Chapter VII

Perspectives

7.1 The financial system in India is undergoing structural transformation under the influence of globalisation, deregulation, technological advances, and institutional and legal reforms. While the liberalised environment has opened new avenues of business for financial institutions, it has led to intensified competition. To survive in a competitive environment, financial institutions have been diversifying into non-traditional activities, altering their pricing strategies and looking for non-fund based sources of income. As a result, operations of financial institutions are becoming increasingly complex and, correspondingly, exposed to greater risks. In order to ensure that financial institutions grow along sound lines, a robust prudential regulatory framework has been put in place. Financial regulation and supervision has been progressively aligned with international best practices with suitable adaptations. The corporate governance framework in banks has also been strengthened. At the same time, the Reserve Bank has been making consistent efforts to strengthen credit delivery, improve customer service and encourage banks to provide banking services to all segments of the population. Despite considerable expansion of the banking system in India, large segments of the country's population are not adequately served, some as savers and others as borrowers. The expansion of banking services that are designed to serve all potential customers efficiently is, therefore, emerging as a major concern that is engaging the attention of the Reserve Bank.

Credit Delivery and Pricing

7.2 One of the critical issues facing the banking sector is the flow of credit to all the productive sectors of the economy. Retail financial services, particularly housing and personal loans, continued to traverse a high growth trajectory, fuelled mainly by demographic shifts and rising household incomes. With a view to addressing potential vulnerabilities, several regulatory measures in the form of higher risk weights, appropriate disclosures and fair practices code, were instituted during the year.

7.3 Credit demand by the corporate sector has also turned robust on the back of strong industrial performance. Furthermore, banks are expected to have greater financing opportunities in the area of project finance, especially in the infrastructure sector, given the conversion of two major financial institutions (FIs) into banks. Banks have been focusing mainly on syndication of debt to ensure wider participation in project finance and wholesale lending segment. The guidelines issued by the Reserve Bank on infrastructure financing by banks offered banks various regulatory concessions. Besides, banks were permitted to raise long-term bonds to finance infrastructure investments as also to reduce asset liability mismatches. The ongoing effort to develop the private corporate debt market would help banks meet the long-term funding requirements of the industrial and infrastructure sectors on a sustainable basis.

7.4 Rural credit has emerged as an important growth opportunity. Several new areas such as agri-clinics, contract farming and rural housing are fast becoming viable revenue propositions for banks. Although rural credit witnessed higher growth during the year, there is still need to further enhance credit to the new emerging areas of economic activity in rural areas. In order to enhance the flow of credit to these emerging areas, the Reserve Bank has been undertaking measures to remove the impediments on timely availability of credit through various means. First, the coverage of rural credit has been extended to include facilities such as storage as well as credit through NBFCs. Second, procedural and transactional bottlenecks are sought to be removed by reducing margins, redefining overdues to coincide with crop-cycles, new debt restructuring policies, one-time settlement and relief measures for farmers indebted to non-institutional lenders. Third, public and private sector banks are being encouraged to enhance credit-delivery in rural areas. Finally, banks are urged to price the credit to farmers based on actual assessment of individual risk rather than on a flat rate, depending on the category of borrower or end-use while ensuring that interest rates charged are justifiable as well

as reasonable. As productivity and incomes increase in rural areas, banks will need to serve the credit needs of the full supply chain activities as they emerge, along with those of other service and manufacturing activities. Banks will also need to devise appropriate risk assessment and management strategies and develop technical capabilities to serve the emerging needs.

7.5 The higher returns in agriculture have begun to drive the supply of credit to the priority sector. The scope and extent of priority sector have undergone several changes with several new areas and sectors being brought within its purview.

7.6 While credit to agriculture has tended to move upwards, lending to SMEs has stagnated. This could possibly be due to the perception of higher levels of risk in the sector. Financing the growth of a healthy SME sector is essential for the future sustained growth of the economy. Several measures, therefore, have been initiated by the Reserve Bank to streamline credit flow and address structural bottlenecks in credit delivery to this sector. All scheduled commercial banks, including RRBs and local area banks (LABs), have been advised to undertake pro-active measures to increase the credit flow to the SME sector. Salient among these include fixing of self-set targets for financing, rationalisation of cost of loans, expanding the outreach of formal credit, formulation of comprehensive and more liberal policies for granting of loans, adoption of cluster-based approach for SME financing, and displaying instructions/guidelines formulated by banks as well as the Reserve Bank on their respective websites. The Reserve Bank has also advised public sector banks to institute specialised SME branches in identified clusters/ centres with preponderance of medium enterprises. Further, a simplified, non-discretionary and non-discriminatory mechanism has been formulated for one-time settlement of chronic NPAs below Rs.10 crore in the SME sector. A debt restructuring mechanism for units in the SME sector has also been formulated for implementation by all scheduled commercial banks. On its part, the Reserve Bank has constituted empowered committees at its Regional Offices to review the progress in SME financing and rehabilitation of sick SSI and SME units so as to ensure smooth flow of credit to these sectors. In order to increase the flow of credit to the SME sector, appropriate risk management is essential. With the operationalisation of Credit Information Bureau of India Ltd. (CIBIL), the quality of credit analysis is expected to improve. This should help in reducing the transaction cost and improving the credit flow to the SME sector.

7.7 Micro-finance institutions (MFIs) now provide several non-credit services such as capacity building, training, marketing of the products of the SHGs and micro insurance. The focus of discussion is expanding beyond the narrow domain of micro-credit to encompass micro-finance. This underscores the need for a clearer policy framework to cover the non-credit financial services by MFIs as well as the need to evolve a differentiated legal framework as per the organisational form. Micro-finance process would also need to iron out several operational issues as well as putting in place co-ordinating mechanisms amongst the various regulatory agencies. The policy environment has been fine-tuned such that the micro credit extended by banks is presently reckoned as part of their priority sector lending. Banks have been provided the freedom to devise appropriate loan and savings products in this regard. Use of intermediaries or franchise agents could emerge as a mechanism to reduce transaction costs. The thrust is on enhancing credit delivery within the existing legal and institutional framework. The Reserve Bank is currently engaged in exploring a forum where these issues could be addressed on a continuing basis through a participative and consultative process amongst all the stakeholders.

7.8 The approach of the Reserve Bank has been to emphasise the informality of micro-finance and focus on the developmental aspects. The micro-finance movement in the country has benefited immensely from simplicity and flexibility in organisation, structure and methods of working and involvement of common people. Therefore, any regulation of the MFIs would be inconsistent with the core spirit of the movement. However, NABARD and banks would need to evolve appropriate indigenous/local safeguards in their relationship with the MFIs, taking into account different organisational forms of such entities.

7.9 The benchmark prime lending rate (BPLR) system was introduced to increase the transparency in pricing of credit by banks. In the recent past, however, with the introduction of sub-PLR lending, spreads between minimum and

maximum lending rates have increased significantly. Furthermore, the sub-BPLR lending of the banking system (excluding exports, the bulk of which is at sub-BPLR) has also increased substantially - to the extent of over 60 per cent of total outstanding advances above Rs.2 lakh. Though sub-PLR lending has enabled corporates to raise funds at competitive rates from banks without incurring any additional cost towards stamp duty, dematerialisation costs or fees for issuing and paying agents (IPAs), it is distorting the role of BPLR itself. Many banks have their average lending rate below their BPLR, which is also putting pressure on their spreads. Furthermore, there is a growing perception that there is under-pricing of credit risk for large private sector corporates, whereas there could be over-pricing of risk in lending to agriculture as well as small and medium enterprises. There is, therefore, merit in reviewing the current procedures and processes of pricing of credit, perhaps through a well structured segment-wise analysis of costs at various stages of intermediation in the whole credit cycle, and bringing improvement in risk assessment and risk management systems in banks.

Customer Service and Financial Inclusion

7.10 Liberalisation of financial services and competition have improved customer service. However, experience shows that consumer's interests at times are not necessarily accorded full protection and their grievances are not properly attended to. There have been complaints relating to charges for balance enquiry, cheque status verification, signature verification, address confirmation, photograph verification, punitive service charges for non-maintenance of minimum balance in saving accounts, transaction charges for reorder of cheque book and for cash transactions at the branch beyond a stipulated number. The Reserve Bank has been issuing guidelines from time to time to facilitate banks' focus on service to the common man. With the Reserve Bank's initiative, the Indian Banks' Association (IBA) has prepared a model 'Fair Practices Code' which is a public document enlisting things that a customer can expect from the concerned bank. The purpose of the policy is that banks should deliver to depositors what they had promised at the time of accepting deposits. The scope of the Banking Ombudsman is also being expanded to cover all individual cases/grievances relating to non-adherence to the 'Fair Practices Code' evolved by the IBA and adopted by individual banks. In addition, the Reserve Bank decided to institute an independent Banking Codes and Standards Board of India in order to ensure that comprehensive code of conduct for fair treatment of customers is evolved and adhered to.

7.11 The expansion of banking services and diversification of ownership has led to both enhanced efficiency and systemic resilience in the banking sector. However, there are legitimate concerns with regard to the banking practices that tend to exclude rather than attract vast sections of population, in particular pensioners, self-employed and those employed in the unorganised sector. Banks have been bestowed with several privileges, especially of seeking public deposits on a highly leveraged basis. It is, therefore, imperative that they provide banking services to all segments of the population on an equitable basis. In this context, the Reserve Bank has announced its intention to implement policies to incentivise banks to provide extensive services responsive to the needs of the community, including the underprivileged.

Basel II and Risk Management

7.12 It has been the endeavour of the Reserve Bank to facilitate gradual convergence of prudential norms for the banking sector with international best practices with suitable country specific adaptations. In India, the capital adequacy norms were adopted in 1992 following the Basel Accord, 1988. With the increasing sophistication in banking operations and the growing cross-border activities of banks, the earlier Accord, which focused exclusively on credit risk, did not adequately address the emerging realities of banking. After due consultative process which began in 1999, the New Capital Accord, popularly known as Basel II, was enunciated in 2004 for adoption by banks. The revised Accord takes into account both market and operational risks, reinforced by a three-pillar strategy. Basel II, under which banks' capital requirements will be more closely aligned with the underlying risks in their balance sheets, is expected to promote stronger risk management practices in banks.

7.13 In India, commercial banks will start implementing Basel II with effect from March 31, 2007. In particular, they will adopt the Standardised Approach for credit risk and the

Basic Indicator Approach for operational risk. After adequate skills are developed both at the bank and the supervisory levels, some banks may be allowed to migrate to the Internal Ratings Based Approach. The Reserve Bank had advised banks in May 2004 to examine in depth the options available under Basel II and draw a road map by end-December 2004 for migration to Basel II and review the progress made at quarterly intervals. Subsequently, all banks were advised to undertake a self-assessment of the various risk management systems in place, with specific reference to the major risks covered under Basel II and initiate necessary remedial measures to update the systems to match up to the prescribed minimum standards. Banks were also advised to formulate and operationalise the Internal Capital Adequacy Assessment Process (ICAAP) as required under Pillar II of the new Accord. The adoption of risk based supervision (RBS) would facilitate in factoring the Pillar II requirements under Basel II. In the interim, banks were also advised to create an investment fluctuation reserve of 5 per cent of the investment portfolio, both in the AFS and HFT categories plus a 2.5 per cent risk weight on the entire investment portfolio to address the market risk.

7.14 In the course of implementation of Basel II, banks are expected to face several challenges. First, there is low level of rating penetration in India and ratings are being restricted to issues and not issuers. While Basel II gives some scope to extend the rating of issues to issuers, this would only be an approximation and it would be necessary for the system to move to ratings of issuers. The non-availability of acceptable and qualitative historical data relevant to ratings, along with related costs in building up and maintaining the requisite database, is likely to influence the pace of migration to advanced approaches of risk measurement under Basel II. Second, Basel II provides scope for the supervisor to prescribe higher than the minimum capital levels for banks for interest rate risk in the banking book and concentration of risks/risk exposures, among others. Third, the existence of large and complex financial conglomerates could potentially pose a systemic risk. It would, therefore, be essential to institute appropriate supervisory policies in order to address the challenges posed by the presence of such conglomerates. Capacity building, both in banks and the regulatory bodies, is a serious challenge for implementation of Basel II, especially with regard to adaptation of advanced approaches.

7.15 As implementation of Basel II gathers force and banks capture operational risk appropriately and provide for capital charge for market risk, several banks may need additional capital. With the expected high growth of the economy, banks' lending operations are also expected to expand requiring more capital. The Reserve Bank has, therefore, initiated supervisory measures to identify the gaps, and assess as well as quantify the extent to which additional capital will be required by banks. In the past, banks have tended to rely mainly on retained earnings to strengthen their capital position. However, with the buoyant capital market, it should not be difficult for banks to raise capital from the market, especially when the banking sector is performing well. The Reserve Bank has suggested certain amendments in the Banking Regulation Act, 1949, which are expected to enable banks to augment their capital base while maintaining Government shareholdings at the prescribed levels in public sector banks.

7.16 Modern day banking is all about management of risks. Banks with proper risk management systems would tend to have a competitive advantage by way of lower regulatory capital charge. Such banks would also be able to properly price their services and make adequate provisioning. Risk management has assumed added significance in the context of Basel II. In the changed environment various risks are not independent. Banks, therefore, need to adopt integrated risk management systems, whereby they effectively address all relevant risks in an ongoing and comprehensive manner. The introduction of 'core banking' solutions have enabled banks to segregate the credit sourcing (front office) and appraisal (back office) functions, which can, over time, build up expertise and monitor credit migrations on a bank-wide basis. The use of dynamic credit scoring models and the full-fledged operationalisation of the credit bureau would enable banks to switch from traditional proprietary models to newer methods of credit evaluation to reflect the repayment and recovery experience across asset classes, geographical boundaries and demographics.

Management of NPAs

7.17 The most important facet of risk in India remains credit risk. Banks have been successful

in containing their non-performing assets (NPAs), despite adoption of 90-day delinquency norm and the overhang problem. Net NPAs have now fallen to about just two per cent of net advances. Banks have been able to achieve this by using treasury profits during last few years. Various measures initiated by the Government, the Reserve Bank and the banks themselves have also facilitated the recovery and management of NPAs. The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002 has significantly strengthened the lender's ability to enforce its right to collateral. The Act has also created enabling conditions for asset reconstruction companies. The corporate debt restructuring (CDR) system has also emerged as a time-bound and transparent mechanism for arriving at a consensual financial arrangement between the creditor and the borrower. The enactment of the Credit Information Companies Act, 2005 will also enable sharing of credit information and progressive formation of credit information bureaus, which should help in reducing transaction costs of banks in extending credit to small and medium borrowers. This should also enable banks to keep the NPA levels low *ex ante*, which, in turn, would improve credit delivery and promote appropriate credit pricing. Banks, however, need to further strengthen the risk management systems and enhance further capacity building.

Governance

7.18 Corporate governance lies at the heart of building sound financial institutions. Corporate governance has assumed added significance in the current liberalised environment when the banking sector is expected to function on commercial lines. The governance structure specifies the rights and responsibilities of the Board, the management, the shareholders and other stakeholders. It is only through a proper interaction among these constituents that governance of banks can improve. Since institutions have different business philosophies, each institution would need to develop its own governance system based on the guiding principles as it evolves and develops over time. The system of governance needs to be flexible and adaptable so as to keep pace with changes in the operating environment. Since banks are 'special' and play a fiduciary role, ineffective governance can jeopardize the credibility of banks and impair their functioning. Therefore, a flexible approach to governance which subsumes ongoing evaluation and upgradation, need hardly be overemphasised. The quality of corporate governance in banks becomes critical as competition intensifies and banks strive to retain their client base.

7.19 The regulatory framework, in addition to prescribing prudential guidelines, is increasingly focussing on ensuring good governance through 'fit and proper' owners, directors and senior managers of banks. Shareholding of five per cent and above requires acknowledgement from the Reserve Bank and such significant shareholders are put through a 'fit and proper' test. Banks have also been asked to ensure that the nominated and elected directors are screened by a nomination committee to satisfy 'fit and proper' criteria. The Reserve Bank has recently issued detailed guidelines on ownership and governance in private sector banks emphasising diversified ownership. The listed banks are also required to comply with the governance principles laid down by the securities market regulator.

7.20 Transparency and disclosure standards, which are important constituents of a sound corporate governance mechanism, have been enhanced to align with international best practices. The Reserve Bank has issued detailed guidelines relating to several accounting standards. Banks are currently also required to make several disclosures about their operations in their balance sheets. However, there are some gaps in the disclosures in India *vis-à-vis* the international standards, particularly in the area of risk management strategies and risk parameters, risk concentrations, performance measures, components of capital structure. Hence, the standards need to be further broad-based in consonance with improvements in the capabilities of market players to analyse the information objectively.

Changing Institutional Focus

7.21 In the initial phase of reforms, the focus of reforms was on the scheduled commercial banks, given their systemic importance. In the last few years, however, the reform process has become increasingly broad-based encompassing other institutions such as RRBs, urban co-operative banks, rural co-operatives, FIs and NBFCs.

7.22 In view of importance of RRBs as purveyors of rural credit, the Union Budget, 2004-05, emphasised that the sponsor banks would be 'squarely accountable' for the performance of RRBs under their control. In line with the suggested roadmap for restructuring of RRBs, sponsor banks are being encouraged to amalgamate the RRBs sponsored by them State-wise. In order to reposition RRBs as an effective instrument of credit delivery in the Indian financial system, the Reserve Bank is in the process of reviewing their performance, exploring restructuring through amalgamation/consolidation, changing of sponsor banks, reviewing minimum capital requirement and suggesting suitable measures for their regulation, supervision and governance.

7.23 The strategy for the revival of urban co-operative banks is premised on three major planks, *viz*., consolidation, infusion of capital and weeding out of weak banks. In this regard, the Reserve Bank issued guidelines on merger and amalgamation of UCBs in February 2005. A Medium-Term Framework (MTF) for this segment is being finalised which envisages harmonisation of the regulatory and supervisory domain of the State Governments and the Reserve Bank to mitigate the conflicts in a regime of dual control. Concurrently, Memoranda of Understanding (MoUs) have been signed between the Reserve Bank and the State Governments with sizeable presence of UCBs to work out a time bound action plan for revival of weak banks. The MoUs also provide for a process of professionalising audit of UCBs and a structured arrangement for coordination and consultations.

7.24 The rural co-operatives which can play an important role in credit delivery in the rural area are beset with several problems. A Task Force (Chairman: Shri A. Vaidyanathan) for the revival of rural co-operatives submitted its Report, which is being examined by the Government for implementation. The envisaged restructuring of this segment broadly comprises the five inter-related areas. First, there is a need for legal and institutional changes relating to governance, regulation and functioning of the rural co-operative structure. Second, there is a need to rationalise this segment through early restructuring and recapitalisation. Third, the credit culture needs to evolve in a fashion to ensure enhanced rural credit a lasting phenomenon. Fourth, there is merit in exploring the possibility of insurance for facilitating credit flow to riskier ventures. Finally, a comprehensive public policy on risk management in agriculture would serve as a means of relief for distressed farmers and also promote a more commercialised agriculture sector.

7.25 There has been substantial consolidation of the NBFC sector after introduction of the new regulatory regime in 1997. The Reserve Bank's supervisory thrust so far has been on deposit taking companies with focus on protection of depositors' interest. Those NBFCs which find the regulatory cost outweighing the benefits, are, however, allowed to opt out from deposit taking activity on a purely voluntary basis. This stance is expected to lead further consolidation in the sector. More recently, a new monitoring arrangement for large non-deposit taking companies (with asset size of Rs.100 crore and above) has been devised with a view to enhancing supervisory focus from the systemic point of view.

7.26 The Reserve Bank is also examining various issues involved in financing of NBFCs by banks so that the bankers are able to use the core competencies of NBFCs to extend their outreach. The revised policy relating to access of external commercial borrowings (ECBs) by NBFCs with prior approval of the Reserve Bank (under approval route) to finance import of infrastructure equipment for leasing to infrastructure projects, is expected to invite increased participation of NBFCs in infrastructure financing by easing the resource constraint.

7.27 In the emerging scenario, the role of PDs will undergo a significant change. Following the enactment of the Fiscal Responsibility and Budget Management (FRBM) Act, 2003, the Reserve Bank will cease to participate in the primary issues of Central Government securities with effect from April 1, 2006. This would have implications both for the ability and cost of Government borrowings and for the financial sector, as the cushion for containment of market volatility through the Reserve Bank's balance sheet would not be available. Both the Government and market participants would, therefore, need to be better geared to manage market risks.

7.28 Since the Reserve Bank would no longer play the role of an underwriter of the last resort from 2006-07, PDs would need to be adequately prepared to ensure the success of Government's

market borrowing programme. The role of the PDs in the Government securities market in the post-FRBM scenario is envisaged to be more important not only from debt management perspective, but also from market development point of view. Certain risk mitigation tools are under consideration of the Reserve Bank which, together with the proposal that permitted structures of PD business would be expanded to include banks, might necessitate changes in the regulatory guidelines.

Competition and Consolidation

7.29 One of the major objectives of banking sector reforms has been to enhance efficiency and productivity through competition. This involved three elements. First, private shareholding in public sector banks has been injected by permitting reduction in the Government shareholding in public sector banks up to 51 per cent. Second, entry of new private sector banks has been allowed. Third, foreign banks have been permitted additional branches. The roadmap for banking sector reforms, which put forth guidelines on ownership and governance in private sector banks and a two-phase roadmap for presence of foreign banks in India, has also been announced by the Reserve Bank in February 2005.

7.30 Various indicators suggest that competition in the banking industry has intensified. The share of private and foreign banks in total assets, which was less than 10 per cent at the inception of reforms, has steadily risen to about 25 per cent at end-March 2005. The rise in market share of the new private sector banks is particularly evident. New private sector banks and foreign banks with comparative advantage in technology, have ushered in highly competitive banking. This has encouraged other banks to devise imaginative ways to maintain their market share.

7.31 Although the financial system in India has developed considerably over the years, the ratio of bank assets to GDP in India is still low in comparison with that prevailing in several other emerging market economies. This, combined with the fact that India's economy is growing at a robust rate, would suggest that there is enormous potential for future growth of banking, especially in rural and semi-urban areas.

7.32 Subsequent to the issuance of the guidelines for mergers between non-banking financial companies and banks, the Reserve Bank also issued guidelines for mergers between private banks in May 2005. The principles underlying these guidelines would be applicable, as appropriate, to public sector banks also, subject to the provisions of the relevant legislation. It is expected that consolidation of the domestic banking system in both public and private sectors would be combined with gradual and calibrated enhancement of the presence of foreign banks. The move towards consolidation also encompassed the financial institutions (FIs), which have been providers of long-term finance. Two large term-lending institutions have already converted into banks. The Government of India has notified on September 12, 2005, under Section 23A of the RRB Act, 1976, State level amalgamation of 28 RRBs into 9 new RRBs in six states, *viz.*, Bihar, Gujarat, Karnataka, Maharashtra, Punjab and Uttar Pradesh. The amalgamations have become effective from September 12, 2005.

7.33 The growing complexity of the financial sector with banks, insurance companies and NBFCs making foray into non-traditional activities, has led to the emergence of financial conglomerates which pose a significant risk to the financial sector. Accordingly, it was felt desirable to move away from the segmented approach to supervision to a comprehensive process involving inter-regulatory exchange of information. Based on a consultative approach, a mechanism has been evolved, which seeks to capture intra-group transactions/exposures of identified financial conglomerates and exchange of relevant information among the principal regulatory authorities on a quarterly basis. Since different financial conglomerates have different lead area of operations, the oversight framework envisages that the principal regulators obtain data/ information in the prescribed format in respect of their conglomerates and address the issues of concerns arising out of the analysis of the data. As part of the process for closer and continuous interaction with the identified conglomerates, a system of half-yearly discussion with the Chief Executive Officer of these conglomerates in association with other principal regulators has been introduced to address outstanding issues and supervisory concerns.

Banks Managing the Upturn in Interest Rate Cycle

7.34 The change in interest rate trends has raised concerns about the interest rate risk in banks' portfolio in view of their large holdings of Government securities. The Reserve Bank had sensitised banks of a possible reversal in interest rates through its various communication channels and had prepared them for 'soft landing' through the 'investment fluctuation reserve' (IFR) and other prudential measures.

7.35 As the interest rates inched upwards during 2004-05, the share of floating rate bonds (FRBs) in Government securities was raised to assure the investors of a rate of return in line with future interest rate movements and also to address their asset liability management (ALM) requirements, even while enabling the Government to lock-in funds for a longer maturity period. However, pricing difficulties and the resulting secondary market illiquidity continue to beset FRBs. Consideration is being given to re-introduction of capital indexed bonds, issued only once in 1997, with modified features to enable market participants to hedge both principal and coupon payments from inflation risk. Such bonds also help in reducing the cost of borrowings as they eliminate the inflation risk premium. Further, it could provide an idea of inflationary expectations and support the conduct of monetary policy. Such bonds could also provide a preferable investment avenue for retail investors with high net worth and small savers, including the senior citizens. The introduction of Separate Trading for Registered Interest and Principal of Securities (STRIPS), would also be enabled if the Government Securities Bill, 2004 gets enacted. It would enable better ALM and, therefore, help reduce interest rate risk.

7.36 In view of the significant quantum of Government securities on the books, banks were permitted, as a one-time measure, to shift SLR securities to the 'HTM' category during 2004-05. Although this entailed a one-time cost, it enabled banks to shield the 'mark to market' portion of their investment portfolio from interest rate risk. Additionally, banks have been making conscious efforts to reduce the residual maturity of their investments portfolio. As a result of these measures, the estimated modified duration of the total investment portfolio has come down significantly, making the system much more resilient to withstand any adverse movement in interest rates.

Banking and Technology

7.37 In an environment of large scale use of technology, an effective security policy covering physical and other aspects has assumed high importance. There is a need for surveillance, monitoring and auditing to detect unusual usage patterns and deficiencies. Banks need to institute an appropriate security policy to ensure adequate and effective safety. Regular IT related functions also need to be undertaken to ensure that there are no lapses or deviation from the approved information security policy. Information systems and information technology have an impact on the reputational risk of a bank. While outsourcing of IT related and other services does have certain advantages, it also has its own challenges. This calls for putting in place appropriate and adequate safeguards in place. The Reserve Bank has constituted an internal group on outsourcing and based on its recommendations, regulatory guidelines are expected to be issued shortly.

7.38 Calibrated deregulation, prudential regulation and supervision, and a responsive policy environment have resulted in significant improvement in the efficiency, stability and resilience of financial institutions. This is reflected in their profitability, improved asset quality and higher capital levels. As the economy grows and becomes more sophisticated, the banking sector has to develop in a manner that supports and stimulates such growth. There are, however, several challenges in future which may require new technologies, better processes of credit and risk appraisal, product diversification, robust internal controls and corporate governance, and efficient human resource management. Banks are also facing increased market risk uncertainties on account of rising interest rates as a result of growing global financial imbalances. The banking sector, therefore, needs to equip itself to meet these challenges as well as those arising out of introduction of Basel II norms and international accounting standards. Competition, consolidation and convergence are emerging as the key drivers of the banking sector in the years to come.