the subsequent three years. In October 2004, an ordinance to amend Banking Regulation Act, 1949 has been promulgated to enable the Reserve Bank to issue licences to Multi State Co-operative Societies to carry on banking business. The Deposit Insurance Cover for deposits in the UCBs registered under the Multi-State Co-operative Societies Act has also been extended. The Government has appointed a Task Force (Chairman: Prof. A. Vaidyanathan) to propose an action plan for reviving the rural co-operative banking institutions and suggest an appropriate regulatory framework for these institutions. The Task Force is expected to submit its Report shortly.

8.28 Regional Rural Banks (RRBs) are another source of credit in rural areas. Several measures have been initiated to strengthen RRBs in the form of recapitalisation of weak RRBs, relaxing lending to non-target group and deregulating deposit and lending rates. The Reserve Bank has also constituted Empowered Committees in its Regional Offices with members drawn from NABARD, sponsor banks, conveners of SLBCs and State Governments to ensure that the RRBs adhere to good governance and comply with prudential regulations. The Committees would also focus on operational issues and provide clarifications on regulatory issues. The Reserve Bank in its mid-term Review of annual policy for 2004-05, has raised concerns about discrimination between RRBs and co-operative banks in matters of stamp duty, mortgage fee *etc*. State Governments are also being requested to accord approval of merger of RRBs within the State, sponsored by the same bank, as and when approached with such proposals. Sponsor banks have been advised to provide support to their RRBs in matters relating to efficient management, training of staff, computerisation and networking of their activities.

Consolidation in the Financial Sector

8.29 The Indian banking sector is gradually heading towards consolidation of core competencies of different financial intermediaries and to universal banking, with banks being permitted to diversify into long-term finance and the DFIs into working capital. The universal banking may lead to greater economic efficiency in the form of lower cost, higher output and better products, but there is a need for caution in moving towards such a system by banks and FIs.

8.30 Consolidation in the financial sector has started encompassing development financial institutions, public sector banks and non-bank financing companies. The need is to design the consolidation process so as to achieve and harness convergence between the reforms undertaken in real sector, external sector and the financial sector. The Indian Banks' Association, the bankers' apex body, has recently set up a committee to look into the intricacies of mergers and acquisitions in the banking sector.

8.31 NBFCs encompass an extremely heterogeneous group of intermediaries. They differ in various attributes *viz*., size, nature of incorporation and regulation, as well as the basic functionality of financial intermediation. While regulation of banks has been in place for a long time, the regulation of NBFCs started when the Reserve Bank of India Act was amended in 1963 to provide for the regulation of the deposit acceptance activities of these entities. Internationally, acceptance of public deposits is restricted to banks, and non-banks including NBFCs raise resources from institutional sources or by accessing capital market. NBFCs are being encouraged to move in this direction in line with international practices. The Reserve Bank would be holding discussions with NBFCs in regard to their plan of action for voluntarily phasing out their acceptance of public deposits and regulations on banks' lending to NBFCs will be reviewed by the Reserve Bank.

8.32 Residuary Non-Banking Companies (RNBCs) fall under the sub-category of NBFCs with limited supervision of the Reserve Bank. RNBCs are allowed to tap resources from banks, financial institutions and corporates though in practice they have focussed primarily on public deposits. Given the discretionary portfolio of the RNBCs, the scope for unrestricted growth in RNBCs may pose serious threat to depositors' safety. As such, revisiting the existing regulatory structure for the RNBCs is of critical importance in the context of their historical evolution.

8.33 Since RNBCs have little commonalities in terms of objectives and workings of Development Financial Institutions (DFIs), attempts would need to be made to transform them into one of the definable categories of NBFCs. In order to impart greater liquidity and safety to investments of RNBCs, the Reserve Bank has prescribed rationalisation of the pattern of directed investment. This aims to reduce the overall systemic risk and thereby enhance the protection available to depositors. RNBCs have been advised to reduce their discretionary investment to 10 per cent of their deposits by April 2005 and completely dispense with it from April 2006. With a view to smoothening the process of transition of RNBCs an approach to comply with the Reserve Bank's directions has been proposed in the mid-term Review of annual policy for 2004-05. Under this approach, investments of RNBCs in certificates of deposit of financial institutions which have a minimum rating of AA+ at the time of investment would be reckoned as eligible securities as long as they have minimum investment grade rating; current account balances of RNBCs with commercial banks would be considered as eligible investments; and the investments of RNBCs in bonds and debentures of companies which meet stipulated listing and rating requirements at the time of investment would be considered as ineligible investments if they migrate to below the investment grade rating. In order to ensure that depositors are served appropriately and systemic risks are avoided, the Reserve Bank has focused on transparency of operations, corporate governance standards, adherence to 'know your customer' rules and customer services, *etc*.

Financial Stability

8.34 The critical challenge at this juncture is to improve the allocative efficiency of resources and at the same time, guard against the risks of disruptive financial imbalances. The mandate of financial stability, in the Indian context, thus has to be seen in the broadest sense of the term, calling for a three-pronged strategy of ensuring uninterrupted financial transactions; maintaining a level of confidence in the financial system amongst all the participants and stakeholders; and ensuring orderly conditions in the financial markets to guard against potential adverse effects on real economic activity. The growing integration of financial markets, especially the increasing inter-linkages between domestic financial markets and the foreign exchange market, while desirable for economic efficiency, tends to heighten the risk of contagion. Accordingly, early warning indicators, pre-emptive measures and special defence mechanisms need to be instituted for ensuring financial stability in the face of increasing uncertainties in the global financial scenario. Recognising the increasing concern about the impact of the conflicts of interest in the financial sector, a Working Group on avoidance of conflicts of interest has been constituted to identify sources and nature of potential conflicts of interest and make recommendations for avoidance of such conflicts.

Regulatory Role of the Reserve Bank

8.35 Recognising the strengths of risk management systems that have been put in place by the banks, the Reserve Bank has extended further flexibility to banks on their loan policies. This is evident from the recent policy measures announced by the Reserve Bank regarding credit exposure limits and unsecured exposures. Recently, banks fulfilling certain criteria have been granted the freedom to pay dividends without the prior approval of Reserve Bank, provided the dividend pay out ratio does not exceed 33.3 per cent. In the present scenario, the Reserve Bank has laid stress on greater responsibility of banks to safeguard depositors' interest and promotion of systemic stability through monitoring of banks to ensure that they have adequate capital to cushion risk and that they follow prudent and transparent accounting practices.

8.36 The Reserve Bank has been focusing on developing a competitive operating environment in the financial sector in terms of markets, institutions, products and practices. Increasing market orientation of the financial system helps in improving allocative efficiency of resources.

At the same time, however, it exposes both public sector and private sector financial intermediaries to various risks, necessitating prudential regulation and supervision. The litmus test of regulatory design in a competitive environment is to strengthen financial stability while at the same time, minimising the costs of financial regulation. As the process of deregulation deepens, regulatory initiatives have to be reoriented towards more pro-active supervision of the financial system. It is in this context that the Reserve Bank's supervisory strategy has been to move away from micro-prescription oriented on-site supervision to risk-based supervision. A key element of a market-oriented risk-based supervisory strategy is to develop sound corporate governance practices, which would minimise the need for process-focused supervision. The Reserve Bank, therefore, has been emphasising corporate governance and better risk assessment within banks and financial institutions, both public and private.

8.37 Greater transparency and better communication can make the process of evolution and implementation of policy more effective. Therefore, the Reserve Bank has adopted a consultative approach through formal institutional structures such as the Board for Financial Supervision, the newly-formed Standing Committee on Financial Regulation, the Technical Advisory Committee on Money, Foreign Exchange and Government Securities Markets and also through specific working groups and committees as well as formal and informal consultations with the regulated entities, external experts and professionals.

Conclusion

8.38 The imperative of improving risk management systems of banks must be seen as much from the angle of financial stability as from the process of economic development. Improved risk assessment systems are expected to enable banks to take greater exposures to sectors such as agriculture and small-scale industries in which collateral valuations often pose difficulties. This is all the more important as the pattern of credit demand has been changing in recent years. Demand for bank credit from large corporates has been decelerating because of financial restructuring, improvements in productivity, optimisation of inventory cycles, better cash flow management, increased access to external commercial borrowings and improved internal generation of funds. With better risk assessment capabilities, banks should be able to shed their risk averse attitude and extend more finance to hitherto unbanked segments of agriculture, industry and services. Lending to retail segments, including housing and other non-priority sector personal loans is increasing, fast. In this context, it is important that banks Boards undertake an assessment of the risks involved. Adequate risk management techniques should be put in place to enable banks cope with risks of debt finance supported boost in consumer spending. Indian banks, especially public sector banks, have significantly cleaned up their balance sheets and are in a much better position to capitalise on this opportunity. However, banks' lending policies should address the new risks that emerge.

8.39 With revival in industrial credit off-take, the impact of large credit increase has implications for macroeconomic management. It is also important to ensure that the credit quality does not deteriorate. In view of the strong growth in housing and consumer credit witnessed in recent years, the mid-term Review of annual policy for 2004-05 has proposed to put in place temporary risk-containment measures on housing and consumer loans. Risk weights were increased from 50 per cent to 75 per cent in the case of housing loans and from 100 per cent to 125 per cent in the case of consumer credit including personal loans and credit cards. However, it is for banks' Boards to exercise due diligence and put in place risk containment measures. This will help in keeping debt-financed growth in consumption orderly while helping asset formation in the economy.

8.40 In order to enhance transparency in banks' pricing of the loan products, in the monetary and credit policy 2003-04 banks were advised to announce a Benchmark Prime Lending Rate (BPLR) taking into account actual cost of funds, operating expenses and a minimum margin to cover regulatory requirement of provisioning/capital charge and profit margin, with the approval of their Boards to ensure that the PLR truly reflects the actual cost. The BPLR guidelines were modified suitably in consultation with banks and Indian Banks' Association so as to evolve an operationally flexible system. As of now, almost all commercial banks have adopted the new system of benchmark PLR.

8.41 In order to support broad-based improvement in customer service in respect of various banking services, banks have been advised to constitute *ad hoc* Committees to undertake procedures and performance audit on public services rendered by them. The Committees would look into simplification of procedures and practices with a view to safeguarding the interests of common persons, review the systems in place for providing service to the customers in respect of meeting their demands for fresh/good notes and coins of all denominations, exchanging soiled notes, adjudicating mutilated notes, and accepting coins and notes either for transactions or in exchange, as also the regulations and procedures prescribed by the Reserve Bank that impinge on customer service of banks. Banks were advised to submit reports thereon to the Reserve Bank to enable the Standing Committee (Chairman: Shri S.S.Tarapore) to review the existing policies and procedures. The Standing Committee has submitted four Reports, on Foreign Exchange Transactions, Government Transactions Relating to Individuals, Banking Operations and Currency Management. Some of the recommendations of the Committee have already been implemented by the Reserve Bank.

8.42 The Reserve Bank is currently examining various policy options for further strengthening the financial sector. A well-calibrated deregulation process is currently underway. As the process of strengthening financial sector unfolds, it would have to take into account factors such as emerging market structure in banking sector after the likely mergers and acquisitions, restructuring of development financial institutions and appropriate timing of the entry of foreign banks so as to be co-terminus with the transition to greater capital account convertibility while being consistent with continuing obligation under the WTO commitments. This has underscored the need for adoption of international standards and global benchmarks in the progress towards globalisation, particularly in the banking sector, given its systemic importance in the overall economy.