Chapter VII

Perspectives

7.1 Financial sector reforms have been introduced in a calibrated and well-sequenced manner since the early 1990s. The sustained efforts by the Government, the Reserve Bank and by banks themselves have resulted in a competitive, healthy and resilient financial system. The asset quality and soundness parameters of the Indian banking sector, on the whole, are now comparable with global levels. This has been achieved in the backdrop of gradual alignment of prudential norms with international best standards and in an environment of growing competitive pressures. There is also an evidence of some financial deepening in recent years. Having achieved substantial success in improving the financial health of commercial banks over this period, there is now need to focus on the further expansion and deepening of financial services so as to serve the needs of those who are underprivileged. This would include particular attention being given to the underdeveloped regions of the country. The reform process is also being extended to the improvement of financial health and prudential regulation of urban co-operative banks, regional rural banks, the rural co-operative banking sector and non-banking financial institutions. In view of the dual regulatory control of urban co-operative banks, the strategy of reform is being conducted through a consultative mechanism involving State Governments.

7.2 In view of accelerating economic growth, the main challenge for the banking sector in the coming years would be to expand while maintaining sound financial health. With large credit expansion during the last two years, while banking penetration has increased on the asset side, it continues to be relatively low on the liability side. Banks, therefore, would need to focus on reaching the hitherto untapped clients and regions. With increasing competition on the asset side, banks would also need to look for new creditworthy borrowers. While there is an enormous scope, the need is to find innovative methods to reach them. With the expected expansion of banking operations in line with the overall macroeconomic growth and the introduction of Basel II requirements, there is clear recognition of the need for banks to also extend their capacity. Consequently, the Reserve Bank allowed banks to raise capital from the market by way of certain innovative instruments during the year.

Credit Delivery and Pricing

7.3 The high growth in credit offtake by the banking sector during the year (2005-06) was more broad based than in the previous two years. In order to fund large credit demand, banks partially liquidated their SLR portfolio during the year. As on October 13, 2006, SLR holdings of the banks were at 29.8 per cent of NDTL, a significant reduction from 36.7 per cent in 2001-02. With the SLR portfolio now drawing close to the minimum statutory requirements, the higher credit growth in future could be financed mainly through greater accretion of deposits. In this context, the higher increase in time deposit growth during the current year is encouraging.

7.4 In the recent period, robust industrial growth has been an important contributory factor in increased credit demand from the corporate sector. Latest information on sectoral deployment of credit suggests that credit expansion is well diversified across almost all the sectors. The credit expansion to the infrastructure sector, in particular, has been very strong. Banks, which have traditionally financed working capital requirements, have been gradually increasing their exposure to project finance, including infrastructure. While this is a welcome development, banks need to ensure that their exposure to project finance is in sync with their asset liability management (ALM) structure.

7.5 Although credit to agriculture and allied activities has been increasing in recent years, there is a clear room for further improvement in the rural credit delivery system, particularly in some under-served regions. To increase the flow of credit to agriculture and related activities, most of the recommendations of the Advisory Committee on Flow of Credit to Agriculture and Related Activities from the Banking System (Chairman: Prof. V.S. Vyas) have been implemented by the Reserve Bank and NABARD.

7.6 With a view to aligning bank credit to the changing needs of the society, the scope and definition of the priority sector are being continuously fine-tuned by including new items as also by enhancing credit limit of the constituent sub-sectors. Continuing with the process, several measures were initiated during 2005-06. These were: (i) excluding fresh investments by banks on or after July 1, 2005 in venture capital from priority sector lending; (ii) requiring all private sector banks to actively participate in various fora under the Lead Bank Scheme; (iii) advising banks to provide a simplified mechanism for one-time settlement of loans where the principle amount is equal to or less than Rs.25,000 and which have been ëdoubtfulí and ëlossí assets as on September 30, 2005; (iv) requiring banks to introduce general credit card (GCC) scheme for issuing GCC to their constituents in rural and semi-urban areas without any insistence on the security and the purpose or end-use of credit.

7.7 The small and medium enterprises (SME) sector is an important segment of Indiaís economy, especially because of its export and employment generating potential. However, bank credit to the SME sector has tended to stagnate in recent years, which is a matter of concern. The Reserve Bank, therefore, initiated several measures to boost the credit flow to the SME sector. Banks were advised to include only SSI financing in the priority sector. The following measures were also advised to banks: (i) to fix self-targets for financing the SME sector so as to reflect a higher disbursement over the immediately preceding year; (ii) to initiate necessary steps to rationalise the cost of loans to the SME sector by adopting a transparent rating system; (iii) to adopt at least five new small/ medium enterprises of each of their semi-urban/ urban branches per year to increase the outreach of formal credit to the SME sector; (iv) to treat cluster-based approach for financing as a thrust area and increasingly adopt the same for financing; (v) to ensure specialised SME branches in identified clusters/centres with preponderance of medium enterprises to enable the SME entrepreneurs to have an easy access to bank credit; (vi) to implement a one-time settlement scheme for recovery of NPAs below Rs.10 crore for SME account applicable to public sector banks; (vii) to implement a debt restructuring mechanism for units in the SME sector; and (viii) to implement a scheme for Small Enterprises Financial Centres (SEFCs) which encourages banks to establish mechanism for better co-ordination of their branches and those of SIDBI.

7.8 Subsequent to the deregulation of lending rates, the Reserve Bank had introduced the benchmark prime lending rate (BPLR) to enhance transparency in pricing of credit by banks. Given the competitive conditions in the credit market, the share of sub-BPLR lending in total lending of commercial banks increased to 77.0 per cent of total outstanding advances above Rs.2 lakh at end-July 2006 from 69.0 per cent at end-June 2005. This was evident from the modest increase in the weighted average lending rate of banks from 12.57 per cent at end-March 2005 to 12.60 per cent at end-March 2006, even though interest rates hardened during this period.

7.9 The robust credit expansion witnessed in the last two years has continued during the current year. In the context of the anticipated higher growth rate of the economy in the next few years, the banking system needs to innovate in order to support and facilitate the growth process. In dealing with new consumer and production demands of rural enterprises and that of small and medium enterprises in urban areas, banks have to look for new delivery mechanisms that economise on transaction costs and provide better access to the currently under-served. Innovative channels of credit delivery for serving these new rural credit needs are already being explored by some banks and financial institutions under the umbrella of financial inclusion. The budding expansion of non-agriculture service enterprises in rural areas will also have to be financed adequately to augment income and employment opportunities. The banking system is being strengthened to respond adequately to the challenges of greater diversification that is taking place in the economy. These challenges are particularly important since banking penetration is still low in India as compared to other countries with similar socio-economic background.

7.10 The flow of credit to retail financial services, particularly housing and personal loans has been quite robust in recent years. With the changing growth dynamics of the economy, certain segments of the population could become susceptible to excessive optimism or even to vicissitudes in the macro-economic conditions. While the surge in credit offtake reflects buoyant aggregate demand conditions in a growing economy, it could also raise concerns about the quality of credit. In order to address potential vulnerabilities, several regulatory measures were introduced by the Reserve Bank during the year.

7.11 It is increasingly felt in some quarters that individuals are not in a position to take full advantage of the guidelines issued regularly to the banks by the Reserve Bank for a variety of reasons.†These may include inadequacies in managing their finances, especially delinquent accounts. Further, individuals may not be able to articulate their financial situation adequately to the banks.†Therefore, it will be in the interest of banks themselves to help individual borrowers through appropriate credit counselling. It is encouraging that some banks have already initiated efforts in this direction.

7.12 Counselling generally serves three purposes. First, it examines ways to solve current financial problems. Second, by creating awareness about the costs of credit, it improves financial management and develops realistic spending plans. Third, it advises the distressed people to gain access to the structured financial system, including banking. However, such counselling will be appropriate only if it addresses unique situations of households in different parts of the country.

Customer Service and Financial Inclusion

7.13 The Reserve Bank has taken several initiatives recently for ensuring delivery of quality service by banks to their customers at a reasonable price. The focus of attention has been on basic banking services provided to the common person and positioning of an effective customer grievance redressal mechanism. Banks have been advised to fix reasonable service charges in line with the average cost of providing these services.

7.14 A significant initiative to improve customer service was the announcement made in April 2005 to set up the Banking Codes and Standards Board of India (BCSBI), which became operational in March 2006. The BCSBIís objective is to locate and rectify systemic deficiencies by taking collaborative remedial actions rather than through penal measures. The Board would measure a bankís performance against established best practices. A ëCode of Bankís Commitment to Customerí has been evolved through which banks have committed to have in place a ëtariff scheduleí covering all charges.

7.15 To improve grievance and complaints redressal mechanism, the Banking Ombudsman Scheme (BO) was revamped in January 2006, enlarging its scope and authority. It incorporated new grounds of complaints such as credit card issues, failure in providing the promised facilities, non-adherence to the Fair Practices Code and levying of excessive charges without prior notice. It relaxed the mandatory requirement of filing of complaints to facilitate registering of complaints through on-line or through e-mail. Further, the complainants can also appeal against the award of BO.

7.16 The Reserve Bank constituted a separate Customer Service Department in July 2006 with a view to bringing all the activities relating to customer service in banks under a single umbrella. The Reserve Bank also issued guidelines to banks on Fair Practices Code and advised them not to resort to undue harassment of customers in matters pertaining to recovery of loans. In order to ensure transparency in banking services, banks were advised in May 2006 to display and update, on their websites, the details of various service charges in the prescribed format. The format could be modified depending on products offered and all service charges, as indicated in the format, should be covered. The Reserve Bank is now in the process of finalising a scheme for ensuring reasonableness of bank charges.

7.17 In an endeavour towards improving customer service, the Reserve Bank has been looking into state specific requirements. Thus, in order to address the problems of small traders, businessmen and the general public, the Reserve Bank constituted a Task Force to accelerate resolution of relief measures to *Tsunami* affected borrowers in the Union Territory of Andaman and Nicobar Islands. Similarly, separate Working Groups were constituted to examine the problems/ issues relating to banking services in Uttaranchal and Chattisgarh, and to prepare an action plan for implementation.

7.18 The Reserve Bank has been seriously concerned with regard to the banking practices that tend to exclude vast sections of population. The All-India Debt and Investment Survey (2002) suggests that the dependence of households on institutional finance declined from 64 per cent in 1991 to 57 per cent by 2002 in rural areas, while it increased from 72 per cent to 75 per cent in the urban areas. Rural landlords and moneylenders accounted for over 30 per cent of the household debt compared with 18 per cent in 1991. Thus, notwithstanding the outreach of the banking sector, the formal credit system has not been able to adequately penetrate into informal financial markets. In the past few years, therefore, the Reserve Bank has been advising banks to review their existing practices with a view to aligning them with the objective of financial inclusion. Banks were advised to make available a basic banking ëno-frillsí account either with ënilí or very low balances as well as charges that would make such accounts accessible to vast sections of the population. Banks were also advised to give wide publicity to the facility of such ëno-frillsí accounts. According to the information available with the Reserve Bank, about 5,00,000 ëno-frillsí accounts have been opened, of which about two-third are with the public sector and one-third with the private sector banks.

7.19 With the objective of ensuring greater financial inclusion and increasing the outreach of the banking sector, banks have also been allowed to use the services of Non-Government Organisations/Self-Help Groups/Micro-Finance Institutions/Civil Society Organisations, as intermediaries in providing financial and banking services through the use of business facilitator and business correspondent models. Banks were also advised to adopt a flexible approach with the parameters of ëKYCí norms from time to time. The Reserve Bank has directed banks to make available all printed material used by retail customers in English, Hindi and the concerned regional language. With a view to providing hassle free credit to customers, banks were encouraged to issue GCC akin to *Kisan* credit cards.

7.20 As part of ongoing efforts to encourage greater financial inclusion, particular attention has also been paid to issues relating to farmers. A Working Group has been constituted to ensure greater outreach of banking facilities in rural areas and to ensure availability of bank finance at reasonable rates. The convenors of the State Level Bankers Committee in all States/Union Territories have been advised to identify at least one district in their area for achieving 100 per cent financial inclusion by providing a ëno-frillsí account and a general purpose credit card. A Technical Group has also been set up to review the existing legislative framework governing money lending and its enforcement machinery so as to provide for greater credit penetration by the financial sector in the rural areas at reasonable rates of interest.

7.21 While resource limitations experienced by low-income households will continue to constrain their access and use of financial products, the challenge remains for developing appropriate policies, procedures and products that can overcome this difficulty within the bounds of resource constraints. One area that calls for greater latitude in this regard is the range of identity documents that are acceptable to open an account with a bank. Keeping this in view, the Reserve Bank, in its Mid-term Review for 2006-07 released in October 2006, relaxed the KYC procedure for small accounts. It was proposed that for opening small accounts, banks need to seek only a photograph of the account holder and self-certification of address. However, some prudent limits were fixed for transactions and outstanding balances beyond which banks are required to follow normal procedure of KYC. The Reserve Bank will also issue certain clarifications in respect of conduct of the KYC procedure for normal accounts so as to make it more customer-friendly.

7.22 In recent years, there has been a significant growth and development of micro-finance activities. Self-Help Groups (SHGs) formed by non-Government organisations and financed by banks represent an important element of this development process in India. However, the micro-finance programme has also brought in various associated non-financial activities under its fold. Time has, therefore, arrived for older and mature SHGs to graduate into micro enterprises by taking to income generating activities. There is also a need for the programme to expand in those states where it is yet at a nascent stage. It is also important to develop a proper regulatory structure for micro-finance institutions for healthy growth of the sector along with supportive refinance and capacity building measures.

7.23 The experience of developed countries suggests that the level of financial inclusion increases with rising prosperity and declining income inequality. However, there are a number of barriers that can come in the way of achieving banking for all. It is, therefore, a continuous challenge for policymakers to identify ways in which these barriers can be minimised. First, there is a need for independent information and advisory service. Lack of knowledge of financial products deters some households from taking up financial services. Second, nurturing appropriate public-private partnership remains a challenge. Third, solutions to banking exclusion need to involve more intensive use of technological developments not only to contain costs but also to enable wider geographical access. Finally, there is a need to monitor whether financial exclusion is replaced by marginalisation. In other words, people are offered products and methods of delivery that are either unable to fulfil their requirements or are not equipped to integrate them into the mainstream of financial services.

Banking Expansion

7.24 As the economy begins to grow rapidly and an increasing number of people migrate out of the poverty levels, the rate of financial intermediation of savings is expected to increase further. In other words, the banking system will have to intermediate a larger quantum of funds than is presently the case. In India, the ratio of bank assets or bank deposits to GDP is among the lowest in the world, notwithstanding some increase in recent years. As banking expansion takes place, the ratio of deposits to GDP first rises and then begins to decline as high-rated corporates begin to successfully tap the capital market. Given the prudential requirements associated with raising capital through equity issues and inadequately developed private corporate debt market, the rural sector and small and medium enterprises would continue to depend on bank finance to a significant extent. This, in effect, provides a lot of room for credit expansion to financing varied and multifaceted activities in the rural areas.

7.25 In the current situation of high credit expansion, banks have been unwinding their surplus investments in SLR securities, over and above the stipulated statutory minimum. This unwinding would soon reach a limit. Therefore, banks need to make sustained efforts towards mobilising stable retail deposits by extending banking facilities and wide-spreading its deposit base. The rural areas are also not being served adequately. Banks would need to devise imaginative ways to mop up the resources in rural areas if they are to balance their deposit mobilisation and credit creation.

7.26 In dealing with the new demands of rural enterprises and that of SMEs in urban areas, banks need to innovate and look for modern delivery mechanisms that economise on transaction costs and provide better access to the currently under-served. Innovative channels for credit delivery for serving these new rural credit needs, encompassing full supply chain financing, covering storage, warehousing, processing, and transportation from farm to market will have to be found. Banks would be required to invest in fresh skills through new recruitment and through intensive training of existing personnel.

Implementation of Basel II

7.27 With a view to facilitating gradual convergence of prudential norms for the banking sector with international best practices, commercial banks in India were advised to implement Basel II with effect from March 31, 2007. Taking into account the state of preparedness of the banking system, however, it was decided to provide banks some more time to put in place appropriate systems so as to ensure full compliance with Basel II. In terms of the new timeframe, foreign banks operating in India and Indian banks having presence outside India are required to migrate to the standardised approach for credit risk and the basic indicator approach for operational risk under Basel II with effect from March 31, 2008. All other scheduled commercial banks are encouraged to migrate to these approaches under Basel II in alignment with them but in any case not later than March 31, 2009. The Reserve Bank is committed to the adoption of Basel II by banks and will guide the smooth implementation of Basel II.

7.28 Compared to Basel I, Basel II is considered to be highly complex. The complexity of Basel II arises from several options available, making its understanding and implementation a challenge to both the regulatory and the regulated community. However, as Basel II is more sensitive to risk, it allows banks to utilise capital more efficiently and also provides direct incentives for stronger corporate governance and greater transparency.

7.29 With a view to ensuring smooth migration to Basel II, a consultative and participative approach has been adopted for both - designing and implementing Basel II. Implementation of Basel II will require more capital for banks in India due to the fact that operational risk is not captured under Basel I, and the capital charge for market risk was not prescribed until recently. Preliminary analysis indicates that the combined capital adequacy ratio of select banks is expected to come down by about 100 basis points when these banks apply Basel II norms. These estimates are based on eleven banks accounting for about 50 per cent of market share (by assets) which participated in the Quantitative Impact Study (QIS 5) conducted by the Basel Committee on Banking Supervision. The estimates revealed that although none of the eleven banks would be breaching the minimum capital adequacy ratio under the new framework, the net impact reflects a wide range. The banking system on the whole with a capital to risk assets ratio (CRAR) of over 12 per cent is comfortably placed, especially when 78 out of 84 banks had CRAR more than 10 per cent. While banks are exploring various avenues for meeting the capital requirements under Basel II, the Reserve Bank has, on its part, issued policy guidelines enabling issue of several instruments by banks, *viz.*, innovative perpetual debt instruments, perpetual non-cumulative preference shares, redeemable cumulative preference shares and hybrid debt instruments to enhance their capital raising options. The Reserve Bank is also involved in capacity building for ensuring the regulatorís ability for identifying and permitting eligible banks to adopt Internal Rating Based (IRB)/Advanced Measurement approaches.

7.30 Taking into account the size and complexity of operations of the banking system [commercial (public, private, foreign) and co-operative banks; single and multiple state co-operative banks; duality of control; and deposit taking non-banking companies], the capital adequacy norms applicable to these entities have been maintained at varying levels of stringency. A three-track approach has been adopted with regard to capital adequacy. On the first track, commercial banks would be required to maintain capital for both credit and operational risks as per Basel II framework. Commercial banks are already required to maintain capital for market risk as per Basel I framework; capital charge for market risk has not been modified under Basel II. The co-operative banks, on the second track, are required to maintain capital for credit risk as per Basel I framework and through surrogates for market risk; and the regional rural banks, on the third track, have a minimum capital requirement. Thus, a major segment of systemic importance will be on a full Basel II framework, a portion of the minor segment partly on Basel I framework, and a smaller segment on a non-Basel framework. A somewhat similar choice has been exercised even in the US where one is likely to see at least Basel II and Basel I-A entities operating simultaneously. Similarly, amongst the Basel II entities in the US, it is likely that banks will be implementing various combinations of the multiple options available for computing capital requirements for the three major risks. Consequently, Basel II implementation may follow as a part of a spectrum of frameworks within which there can be progressive enhancement of quality amongst different categories.

7.31 Risk management has assumed added significance in the context of Basel II. Financial entities have become increasingly conscious about risk management practices and have instituted risk management models based on their product profiles, business philosophy and customer orientation. It is likely that on implementation of Basel II, some banks might adopt the IRB approach for credit risk, while some other banks in the same jurisdiction might adopt the standardised approach. Since the IRB approach is more risk sensitive *vis-‡-vis* the standardised approach, a small change in the degree of risk could result in a large additional capital requirement for the banks following the IRB approach - which would dissuade such banks from assuming high-risk exposures.

NPA Management

7.32 One of the major achievements of the Indian banking sector in recent years has been the reduction in non-performing assets (NPAs). Gross NPAs have declined sharply to close to 3.0 per cent (15.7 per cent at end-March 1997). Net NPAs of the banking sector are now at close to one per cent and the gap between the gross and net NPAs has narrowed over the years. Recovery of dues is also more than the fresh slippages. NPAs of the Indian banking system are now comparable to several advanced economies and significantly lower than several economies in the Asian region. The decline in NPAs is particularly significant as income recognition, asset classification and provisioning norms were tightened over the years. For instance, banks now follow 90-day delinquency norm as against 180-day earlier. An asset is now treated as ëdoubtfulí if it remains unpaid for more than 120 days instead of 180 days earlier. Banks are also required to make general provisioning (0.40 per cent) for standard advances, barring banksí direct advances to agricultural and SME sector. The general provisioning requirement is 1.0 per cent for certain sensitive sectors. Improved profitability, underpinned by robust macroeconomic environment and upturn in interest rate cycle, has enabled banks to reduce the backlog of NPAs. Improvement in the credit appraisal process and new institutional mechanisms created by the Government and the Reserve Bank for resolution of NPAs (including enactment of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002; *Lok Adalats;* debt recovery tribunals; and corporate debt restructuring mechanism) have also played a significant role.

7.33 Although asset quality in the banking system has improved considerably over the years, banks need to guard against any deterioration of credit quality, particularly in the wake of significant expansion of credit. Banks need to have a comprehensive system in which the process of risk monitoring is combined with proper risk assessment. This would entail creation and maintenance of an appropriate data base on risk assessment and credit extended, which would be required to be updated periodically. The enactment of the Credit Information Companies (Regulation) Act is an important development in this regard. As the Reserve Bank issues guidelines for such companies to be formed, the availability of credit information to banks can be expected to increase over time. This should help significantly in risk assessment and monitoring, thereby leading to lower transaction costs.

Corporate Governance

7.34 A strong financial system is premised on principles of sound corporate governance. Corporate governance lays down the fundamental rules by which companies are governed in their management. Each institution needs to evolve its own governance principles based on its changing business philosophy over a period of time. These principles would have to be adapted in line with the changing circumstances. The quality of corporate governance has become particularly important in the banking system in view of growing competition and consolidation of the banking system.

7.35 The banking sector in India is quite large and widespread across the country. There are several banks of varying sizes and the shareholding pattern also varies significantly. The issues of size and governance are extremely important from the point of view of financial stability. The two major concerns that arise in the context of corporate governance in banks are concentration of ownership and the quality of management that controls the bank. The recent irregularities involving accounting firms in the US have amply demonstrated the importance of good corporate governance practices. The quality of corporate governance in banks assumes critical importance as competition intensifies and banks strive to retain their client base.

7.36 Corporate governance in banks has improved significantly over the years. As part of its efforts to promote sound corporate governance, the Reserve Bank has been focusing on ensuring ëfit and properí owners and directors of banks and laying stress on diversified ownership. Banks have been advised to ensure that a nomination committee screens the nominated and elected directors to satisfy the ëfit and properí criteria. The improved corporate governance practices would also provide an opportunity to accord greater freedom to the banksí boards and concentrate on macro risk management aspects.

Competition and Consolidation

7.37 Competition in the banking sector has been intensifying. The share of private and foreign banks in total assets increased to 27.6 per cent at end-March 2006 from 24.7 per cent at end-March 2005 and less than 10.0 per cent at the inception of reforms. The growth of new private sector banks is particularly noticeable. Increased competition has led to a significant improvement in efficiency and customer service.

7.38 The trend is towards consolidation among banks the world over. As banking business is expanding, the number of banks have been declining. The consolidation process is being driven by increasing competition and the desire to cut costs. When competition increases, banks focus on cutting cost through increased use of technology and newer range of products and services. This requires increased investment and effective use of technology, and skilled human resources. As small banks find it difficult to manage, the pressure is to become bigger through inorganic growth.

7.39 An important issue concerning the banking sector in India is consolidation. It is interesting to note that in the background of the liberalisation process, the structure of the Indian banking system has continued without much change. The consolidation process within the banking system in recent years has primarily been confined to mergers of two development finance institutions with banks and a few mergers in the private sector segment induced by the financial position of banks. The process of consolidation is now beginning to gain momentum. Since October 2005, three banks have been amalgamated. The Reserve Bank has created an enabling environment by laying down guidelines on mergers and acquisitions.

7.40 The consolidation, however, is taking place in a significant way amongst RRBs, following the initiative by the Government. RRBs are facing several problems such as constraints of timely credit availability, its high cost and neglect of small farmers and continued presence of informal lenders. RRBs are also not well capitalised and they often have high level of delinquent loans. However, there are several viable institutions among the RRBs. The problems facing the RRBs are being addressed on a priority basis and the process of revitalising them in a medium-term framework is also under way.

7.41 In order to reposition the RRBs as an effective instrument of credit delivery in the Indian financial system, the Government of India, after consultation with the State level sponsored banks, initiated amalgamation of RRBs in September 2005. Till October 31, 2006, 137 RRBs were amalgamated to form 43 new RRBs sponsored by 18 banks in 15 States, bringing down the total number of RRBs to 102 from 196. The amalgamation process is still continuing. After amalgamation, RRBs would become bigger in size with a larger area of operation, which would enable them to function in a competitive environment more effectively by taking advantage of economies of scale and reducing transaction costs.

Changing Institutional Focus

7.42 Following the liberalisation of the licensing norms, many urban co-operative banks had fallen sick and were placed under direction/liquidation. The sector has shown several weaknesses, including poor financial health, low capitalisation, governance and managerial failures, and lack of professionally qualified staff. Weak enforcement of regulatory and supervisory oversight arising out of dual control has been identified as the most significant challenge for revival of the sector. Consultative approach of policy formulation through the signing of MoU with the State Governments, therefore, has been guiding the process of reviving these institutions in recent years.

7.43 Several structural, legislative and regulatory measures were initiated for urban co-operative banks in recent years with a view to evolving a policy framework oriented towards revival and healthy growth of the sector. The ëVision Document for UCBsí and the ëMedium-Term Framework for UCBsí provided the vision and implementable action plan in this regard. Consequently, memoranda of understanding (MoU) are being entered into with the State Governments. A Task Force for Urban Co-operative Banks (TAFCUB) is also being constituted in each of these States to identify viable/weak UCBs and to strengthen/revive them while suggesting a non-disruptive exit for the non-viable UCBs. The regulatory policy is also being attuned to enhance the capacity of smaller UCBs to align with higher prudential standards.

7.44 Parallel to the initiatives for the UCBs, major revival attempts were also initiated in the rural co-operative banking sector. The Task Force on Revival of Rural Co-operative Credit Institutions constituted by the Government of India (Chairman: Prof. A. Vaidyanathan) to formulate a practical and implementable action plan to rejuvenate the rural co-operatives is one of the most significant measures in this regard. Consequently, a revival package for short-term co-operative credit structure has been formulated and it is being implemented through the mechanism of National Implementation Monitoring Committee (NIMC) in consultation with the State Governments. NABARD has also initiated several capacity building initiatives in consonance with the revival plan. The same Task Force also has submitted its report for revival of long-term co-operative credit institutions which has been placed in the public domain.

Banking and Technology

7.45 Information Technology (IT) has made steady inroads into the financial sector. In fact, IT has brought about a significant change in many aspects relating to financial stability. Banks, customers and the regulators have benefited alike from the increasing use of information technology by the banking sector. Computerisation of transaction processing at banks has enabled the availability of audit trails which could be used for analysis. The greatest beneficiary of use of IT in the banking sector is the payments and settlement systems. With the migration of traditional paper-based funds movement to quick and more efficient electronic modes, funds transfers have become easy and efficient to perform. More importantly, these systems have ensured settlement finality being achieved within time frames which are much smaller than was possible under the manual system. Quicker funds settlement has a direct impact on availability of money, which has a positive impact on liquidity management.

7.46 IT has provided for better asset-liability management, which was a relatively difficult task in a manual based system spanning a large number of branches of banks, geographically spread across the country. This has helped banks in better funds management, thereby improving profitability for banks. IT has also improved information availability as also their timeliness. Concepts such as core banking systems, internet banking, anytime banking and anywhere banking have all been made possible with the help of IT. All these have made banking transactions to be performed in a manner, which is beneficial not only for the customer and his banker but for the economy as a whole.

7.47 The Financial Sector Technology Vision document provides a broad overview of the thrust areas of the direction provided by the Reserve Bank in respect of IT for the financial sector for more than two decades and sets out a roadmap for 2005-08. The Vision document focuses on four major areas, *viz.*, IT for regulation and supervision, IT and Institute for Development and Research in Banking Technology (IDRBT), IT for the Financial Sector and IT for Government related functions. The Vision document envisages: (i) emerging challenges in achieving standardisation across a variety of hybrid systems at different financial entities; (ii) need for decision support systems; and (iii) the requisite technology to facilitate risk based off-site supervision. The Vision document visualises the IDRBT to be a premier research institute, concentrating on research and development for the banking and financial sector, providing educational/training facilities. The Vision document proposes that specific attention would be devoted to percolation of technology efforts to all types of banks and all sections of customers in the banks with specific reference to the rural areas. It also emphasises the use of affordable technology products which can be easily used by the target clientele with inter-shareable resources. The document also details the use of IT in the Government sector transactions (which has the largest potential to grow significantly in the years to come) with specific attention on the need for business process re-engineering and changes in rules and procedures for aligning them with e-governance in a manner so as to achieve implementable objectives.

7.48 In India, the spread of the RTGS system has been very rapid in comparison with other countries. While the payment system is cheque dominated in the US and the UK, in continental Europe it is mainly through the electronic mechanism. In view of the existing IT capabilities in India, it should be possible to leverage this capability in reducing transaction costs within the banking system and furthering the cause of financial inclusion.

Primary Dealers

7.49 In terms of the Fiscal Responsibility and Budget Management Act, 2003, the Reserve Bank is prohibited from participating in the primary issuance process of Central Government securities from April 2006. In this context, effective institutional arrangements are required to ensure that debt management objectives are met and that the Government is able to borrow under all market conditions without exacerbating market volatility. Since the Reserve Bank can no longer act as the underwriter of last resort, the responsibility of ensuring full subscription to the primary issuance has fallen upon the primary dealers (PDs). The Reserve Bank has, therefore, been working towards enabling the PDs to cope with interest rate cycles by giving them greater flexibility in operations. The multi-pronged approach in this direction includes measures such as allowing intra-day short sales in Government securities; introduction of ìwhen issuedî trading; allowing PDs to diversify their activities and generate alternative streams of income; revamping the system of underwriting; and allowing financially healthy commercial banks to undertake PD activity. It is expected that such steps would enhance the market making role of PDs and enable them to make the Government securities market more efficient as well as widen the investor base.

Non-Banking Financial Companies

7.50 Non-banking financial companies (NBFCs) play a crucial role in extending financial services, enhancing competition and diversification of the financial sector. In recent years, the deposit taking NBFCs and deposits held by them have come down and the emerging trend indicates a shift in resources from deposits raised by them. However, the prime concern of the Reserve Bank in the current scenario is the protection of interest of depositors in the case of deposit taking NBFCs. Keeping this in view, discretionary investments in respect of RNBCs are being phased out and from April 1, 2007, all liabilities of RNBCs to the depositors would be required to be invested in directed investments only. In the medium to long run, the Reserve Bank aims to streamline the reporting mechanism, improve the quality of surveillance and strengthen the viability of the sector.