Chapter VII

Perspectives

7.1 Financial sector reforms introduced in India since the early 1990s have had a profound impact on the functioning of commercial banks, which are systemically the most important segment of the Indian banking system. As a result of various reform measures initiated by the Government and the Reserve Bank, the banking system in India has become strong, healthy, dynamic and resilient – a necessary condition for sustained economic growth and financial stability. After having transformed the commercial banking sector, the focus in recent years has shifted to other institutions in the financial system such as regional rural banks (RRBs), urban co-operative banks (UCBs) and rural co-operative banks. As these institutions play a crucial role in broadening the access of financial services to various sections of society, they have assumed added significance in the context of recent policy thrust on financial inclusion.

7.2 The major challenge for banks in India is to raise enough resources for meeting the demands of a growing economy. Most of business of banks in India is still concentrated in a few urban centres. To mitigate this problem, since 2006, opening of new branches for any bank is approved by the Reserve Bank only on condition that at least half of such new branches are opened in under-banked areas as notified by the Reserve Bank. Many banks now find that the branches in semi-urban and rural areas are also commercially viable. The Reserve Bank, in recent years, has also focussed on democratisation of the financial sector with the aim of ensuring hundred per cent financial inclusion. The Reserve Bank has also made a beginning to enhance financial literacy and impart financial education to enable vast numbers of new entrants into employment and higher incomes to better manage their finances in a rapidly marketising financial sector. There are also some States where the credit-deposit ratio is observed to be low. Already some area-specific action plans for accelerated financial deepening have been drawn up with full participation of the State Governments, banks and other local development agencies. The Reserve Bank would continue to play a catalyst as well as a co-ordinating role, in these initiatives of growing co-operation between the States and the banking system. There remains huge potential for growth in small centres and States with low credit-deposit ratios. The challenge going forward is to increase banking penetration further. Banks, therefore, need to expand their outreach to hitherto under-banked areas/States by re-focussing their strategies and using appropriate technology and delivery channels. Information technology is critical to minimising transaction costs.

7.3 There is also a need for the banking sector to increase the flow of credit to agriculture and small scale industries. In order to address inadequate flow of credit to agriculture and small scale industries, the Reserve Bank has already modified the definition of the priority sector. The revised guidelines on priority sector were issued in April 2007. Priority sector is now restricted to advances to highly employment intensive sectors such as agriculture, small industry, educational loans for students and low cost housing.

7.4 Another challenge for banks is to raise capital from the market continuously to sustain their operations in a fast growing economy. Banks also need to be vigilant about maintaining their profitability in future. Banks' net interest margins have come under pressure in recent years. This is the outcome of increased competition and reflects an improvement in the efficiency of the banking sector. However, the impact of reduced margins on the profitability of banks has been disguised by strong volume growth in the last few years. In order to maintain their profitability in future, banks would have to contain operating costs, apart from searching for non-interest sources of income.

7.5 The financial services industry is becoming increasingly global and competition is intensifying. Globalisation, increased competition and advances in information technology are leading to product innovations. Some of the new products being introduced are complex, and it is becoming increasingly difficult to determine as to where the risk lies in such products. The challenge for banks is to institute appropriate risk management

systems to manage such risks and for the Reserve Bank to understand the changing forms of risk and adapt its regulatory and supervisory responsibilities appropriately while maintaining financial stability.

Credit Delivery and Pricing

7.6 The high credit growth witnessed during 2003-04 to 2005-06, continued during 2006-07, *albeit* with some moderation. Rapid credit growth in 2006-07 was facilitated by robust deposit growth, unlike the previous year when banks had to liquidate Government securities to fund credit growth. Although banks made incremental investments in Government and other approved securities during 2006-07, such investments did not keep pace with the expansion in net demand time liabilities (NDTL). As a result, SLR holdings as percentage of NDTL declined to 28.0 per cent at end-March 2007 from 31.3 per cent at end-March 2006 and peak of 42.7 per cent as on April 16, 2004. Thus, the excess holdings of SLR portfolio built up in the mid-1990s have been considerably offloaded to a large extent during the last three years.

7.7 The Reserve Bank in the last few years had used prudential tools such as increasing the risk weights and provisioning requirements to moderate the credit flow to certain sectors and protect the asset quality of banks. This strategy has worked as credit to commercial real estate and personal loans has moderated, even as the credit growth of commercial real estate was still high. The slowdown in credit during 2006-07 was spread across sectors, *i.e.*, agriculture, industry, personal loans and other services. However, credit to the SSI sector accelerated, which is a positive development. Although credit to agriculture slowed down, it still grew faster than the overall credit.

7.8 Latest information on sectoral deployment of bank credit during 2007-08 (up to August 17, 2007) suggests that while there is moderation in credit growth across all the major sectors, there is some re-balancing in the sectoral allocation of credit in favour of agriculture and industry. In response to prudential and other measures taken by the Reserve Bank during 2006-07 in respect of sectors which registered rapid credit growth such as real estate, housing, personal loans including credit cards, growth of bank credit to these sectors has decelerated further significantly. Bank credit to other fast growing sectors such as computer software, trade and transport operators also moderated. Within the industrial sector, credit expansion to the infrastructure, metals and textiles sectors, in particular, has been strong. Banks have a role to play in meeting the medium and long-term funding requirements of the economy. However, at the same time, banks need to ensure that such lending operations do not result in asset-liability mismatches.

7.9 The Reserve Bank continued to take measures to increase the flow of credit to the agricultural sector. The procedures and processes for obtaining agricultural loans by scheduled commercial banks (including RRBs) were reviewed. Banks were advised to dispense with the requirement of 'no dues' certificate (NDC) for small loans up to Rs.50,000 for small and marginal farmers, share-croppers and instead, obtain a self-declaration from the borrower. Banks were also advised to accept certificates provided by local administration/*panchayati raj* institutions in the case of landless labourers, share-croppers and oral lessees. In order to assist distressed farmers whose accounts had earlier been rescheduled/converted on account of natural calamities, as also farmers who had defaulted on their loans due to circumstances beyond their control, banks were advised to frame transparent one-time settlement (OTS) policies for such farmers. It is also proposed to consider a credit guarantee scheme for distressed farmers.

7.10 In line with the changing needs of society, the scope and definition of the priority sector have been continuously refined in the last few years. Revised guidelines on lending to the priority sector were released on April 30, 2007 to ensure adequate flow of bank credit to those sectors of society/economy that impact large segments of the population, the weaker sections and the sectors which are employment-intensive such as agriculture and tiny and small enterprises.

7.11 The small and medium enterprises (SME) sector constitutes an important segment of the Indian economy. However, bank credit to this important segment had stagnated. The Reserve Bank, therefore, initiated several measures in the recent past to increase the flow of credit to this important sector. These efforts have yielded some results as credit to the SME sector has increased noticeably in recent years. Even during 2006-07, when there was a moderation in credit to all other sectors, credit to the SSI sector accelerated.

7.12 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. Individuals may also not be able to articulate their financial situation adequately to the banks. Furthermore, some of the products being developed are complex and difficult for consumers to understand. Some consumers may also take loans that are inappropriate and expensive. Credit counselling centres can mitigate such problems to a large extent. It is encouraging that some banks have already initiated efforts in this direction.

7.13 In recognition of the fact that financial and livelihood counselling are important for increasing the viability of credit, the Reserve Bank in the Annual Policy Statement for the year 2007-08 advised State Level Bankers' Committee convenor banks to set up, on a pilot basis, a financial literacy-cum-counselling centre in any one district. Based on the experience gained, the concerned lead banks may set up such centres in other districts.

7.14 Considering that high indebtedness to money lenders could be an important reason for distress of farmers, a Technical Group as announced in the Annual Policy Statement for the year 2006-07, was set up to review the efficacy of the existing legislative framework governing money lending and its enforcement machinery in different States and make recommendations to the State Governments for improving the legal and enforcement framework in the interest of rural households. The Group submitted its report on July 24, 2007, which has been placed in the public domain for comments from the stakeholders, and forwarded to the State Governments for appropriate action as may be considered necessary.

7.15 The continued high credit demand during the year (2006-07) exerted some upward pressure on lending rates as well as deposit rates of banks. Accordingly, interest rates hardened across various maturity spectrum on both the liability and the asset sides of banks. Reflecting these trends, during 2006-07, the range of BPLRs of PSBs, private sector banks and foreign banks hardened in the range of 100-250 basis points. Though the Reserve Bank has been advising banks to evolve their own BPLR by taking into account the cost of funds, transaction cost and reasonable cover for the risk, the fixation of the BPLR continues to be more arbitrary than rule-based. This was reflected in the sub-PLR lending, the share of which in total lending of commercial banks increased to 79.0 per cent of total outstanding advances above Rs.2 lakh at end-March 2007 from 69.0 per cent at end-March 2006. Lending below the BPLR has several implications. First, it lacks transparency and, hence, affects both lenders and borrowers. Second, to compensate for sub-BPLR lending, other segments are charged higher rate of interest, thus, leading to cross subsidisation of the economically well-off borrowers by the economically poor borrowers.

Financial Inclusion

7.16 Financial markets are characterised by asymmetric information which may not only impinge the price but also the market clearing process. Such market failure in the context of financial exclusion may arise from both the banks and customers. While banks may not accurately assess potential profitability among the financially excluded, potential customers may be dissuaded from approaching the banks fearing refusal of access to mainstream financial services. Hence, Governments in many countries have taken specific regulatory and supervisory measures to promote financial inclusion. To avoid any adverse impact on the profitability of banks, these measures centred around providing 'no-frills' or 'basic bank' accounts to every individual approaching them. These accounts provide minimum or basic banking facilities to the account holders at low or minimum costs to banks. The other major initiative taken in this context is the formulation of general banking code, a voluntary arrangement amongst banks without any formal charters, which commits banks to inform people about basic bank accounts.

7.17 The focus of the Reserve Bank's recent policy initiatives has been to promote financial inclusion by providing basic banking services to the common person. The Reserve Bank's broad approach to financial inclusion aims at 'connecting people' with the banking system and not just credit dispensation; giving people access to the payment system; and articulating financial inclusion as a viable business model and opportunity.

7.18 Micro-finance has been recognised as a tool for extending banking services to the poor and the needy and for poverty alleviation. The Reserve Bank has been making efforts since 1992 to create an environment for orderly development of micro-finance recognising its potential to positively influence the upliftment of the poor. A joint fact-finding study conducted by the Reserve Bank in May 2006 with a few major banks revealed that some of the micro-finance institutions (MFIs) financed by banks or acting as their intermediaries/ partners appeared to be (i) focussing on relatively better banked areas; (ii) trying to reach out to the same set of poor resulting in multiple lending; (iii) not engaging themselves in capacity building and empowerment of the groups to the desired extent, and improving their systems, practices and lending policies. An advisory was, therefore, issued to banks in November 2006 communicating these findings and advising them to take corrective action at their end.

7.19 Banks need to make concerted efforts to join the initiatives of the Government and the Reserve Bank for extending banking services to a wider section of the population. Apart from fulfilling the social objectives of the Government, expansion of banking services is critical in supporting the growth of banking business. Increased competition in the banking sector requires banks to mobilise resources from the untapped sources. In order to achieve this, banks need to place a greater focus on the use of technology, new products and business models. While regulators have provided the emphasis and acted as facilitators in this direction, banks need to reengineer their business processes by leveraging technology to innovate suitable products for market outreach. The use of information technology also enables banks to handle the enormous increase in the volume of transactions for millions of households for processing, credit scoring, credit record and follow-up.

Customer Services

7.20 The development of a customer centric banking practice is the corner-stone of any successful banking system. Such a system benefits all the stakeholders, *viz.*, the banks, customers and the regulators alike. For the banks, customer service is an important tool of product differentiation, customer retention and product innovation. Customer saves the costs of poor services in the form of costs of litigation, transaction cost, search cost for alternatives and cost of uncertainties. The regulator can focus on a more optimal distribution of limited regulatory and supervisory resources. Critical elements of an effective customer service delivery system would encompass easy availability of information, simplified and quick procedures, leveraging technology for product innovation and faster delivery of services, while at the same time reducing transaction costs, and an easy and speedy dispute resolution mechanism at the banks' end.

7.21 It has been the constant endeavour of the Reserve Bank to improve the quality of customer service by banks. The Reserve Bank initiated several measures during 2006-07 to protect customer's rights, enhance the quality of customer service and strengthen the grievance redressal mechanism in the Reserve Bank as well as in banks. The 'Code of Bank's Commitment to Customers' was released on July 1, 2006. The Banking Ombudsman Scheme was amended on May 24, 2007 to enable the bank customers to appeal to the Reserve Bank against not only the Awards passed by the Banking Ombudsman offices but also other decisions given by them in respect of the complaints falling within the grounds of complaints specified in the scheme. In order to facilitate easy comparison of service charges of various banks by their customers, banks were advised on July 20, 2006 to place service charges and fees on the homepage of their website at a prominent place under the title of 'service charges and fees'. The Reserve Bank had set up a Working Group to formulate a scheme for ensuring a reasonableness of bank charges. The Group in its Report submitted in August 2006 examined various issues such as basic banking/ financial services to be rendered to individual customers, the methodology adopted by banks for fixing the charges and the reasonableness of such charges. The Report has identified twenty-seven basic banking services relating to deposit accounts, loan accounts, remittance facilities and cheque collection and defined low value transactions for cheque collection and remittance up to Rs.10,000 in each case and up to US $500 for foreign exchange transactions. The Working Group also recommended that the individual customers be provided upfront and in a timely manner, the complete information on the charges

as well as the proposed changes in charges applicable to all basic services. As recommended by the Working Group, banks were advised on February 2, 2007 to lay down general principles and broad parameters to be followed by them while offering 'doorstep' services to their customers and to ensure transparency in respect of rights and obligations of customers, uniformity in approach and clearly delineate the risks involved. Banks were also advised to take suitable steps to educate their 'agents' to enable them to detect forged and mutilated notes so as to avoid frauds and disputes with the customers.

7.22 It had come to the notice of the Reserve Bank that some banks, while lending for housing, were not fully transparent in indicating the circumstances and factors governing the benchmark in respect of floating rates as well as with regard to reset clauses. Banks were, therefore, urged to review all practices which are less than fair or transparent. They were also urged to afford an opportunity to borrowers to obtain fair and transparent terms consistent with the legal requirements and fair practices.

Implementation of Basel II and Risk Management

7.23 With a view to facilitating gradual convergence of prudential norms for the banking sector with the international best practices, commercial banks in India were initially 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 subsequently 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. After two extensive rounds of consultations with all the stakeholders, the final guidelines on implementation of Basel II were issued in April 2007.

7.24 In conformity with the commitment to ensure a smooth transition to Basel II, several measures were initiated by the Reserve Bank during 2006-07. Taking into account the size, complexity of operations, relevance to the financial sector, need to ensure greater financial inclusion and the need for having an efficient delivery mechanism, the capital adequacy norms applicable to various categories of financial institutions have been maintained at varying levels of stringency.

7.25 A parallel run of the Revised Framework is being conducted by the banks, which will allow them to streamline their systems and strategies so as to ensure a smooth transition to Basel II. In order to provide additional options for raising capital funds, banks were allowed in January 2006 to augment their capital funds by issuing innovative perpetual debt instruments (IPDI) eligible for inclusion as Tier I capital and debt capital instruments eligible for inclusion as Upper Tier II capital (Upper Tier II instruments). The guidelines were reviewed and several relaxations were given in July 2006. Further, with a view to providing wider choice of instruments to Indian banks for raising Tier I and Upper Tier II capital, banks have been allowed to issue various types of preference shares, subject to extant legal provisions.

7.26 Market discipline can complement regulation in ensuring a safe and sound banking system. The purpose of market discipline as detailed in Pillar 3 in the Revised Framework on capital adequacy is to complement the minimum capital requirements under Pillar 1 and the supervisory review process under Pillar 2. The aim is to encourage market discipline by developing a set of disclosure requirements which will allow market participants to assess key pieces of information on the scope of application, capital, risk exposures, risk assessment processes, and hence the capital adequacy of the institution. Disclosures that are based on a common framework are an effective means of informing the market about a bank's exposure to the risks, besides providing a consistent and comprehensive framework for comparability. Recognising the importance of transparency of financial statements as an important tool for supervision and encouraging market discipline, the Reserve Bank has taken a number of steps from time to time to bring the disclosure standards of Indian banks closer to the international best practices.

7.27 The central message of the Basel II framework is the progressive refinement and

sophistication of the risk management configuration of the banking system. The banks with better risk management skills would not only have competitive advantage in the marketplace but would also be better positioned to capitalise on the opportunities for organic and inorganic growth. While the Basel II framework creates an enabling environment for enhancing the risk management capability in the banks by providing the right incentives, the adoption of Basel II framework also raises some issues and challenges, particularly in the Indian context.

7.28 It is often argued that the risk sensitive approach of the Basel II framework is likely to give rise to pro-cyclicality in the capital requirements of the banks since in an economic downturn, the capital requirements would rise but will decline during an economic boom. Such an impact on the banks could accentuate the effects of the cycle and could increase the volatility in the banking system inviting appropriate prudential measures.

7.29 In implementing the new framework, which requires specialised skill sets, the challenge of human resource management for the Indian banking sector would be a constraint to reckon with. The banks would, therefore, need to evolve innovative human resource management practices to be able to attract and retain the right mix of people to ensure effective operationalisation and maintenance of sophisticated risk management infrastructure.

7.30 Risk management is critically important for banks and in the emerging economic scenario, there is a greater need for banks to implement risk-based practices. In view of the growing need for banks to be able to identify, measure, monitor and control risks, appropriate risk management guidelines have been issued from time to time by the Reserve Bank, including guidelines on asset-liability management (ALM). These guidelines are intended to serve as a benchmark for banks to establish an integrated risk management system. However, banks can also develop their own systems compatible with type and size of their operations as well as risk perception and put in place a proper system for covering the existing deficiencies and the requisite upgrading. Detailed guidelines on the management of credit risk, market risk and operational risk, among others, have also been issued to banks by the Reserve Bank in the light of Basel II framework. The progress made by banks is being monitored on a monthly basis.

7.31 Globally, banks are increasingly relying on statistical models to measure and manage the financial risks to which they are exposed. These models are gaining credibility because they provide a framework for identifying, analysing, measuring, communicating and managing these risks. Since models cannot incorporate all possible risk outcomes and are generally not capable of capturing sudden and dramatic changes, banks supplement models with 'stress tests'. In tandem with developments at international level, banks in India have also initiated the use of statistical models to measure and manage risks. In terms of guidelines issued in June 2007, banks were required to put in place appropriate stress test policies and the relevant stress test framework for the various risk factors by September 30, 2007. Banks are required to ensure that their formal stress testing frameworks, which are in accordance with the guidelines, are operational from March 31, 2008.

7.32 The Reserve Bank had issued guidelines on the ALM system in 1999, which covered interest rate risk and liquidity risk measurement/ reporting framework and prudential limits. As a measure of liquidity management, banks were required to monitor their mismatches across various time buckets. Limit on mismatches in each of the first two buckets, i.e., 1-14 days and 15-28 days was prescribed at 20 per cent of the outflows. Keeping in view the international practices, the level of sophistication of banks in India and the need for a sharper assessment of liquidity management, banks were advised to adopt a more granular approach to the measurement of liquidity risk.

7.33 Credit risk is one of the material risks to which banks are exposed. Effective management of credit risk is, therefore, a critical factor in banks' risk management processes and is essential for the long-term financial health of banks. Credit risk management encompasses identification, measurement, monitoring and control of the credit risk exposures. While banks in India have developed systems and skills for identifying, measuring and monitoring their credit risk exposures, the options available to them for controlling or transferring their credit risks were limited to the traditional means, *viz.*, restricting fresh exposures, outright sale of an

existing fund based exposure, obtaining credit guarantee cover, obtaining credit insurance, and securitisation. Also, while banks have been provided with the options of managing their interest rate risk and foreign currency risks through the use of derivatives, similar option was not available for managing their credit risks. Therefore, with a view to enabling banks to control risk in a more efficient manner, it is considered appropriate to introduce credit derivatives in a calibrated manner. Accordingly, the Reserve Bank has issued draft guidelines for introducing, to begin with, single entity credit default swaps (CDS).

NPA Management

7.34 There has been significant improvement in the asset quality of the banking sector in India in recent years. Gross NPAs as percentage of gross advances steadily declined to 2.5 per cent at end-March 2007 from 15.7 per cent at end-March 1997. Net NPAs of the banking sector are now at one per cent. The gap between the gross and net NPAs has also narrowed over the years. NPAs of the Indian banking system are now comparable with 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.

7.35 In spite of best efforts and intentions, borrowers at times find themselves in financial difficulty because of factors beyond their control. In order to help the borrowers in such situations as well as to ensure the safety of the money lent by the banks, timely support through restructuring of debts in genuine cases becomes necessary. However, the prudential treatment accorded to such restructuring and delay in the implementation of the restructuring package may often come in the way of such endeavours. In order to provide a transparent mechanism for timely restructuring of debts of viable entities facing problems outside the purview of BIFR, DRT and other legal proceedings for the benefit of all concerned, guidelines applicable to restructuring/rescheduling of amounts due from borrowers, other than those (i) eligible for restructuring under the CDR mechanism; (ii) eligible for restructuring under the debt restructuring mechanism for SMEs; and (iii) restructured on account of natural calamities, are under preparation. The borrowers under the categories (i), (ii) and (iii) above are already covered by the separate existing set of guidelines.

Corporate Governance

7.36 In order to protect the overall integrity of the financial system, it is imperative that owners and managers of banks are persons of sound integrity. The two major concerns that arose in the Indian context regarding corporate governance in banks were concentration of ownership and the quality of management that controls the bank. In view of these considerations, the Reserve Bank initiated several measures to strengthen the corporate governance practices in the financial sector in India. The guidelines on 'fit and proper' criteria prescribed by the Reserve Bank in June 2004 require private sector banks to undertake a process of due diligence to determine the suitability of the person for appointment/re-appointment as a director on the board based on qualification, expertise, track record, integrity and other 'fit and proper' criteria. Keeping in view the importance of corporate governance even in public sector banks, the Government of India at the Reserve Bank's initiative, carried out amendments to the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/1980 and the State Bank of India (Subsidiary Banks) Act, 1959 to include new sections providing for applicability of 'fit and proper' criteria for elected directors on the boards of public sector banks. Necessary guidelines were issued in respect of nationalised banks in November 2007.

Competition and Consolidation

7.37 As part of economic reforms, the policy framework for the banking sector was liberalised to allow entry by domestic banks. The entry by foreign banks was also relaxed. Taking advantage of this, several new domestic and foreign banks have started operations, which have transformed the landscape of the Indian banking sector. In particular, the entry of new private sector banks and increased presence of foreign banks has intensified competition. The combined share of private and foreign banks in total assets of the banking sector increased to 29.5 per cent at end-March 2007 from 27.7 per cent at end-March 2006; their share was less than 10 per cent at the beginning of the 1990s.

7.38 In India, the process of consolidation in the first stage involved development finance institutions (DFIs). With regard to SCBs, weaker banks have merged with stronger ones. As at end-March 2007, 81 SCBs out of 82 exceeded the minimum capital adequacy prescribed; one bank which did not meet the minimum CRAR norm has since been amalgamated with another bank. Further progress in consolidation will significantly depend on developments in public sector banks.

7.39 In recent years, the process of consolidation of regional rural banks has also been initiated. With a view to strengthening them, banks were encouraged to amalgamate State-wise RRBs sponsored by them. Consequent upon the amalgamation of 147 RRBs into 46 new RRBs, sponsored by 19 banks in 17 States, effected by the Government of India since September 12, 2005, the total number of RRBs declined from 196 to 95 as on September 30, 2007. The structural consolidation of RRBs has resulted in the formation of new RRBs, which are financially stronger and bigger in size in terms of business volume and outreach. This will enable them to take advantage of the economies of scale and reduce their operational costs.

7.40 The consolidation of the UCBs through the process of merger of weak entities with stronger ones has also been set in motion by providing transparent and objective guidelines for granting no-objection to merger proposals. As on October 30, 2007, a total of 33 mergers were effected upon the issue of statutory orders by the concerned Central Registrar of Co-operative Societies/ Registrar of Co-operative Societies (CRCS/RCS).

Regulatory and Supervisory Challenges

7.41 Rapid pace of technological developments and intense competition have resulted in innovation of new products as well as new model of organisational structure. The emergence of financial conglomerates (FCs) offers new challenges to the supervisors and regulators. Aligning the operations of large financial conglomerates with local public policy priorities remains a challenge for domestic financial regulators in many emerging market economies. FCs, being exposed to two or more sector-based regulatory regimes, also lead to overlaps or gaps in the overall supervisory process. Keeping in view the emergence of a few financial conglomerates in India, the Reserve Bank has taken several initiatives in consultation with the other regulators to strengthen the FC monitoring framework for their effective supervision. Financial conglomerates are likely to assume even greater importance in the time to come, particularly in view of the enhanced tendency towards mergers and acquisitions. This would require a comprehensive framework for monitoring the operations of such institutions so that the stability of the financial system is maintained. In view of the emergence of financial conglomerates in India and that some of the players are experimenting with structures hitherto unfamiliar in India, the Reserve Bank issued a discussion paper on 'Holding Companies in Bank Groups' in September 2007 to take a review of some of the conglomerate structures and assess their sustainability for the country given the prevailing legal, regulatory and accounting framework and highlight the regulatory and supervisory concerns for the Reserve Bank emanating from such structures.

7.42 Another regulatory issue which has received greater attention in recent years pertains to dual control over UCBs. Keeping in view the role of UCBs in bridging an important gap in the credit delivery mechanism, The Reserve Bank has sought to address the problem of dual control by putting in place a consultative mechanism, *viz.*, Taskforce for Co-operative Urban Banks (TAFCUBs) based on Memorandum of Understanding (MoU) signed with the State Governments (Central Government in respect of multi-State UCBs). As of September 2007, MoU were signed with 13 State Governments and the Central Government. Accordingly, TAFCUBs comprising representatives from respective State Government, the Reserve Bank and the UCB sector have already been constituted based on these MoUs. About 83 per cent of the UCBs accounting for about 92 per cent of the total deposits are covered under the MoU arrangements.

7.43 Increase in product and process innovations in the financial services sector has generated newer and more complex risks for the banks and the financial system. The Reserve Bank, as a supervisor of the banking system, needs to constantly review the supervisory processes and upgrade its human resources and skills to address the issues arising from organisational structures, business processes and risk positions of banks. Implementation of Basel

II norms also requires the Pillar 2 process to be designed on the basis of policy shifts and changes in the supervisory reorientation. The supervisory efforts in the coming years will have to include the capacity building within the Reserve Bank and in the banks so that the risk based supervisory process seamlessly assimilates with the Pillar 2 consultative approach.

Banking and Technology

7.44 Information technology (IT) has emerged as a key business facilitator for developing new products and services. Banks in India have started to reap the benefits of IT, which commenced in a small way more than a decade ago. IT has helped in handling large transactional volumes and adapting according to the changing customer expectations, apart from providing almost real time information processing for both the banks and the customers.

7.45 While the use of IT has enabled banks to expand their businesses, it has also posed some challenges. Security, which is at the base of all IT based initiatives especially for the banking sector, has assumed high importance. The possibility of making online transactions through internet has made the financial systems the world over susceptible to misuse. Banks need to put in place additional safeguards and mechanisms to establish the identity of customers. In this regard, the common minimum requirements have been indicated by the Reserve Bank for banks to follow, which are applicable for all new IT-based systems and delivery channels.

7.46 Another major challenge in the operations based on modern technology is to ensure uninterrupted functioning of such systems. Therefore, business continuity and disaster recovery management are given due importance by the Reserve Bank. Apart from the regular and periodical disaster recovery (DR) drills of critical systems performed by the Reserve Bank for the comfort of all member banks, individual banks also conduct their own DR exercises to ensure that their systems stand the test of any unforeseen contingency.

7.47 Proper functioning of payment systems is essential to promote the efficient use of financial resources, improve financial market liquidity and facilitate the smooth conduct of monetary policy. Recognising the importance of payment systems, the Reserve Bank has already taken a number of initiatives for bringing about efficiency in the payment and settlement systems and has also been reviewing its actions on a continuous basis. The cheque truncation system is an initiative for bringing in efficiency in paper based clearing. This would facilitate the faster realisation of the cheque, *i.e.,* on T+1 or T+0 basis and reduction in frauds. This platform could also be used for speeding up the clearance of inter-city cheques. Steps are also underway to provide a separate clearing facility for the cheques drawn on core banking branches of banks so that their clearing and ultimate receipt of proceeds by the beneficiaries becomes faster. In the electronic payment systems, the implementation of RTGS and NEFT has enabled receipt of funds on a real time/near to real time basis. Though a minimum threshold amount (*i.e.* Rs. one lakh) has been prescribed for RTGS, there is no minimum or maximum threshold for NEFT and the customers have a choice based on the criticality of the payment, and the service to be used. Like in other developed countries, a national electronic clearing service for bulk payments using the retail electronic payments infrastructure created is being conceived. This would remove the geographical limitations which exist in the present electronic clearing service (ECS). It is also envisaged to bring about more efficiency in the existing electronic clearing service, by compressing the existing settlement cycle. Further, banks are being persuaded to put in place straight through processing capabilities, which would also bring about more efficiency to this system. The banks, which provide the payment services to the public at large, are making use of the infrastructure created and developing products for facilitating customers with more and more on-line payment services. Banks need to integrate the various systems as also tap the potential of the cards/ATM network for providing various services to the customers. The clearing and settlement data are being pooled at a centralised system, which would collect, collate and disseminate the relevant information for better decision making.

7.48 Sound legal framework is the base for smooth operations of the payment systems. The Reserve Bank is pursuing enactment of a separate legislation for the payment and settlement systems. The Payment and Settlement Systems Bill has been placed before the Parliament. On enactment of the Bill, no service provider will be able to operate any payment system unless either

specifically approved by the Reserve Bank, or exempted from such approval. The Bill, once enacted, would also provide legal recognition to multilateral netting that is in vogue. The Bill also provides for penal provisions for bouncing of electronic transactions on par with cheques as covered in the Negotiable Instruments Act, 1881.

Primary Dealers

7.49 The role of primary dealers has assumed added significance in the post-FRBM Act, 2003 phase, as the Reserve Bank is prohibited from subscribing to the primary securities of the Central Government from April 1, 2006. Prior to this, the Reserve Bank used to subscribe to the securities of the Central Government in primary auctions, particularly in tight liquidity conditions, so that the market borrowings programme of the Government was completed without causing any disruption in the market. In the post-FRBM phase, PDs are expected to shoulder a greater responsibility of ensuring the completion of the market borrowings programme of the Government. In view of this, the PD system was revamped by of specifying minimum underwriting commitment and additional competitive bidding of minimum 3 per cent each for all PDs so as to ensure full subscription to the notified amount.

7.50 With increased underwriting obligations, PDs are required to assess the market conditions in a more efficient manner to minimise the market risk. In order to diversify the risks inherent in the PD business, PDs were allowed to diversify their investments into corporate debt, money market, equity and securitisation instruments, subject to certain prudential limits while retaining the requirement of predominance in Government securities business. The revamped PD system is working smoothly.

Non-Banking Financial Companies

7.51 A well developed and efficiently regulated non-banking financial companies segment is an important component of a broad, balanced and efficient financial system as such institutions redistribute risks and enhance the resilience of the financial system to economic shocks. Until recently, the regulation of the NBFC sector was more oriented towards deposit-taking companies. With the increasing business size and market integration, it was felt necessary to monitor not only the deposit-taking companies but also NBFCs which are systemically important. The presence of the banks' arm in the NBFC sector provided an opportunity for regulatory arbitrage. It was, therefore, felt necessary to address this issue. In consonance with these two aspects, regulations have been fine tuned. Steps were initiated to classify the large non-deposit taking NBFCs (NBFC-ND) with asset size of Rs. 100 crore and above as systemically important NBFCs (NBFC-ND-SI) and bring them within the ambit of the rigours of regulation. NBFC-ND-SI are now required to maintain minimum CRAR and credit/ investment concentration norms. Further, in an endeavour to achieve greater transparency in the working and instil greater confidence in customers, measures have been introduced which include a 'fair practices code' for NBFCs. To avoid financial system being used as a conduit for illegal money, 'know your customer' norms and 'anti-money laundering' standards in line with the banks have been prescribed for NBFCs. The regulatory thrust has been on ensuring a more vibrant, healthy and smooth growth of the NBFC sector. The Reserve Bank issued guidelines on corporate governance for non-banking financial companies on May 8, 2007 which are expected to increase investors' confidence as also that of other stakeholders.