Chapter VIII

Perspectives

8.1 At a time when the financial system across the globe is engulfed in a deep crisis, the Indian banking system continues to show resilience. The underlying fundamentals of the Indian economy would continue to underpin the robust performance of the banking sector which remains profitable and well capitalised. The strength of the Indian banking sector reflects the well-thought out and calibrated measures undertaken over the years. Financial markets in India, however, are bearing the indirect knock-on effects of the global financial situation, reflecting the uncertainty and anxiety in the global financial markets. The Reserve Bank has injected liquidity into the system as warranted by the situation. It has been monitoring the situation on a continuous basis, and stands ready to take effective and swift action as appropriate to the evolving situation. Though substantial progress has been made towards strengthening the banking system, there is a need for further consolidating the gains keeping in view the lessons of the recent financial market turbulence.

8.2 The ongoing global financial crisis and financial market developments have highlighted several challenges confronting both the banks and the regulators. The major problems which banks and financial institutions have faced internationally are illiquid assets, capital shortages and collapse of counter-party trust. The crisis suggests that risk management and supervisory practices lagged behind financial innovations and emerging business models. The crisis underscores the extent to which the business models based on increased risk appetite and innovative and complex financial products could undermine financial health of institutions and impair financial stability. It also indicates that liquidity risks can increase manifold during a crisis and can pose serious downside risks to macroeconomic and financial stability. There is a need for regulators/supervisors to closely assess the inherent risks of new instruments.

8.3 The Reserve Bank has already put in place a system to mitigate liquidity risks at the very short-end, risks at the systemic level and at the institution level. In order to further strengthen capital requirements, the credit conversion factors, risk weights and provisioning requirements for specific off-balance sheet items, including derivatives, have been reviewed. Furthermore, in India, complex structures such as synthetic securitisation have not been permitted so far. Introduction of such products, when found appropriate, would be guided by the risk management capabilities of the system.

8.4 While the overall policy approach has been able to mitigate the potential impact of the turmoil on domestic financial markets and the economy, the increasing integration of the Indian economy and financial markets with the rest of the world, pose downside risks from these international developments. The risks arise mainly from the reversal of capital flows on a sustained medium-term basis, the projected slowdown of the global economy and from some elements of potential financial contagion. In India, the adverse effects have so far been largely felt on the equity market because of reversal of portfolio equity flows, the domestic foreign exchange market and liquidity conditions.

8.5 Banks in India need to have a mechanism for proper assessment of risks. The challenge for banks is to develop adequate skill for managing emerging risks resulting from innovations in financial products as well as technological advancements. The Reserve Bank has been encouraging banks to develop an integrated approach to managing risk and also undertake stress testing exercises, both in the context of liquidity and credit risk management. In this context, the availability of reliable data/information is crucial for both banks and regulators/supervisors of the banking system and efforts need to be made to strengthen the existing system. The Reserve Bank, as the regulator of the financial system, receives information on a regular basis from banks and other financial entities. In view of the recent global financial market turbulence, the need is to further improve the transparency and disclosure standards and corporate governance practices in India.

8.6 Though foreign banks and Indian banks with overseas presence have already migrated to Basel II, its full implementation would remain a major challenge for some time to come for both the banks and the Reserve Bank in terms of processes, infrastructure required and capacity building. In view of technological advances and greater reliance of banks on technology-based solutions, there is need for adequate safeguards against fraudulent activities. The asset quality of banks in India has improved significantly in recent years, though in 2007-08 there was an increase in NPAs in absolute terms. Efforts, therefore, need to be made by all concerned to ensure that hard earned gains in reducing NPAs are not frittered away, particularly due to some economic slowdown that is now expected in the wake of the significant global slowdown.

8.7 There are some other challenges faced by the Indian banking system. As the agricultural sector provides employment to the vast majority of the Indian population and lends critical support to the growth momentum of the economy, a major challenge for banks continues to be timely and cost-effective provision of credit to the sector. During 2004-05 to 2006-07, credit to agriculture expanded substantially. However, agricultural credit decelerated in 2007-08, which needs to be reversed. Though credit growth to micro and small enterprises increased significantly during 2007-08, the challenge is to sustain the momentum in view of the sector's critical importance to the overall economy.

Monetary Policy

8.8 The task of monetary management has always centred around managing a judicious balance between price stability, sustaining the growth momentum and maintaining financial stability. The relative emphasis across these objectives has varied from time to time, depending on the underlying macroeconomic conditions. The global financial turmoil has, however, reinforced the importance of putting special emphasis on preserving financial stability. At the same time, moderating inflation and promoting growth continue to be critical policy concerns. Accordingly, the Mid-term Review for 2008-09 (issued in October 2008) indicated that the challenge was to strike an optimal balance between preserving financial stability, maintaining price stability, anchoring inflation expectations and sustaining the growth momentum.

8.9 In India, the domestic financial markets have also been impacted by the turbulence overseas, particulary the equity markets, which have reflected the widespread risk aversion and the increase in uncertainty in the international financial environment. The liquidity crunch in the advanced countries led to significant divestments by FIIs in the Indian stock markets resulting in capital outflows from India and subdued activity in the domestic primary capital market. In the face of reversal of portfolio flows in recent months, the Reserve Bank has been managing the consequent pressure on and volatility in the exchange rate. The reduced availability of funding from international capital, both debt and equity, and the subdued domestic capital market impacted the availability of funding to certain sectors of the economy and led to increased demand for credit from the banking sector.

8.10 The Reserve Bank initiated a variety of policy measures to infuse liquidity into the system. These, *inter alia*, included 350 basis points reduction in the CRR, 250 basis points reduction in the repo rate, 100 basis points reduction in the reverse repo rate, 100 basis points reduction in the SLR to 24 per cent of NDTL, upward revisions in ceilings on interest rates on non-resident and foreign currency deposits, assurance of supply of foreign exchange to meet supply-demand gap and special term repo for a cumulative amount of Rs.60,000 crore for enabling banks to meet the funding requirements of mutual funds, NBFCs and housing finance companies. The ECB policies were further liberalised in October 2008. Foreign exchange swaps with tenure up to three months have been allowed till June 30, 2009 to provide foreign exchange liquidity to Indian banks with foreign branches or subsidiaries. The Reserve Bank announced on November 15, 2008 that it would consider proposals, under the approval route, from Indian companies for buyback of their FCCBs, provided the buyback was financed out of foreign currency resources held in India or abroad and/or out of fresh ECBs. The policy on the premature buyback of FCCBs was reviewed on December 6, 2008 and it was decided to further liberalise the procedure and consider applications for buyback, under both automatic and approval routes. Under the automatic route, the designated AD category-I banks could allow Indian companies to prematurely buyback FCCBs, subject, among others, to the conditions that the buyback value would be at a minimum discount of 15 per cent on the book value and the funds used for the buyback would be out of existing foreign currency funds held either in India or abroad and/or out of fresh ECBs. Under the approval route, buyback, among others, is subject to the conditions that it should be at a minimum discount of 25 per cent on the book value, the funds used for the buyback should be out of internal accruals and the total amount of buyback should not exceed US$ 50 million of the redemption value, per company. The Reserve Bank is monitoring developments closely and continuously and would respond swiftly and even pre-emptively to any adverse external developments impinging on domestic financial stability, price stability and growth momentum of the Indian economy.

8.11 Even as the Reserve Bank has taken steps to bolster the liquidity in the system, banks have been advised to permit drawals of sanctioned limits guided by commercial judgement. They should pay attention to maintaining credit quality which has always been a key concern of the Reserve Bank. Banks have also been advised to undertake credit appraisals on a sectoral basis, monitor loan to value ratios and calibrate their credit portfolio in tune with their asset-liability projections.

Credit Delivery and Pricing

8.12 Bank credit growth moderated during 2007-08 after showing more than 30 per cent growth during the preceding three years. To meet the high credit demand, banks reduced their excess SLR investment. The SLR investment of banks declined from more than 41 per cent of NDTL at end-March 2004 to 27.8 per cent at end-March 2008. Fundamentals of the Indian economy continue to be strong, although there are some downside risks in the short run, suggesting that the demand for credit would also remain strong. While banks need to meet all the legitimate credit requirements of industry, they have to recognise that there are also some critical sectors such as agriculture and SMEs, which do not have access to other sources of funds and are entirely dependent on the banking sector. The high growth in credit during 2004-05 to 2006-07 was broad-based in line with the expansion in economic activity across all the major sectors of the economy. During 2007-08, however, credit to agriculture and allied activities showed a deceleration whereas growth in credit to industry declined marginally. The credit to the services sector, on the other hand, continued to show a higher growth. Though credit growth to sensitive sectors moderated partly in response to the measures taken by the Reserve Bank in this regard, it continued to be high. Despite the sizeable increase in the growth of bank credit during the current financial year so far, there has been a perception of credit pressures. Constraints in access to external financing as also repricing of risks and higher spreads resulted in additional demand for domestic bank credit from corporates with attendant hardening of interest rates across the spectrum. Moreover, domestic equity markets were significantly affected by the global de-leveraging of assets and the adverse sentiments from overseas markets, which made it difficult to raise capital in the markets.

8.13 The Reserve Bank continued its efforts towards further increasing the flow of credit to the agriculture sector. The priority sector advances norms were further fine-tuned during the year. The targets and sub-targets for priority sector are now linked to the adjusted net bank credit or credit equivalent amount of off-balance sheet exposures, whichever is higher. Recognising the problem of agricultural indebtedness and the difficulties faced by the farming community, especially the small and marginal farmers, the Union Finance Minister announced a scheme for agriculture debt waiver in the Union Budget for 2008-09. The Reserve Bank and NABARD are the nodal agencies for implementation of the Agriculture Debt Waiver and Relief Scheme, 2008. The Reserve Bank has, since 2006-07, been carrying forward the Government's relief measure for agriculture in the form of interest rate subvention of 2.0 per cent for short-term production credit up to Rs.3 lakh (the Government increased the subvention for 2008-09 to 3.0 per cent in December 2008). Besides, relief measures were put in place to help the poultry industry which was affected by the outbreak of avian influenza in certain parts of the country.

8.14 Several measures were also initiated to enhance the flow of credit to the agriculture and allied sectors and other underserved sectors based on the recommendations of the various Working Groups/Committees appointed by the Reserve Bank. Banks were advised that landless labourers/share-croppers/oral lessees, who were unable to get the necessary certification from local administration, could submit affidavits regarding their occupational status. The Reserve Bank has encouraged the self-help group (SHG) mode of lending to such persons. The Reserve Bank advised banks to introduce, on a pilot basis, a new product for farmers in rain-fed areas whereby 80 per cent of the total crop loan requirement was released by way of short-term production loan and remaining 20 per cent as a 'clean credit limit' to ensure year-round liquidity on the pattern of cash credit/overdraft facility. The Reserve Bank has also been continuously making efforts to increase the flow of credit to the SMEs. The SME sector is crucial to the overall economy as it is employment-intensive and has significant export potential. The new guidelines on priority sector advances take into account the revised definition of small and micro enterprises as per the Micro, Small and Medium Enterprises Development Act, 2006. The Code of Banks' Commitment to Micro and Small Enterprise (MSE) Customers, a voluntary code aimed at easing the MSEs' access to credit, was formulated by the Banking Codes and Standards Board of India (BCSBI). The Reserve Bank is examining the recommendations made by an Advisory Committee for Rehabilitation of sick SMEs. In dealing with new consumer and production demands of rural enterprises and that of SMEs 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 rural credit needs are already being explored by some banks and financial institutions under the umbrella of financial inclusion.

8.15 The evolving macroeconomic environment and the global financial crisis have resulted in tight domestic liquidity conditions which put an upward pressure on the lending rates of banks. Lending rates of scheduled commercial banks (SCBs) across various bank groups hardened during 2007-08. Overall, there was an increase of around 75 basis points in the benchmark prime lending rates (BPLRs) of public sector banks during 2007-08. The range of actual lending rates on demand and term loans (other than export credit) for the SCBs widened to a range of 4.00-28.00 per cent in March 2008 from the range of 3.15-26.50 per cent in March 2007. The BPLR showed significant variations across bank groups. The share of sub-BPLR lending in total lending of commercial banks, excluding export credit and small loans, however, declined marginally from 78 per cent at end-March 2007 to about 76 per cent at end-March 2008. Banks should do a careful review of their lending rates based on change in the inflation outlook, the domestic liquidity conditions and their cost of funds. BPLRs exhibit upward flexibility during monetary tightening, but downward rigidity during monetary easing which impedes the monetary transmission mechanism. As such, these rigidities do not allow the benefits of easy liquidity conditions to be passed on to the borrowers.

8.16 Measures taken in November/December 2008 to encourage the flow of credit to sectors which are coming under pressure included extension of the period of pre-shipment and post-shipment rupee credit for exports by 90 days, expanding the export credit refinance facility and making the post-shipment rupee export credit interest rate applicable to overdue bills up to 180 days from the date of advance. Besides, contra-cyclical adjustments were made in provisioning norms for all types of standard assets (except in the case of direct advances to agriculture and SMEs which continue to be 0.25 per cent) and risk weights on banks' exposure to certain sectors, which were earlier increased counter-cyclically. To enhance credit delivery to the employment-intensive MSE sector, a refinance facility worth Rs.7,000 crore has been instituted for SIDBI. A similar facility worth Rs.4,000 crore is being worked out for NHB. Furthermore, loans granted by banks to housing finance companies for on-lending to individuals for purchase/construction of dwelling units (up to Rs.20 lakh per dwelling unit per family) would be classified under the priority sector up to March 31, 2010, subject to conditions.

Financial Inclusion

8.17 Access to safe, easy and affordable credit and other financial services by the poor and vulnerable groups, disadvantaged areas and lagging sectors is recognised as a pre-condition for accelerating growth and reducing income disparities and poverty. Access to a well-functioning financial system, by creating equal opportunities, enables economically and socially excluded people to integrate better into the economy and actively contribute to development and protect themselves against economic shocks. To achieve the objective of financial inclusion, banks need to increase the banking outreach to the remote corners of the country, with affordable infrastructure, low operational costs and use of technology, thereby making the small transactions economically viable. Banks have been urged to scale up their financial inclusion efforts by utilising appropriate technology, which is highly secure, amenable to audit and follow widely accepted open standards to allow inter-operability among the different systems adopted by different banks. A few banks have already initiated certain pilot projects in some parts of the country utilising smart cards/ mobile technology to extend banking services similar to those dispensed from branches.

8.18 Branchless banking through business correspondents (BCs) has become important in the area of inclusive finance. The benefits of the model to the customers include saving of their time and cost of travel to the branch, comfort in dealing with the BC as he/she is a familiar face and convenience of transacting business practically at any time of the day. The advantage for the BC is that it is an alternative source of income. The benefits for the bank are that they are able to reach out to the hitherto unreached segments and mop up rural savings at lower transaction costs. The Reserve Bank has steadily increased the number of entities that could be employed as BCs by banks. Besides covering non-governmental organisations (NGOs), micro-finance institutions (other than regular NBFCs) and other civil society organisations as intermediaries; retired bank employees, ex-servicemen, retired government employees and section 25 companies (with some attendant restrictions) have been allowed to be appointed as BCs.

8.19 Banks were allowed to classify 100 per cent of the credit outstanding under general-purpose credit cards and overdrafts up to Rs.25,000 (per account) granted against 'no-frills' accounts in rural and semi-urban areas as indirect finance to the agriculture sector under the priority sector. Banks have also been advised to set up financial literacy-*cum*-counselling centres. With a view to improving the financial well-being of the people at large, financial literacy is believed to play a critical role in equipping consumers with the knowledge required to choose from a myriad of financial products and their providers. Financial literacy could help provide individuals with the knowledge necessary to create household budgets, initiate savings plans, manage debt and make strategic investment decisions for their future.

8.20 In the Annual Policy Statement for 2007-08, it was announced that an evaluation of the progress made in the districts that have reported 100 per cent financial inclusion would be taken up by independent external agencies. The studies conducted in 26 districts in eight States revealed that although several districts were declared by the State Level Bankers' Committees as 100 per cent financially included, actual financial inclusion had not been to that extent in these districts. Further, many of the bank accounts that were opened as part of financial inclusion drive were not operated upon due mainly to distance factor and households not having regular income. In order to make financial inclusion more effective, banks would need to offer banking services much closer to the account holders apart from offering other services such as loan and insurance products. This would need to be done through a variety of channels by leveraging on technology and intermediaries.

Micro Finance

8.21 Micro finance has emerged as an important tool for credit delivery, particularly in the remote areas and for economically weaker sections of the society. However, there are several challenges confronting the sector. The progress of micro finance movement has been skewed. The movement has taken stronger roots in the southern parts of the country, while the progress in the other parts has been slow. The stronger micro finance movement in the southern part is attributable to a variety of factors such as greater presence of micro finance institutions (MFIs) and other micro finance providers, well developed network of NGOs or promotional agencies and greater availability of infrastructure support. Although significant progress has been made in recent years in non-southern States, concerted efforts need to be made by NABARD and other participating agencies to expand its SHG-bank linkage programme, which is a major micro finance programme, in the central, northern, eastern and north-eastern areas.

8.22 There have been reports from certain parts of the country that the interest rates charged by the MFIs are rather high. The cost of micro finance delivery depends upon various factors such as the cost of funds, risk and transaction cost, among others. As micro finance services are generally provided at the doorstep of the customers, the cost of operations of MFIs increase substantially. This tends to get reflected in the ultimate interest rates charged to the clients. It is also important that the interest rates structure of the institutions is simple so that the clients can understand it. MFIs should also have appropriate transparent disclosure mechanisms whereby the various costs and other charges payable by the clients are disclosed properly. In order to reduce the ultimate cost to the clients, MFIs can adopt IT enabled services which may help in reducing the operational costs and interest rates charged to borrowers.

8.23 Another area of concern is that the MFIs, which are on the growth path, face paucity of owned funds which is a critical constraint for scaling up their operations. Many of them are socially-oriented institutions and have little access to financial capital. As a result, they have high debt-equity ratios. The Micro Finance Development and Equity Fund (MFDEF), set up with NABARD, helps in meeting the equity needs of MFIs to some extent.

8.24 In comparison with earlier years, MFIs now find it relatively easier to raise loans from banks. This change came after the year 2000, when the Reserve Bank allowed banks to choose any conduit or intermediary for micro finance delivery and treat such lending as part of their priority sector lending obligations. Some private sector banks have since designed innovative products to fund MFIs and have also started viewing lending to the sector as a viable business proposition. However, banks need to work on choosing the right technologies to assess the risk of funding to MFIs. They also need to improve their capability of appraising MFIs and assessing their credit needs. Appropriate credit rating of MFIs will help in increasing the comfort level of the banking system. In this context, NABARD has introduced a scheme under which 100 per cent of the professional fee for the first rating of a MFI will be borne by it, subject to a maximum of Rs.1 lakh.

8.25 For a successful micro finance programme, the challenge is to provide financial products to clients in the form they desire. The MFIs should be able to offer flexible products according to the convenience of the clients. Flexibility can be with respect to the amount of credit, interest rates, instalments and repayment periods. Often small credit may be required a number of times, rather than a single large credit. Further, the requirement for micro enterprises may vary from that of other categories. An important area where the rural populace is dependent on informal credit providers is their unexpected credit needs for emergencies like medical expenditure, death, marriage or other social functions. Suitable micro finance products for meeting such requirements can go a long way in mitigating the dependence of such people on informal credit providers.

8.26 Owing to the fast growth of the SHG-bank linkage programme, the quality of SHGs has come under stress. This is reflected particularly in indicators such as the poor maintenance of books and accounts. The deterioration in the quality of the SHGs needs to be checked.

8.27 For several years, it was being reported that the repayment rates of loans under micro finance were above 95 per cent. In fact, the high repayment rates in this sector were considered to be the most prominent feature of micro finance. Recent data published by NABARD, however, suggest that the recoveries in the micro finance sector have not been as high as they were believed to be earlier. Under the SHG-bank linkage programme, the largest micro finance programme in the country, out of the 290 reporting banks, only about 37 per cent of banks reported recovery above 95 per cent and around 36 per cent banks reported recovery in the range of 80-94 per cent. The recovery of the remaining banks was below 80 per cent. However, when it comes to recovery by the MFIs, most MFIs had a repayment record of above 90 per cent.

8.28 The emergence of SHG federations has posed another challenge. On the one hand, such federations represent the aggregation of collective bargaining power, economies of scale and are fora for addressing social and economic issues. On the other hand, there is evidence to show that every additional tier, in addition to increasing costs, tends to weaken the primaries. However, keeping in view the beneficial aspects of federations, especially in terms of increasing the bargaining powers of the SHG members and livelihood promotion, NABARD has decided to support federations on a model neutral basis for training, capacity building and exposure visits of SHG members.

Customer Services

8.29 Liberalisation and competition lead to immense benefits, but experience has shown that consumers' interests are not necessarily accorded full protection and their grievances are not properly attended to. The Reserve Bank, as the regulator of the banking sector, has been actively engaged in improving customer service in banks. It has regularly highlighted the inadequacy in banking services available to common person and emphasised the need to benchmark the current level of service, periodically review the progress, enhance the timeliness and quality of service and rationalise the processes taking into account technological developments. The broad approach of the Reserve Bank with regard to customer service is to empower the common person where banking services are concerned and improve customer service by adopting a consultative process with banks, through the Indian Banks' Association (IBA). The focus is on encouraging the involvement of the boards of the banks, strengthening the banks' own grievance redressal machinery, insisting on transparency in all the dealings with the customers, ensuring reasonableness in pricing, promoting adherence to self-imposed codes by banks on commitments to bank customers and monitoring compliance by an independent agency, *viz.*, the BCSBI. The Reserve Bank has been actively encouraging the IBA to take initiatives in these regard.

8.30 The formation of the BCSBI has helped sharpen the customer orientation of the banking industry overall. The Board undertook an evaluation of the implementation of the Code of Banks' Commitment to Customers. As a follow-up to the recommendations of the Working Group on reasonableness of bank charges, an assessment was done of charges levied by banks for some commonly availed services. In recent years, the Reserve Bank has also emphasised protection of customer rights, right to privacy, customer confidentiality, fair practices in debt collection, lender's liability and asset repossession.

8.31 Commercial banks now have a four-fold structure in place to pay adequate attention to customer service. The Reserve Bank has in recent times taken cognisance of methods used by banks that cause harm to customers or go against basic tenets of banking. Accordingly, banks were advised about remedial measures to be adopted in each case. Some of the issues that have engaged the attention of the Reserve Bank include the engagement of recovery agents by banks, increasing recourse to telemarketing calls, non-acceptance of cash over-the-counter, deposit schemes with lock-in periods and credit card operations of banks. Instructions have been issued to offer all banking facilities to the visually challenged and facilitate opening of accounts for disabled persons by their appointed guardians, while settlement of claims in respect of missing persons has been made easier.

8.32 A major initiative in improving customer service was the re-formulation of the Banking Ombudsman Scheme, which is in operation since 1995 and was revised in 2002 and 2006. The scheme is being executed by the Banking Ombudsmen appointed by the Reserve Bank at 15 centres across the country. The scheme helped achieve expeditious and satisfactory disposal of customer complaints in a time-bound manner. At end-March 2008, 89 per cent of the complaints addressed to the Ombudsmen were effectively resolved and only 6 per cent of the complaints remained pending for more than two months. However, the customer service area faces significant challenges in the coming year. The foremost amongst these is creation of more awareness regarding the Banking Ombudsman scheme, especially in mofussil and rural areas. Service standards and transparency in public service is also an area where further improvements are on the anvil. Customer education and skill development in banks and in the offices of the Banking Ombudsman is another area that would be focussed upon in the coming years.

Basel II Implementation

8.33 India has been adopting international best practices in the area of banking regulation and supervision with a view to strengthening the banking sector. Accordingly, as a part of the banking sector reforms, India adopted the Basel norms in a phased manner 1992 onwards. In fact, India went a step further and stipulated the capital to risk-weighted assets ratio (CRAR) at 9.0 per cent as against the international norm of 8.0 per cent. Furthermore, India also prescribed the capital charge for market risk in June 2004, broadly in line with the Market Risk Amendment of 1996 to the Basel Accord of 1988.

8.34 In view of the emergence of large and complex banking institutions and with the increasing sophistication of institutions in risk management, the straitjacket system of risk weights under Basel I became less meaningful. Furthermore, improvements in credit risk measurement facilitated increased use of securitisation and credit derivatives to arbitrage those capital rules. Therefore, the Basel Committee on Banking Supervision (BCBS) introduced the new capital framework (Basel II) in June 2004, which provides a more risk-sensitive approach to determining capital requirement for banks not only for credit and market risks but also for operational risk as well as for all other material risks. The minimum capital requirements stipulated under Pillar 1 of the framework are complemented by supervisory review process (Pillar 2) and market discipline (Pillar 3). According to the timetable for implementation of Basel II framework for commercial banks, Indian banks with international presence and foreign banks operating in India migrated to Basel II on March 31, 2008. The remaining banks (except RRBs and local area banks) are to migrate by March 31, 2009.

8.35 As at end-March 2008, the overall CRAR of Indian banks, under Basel I, was 13 per cent, much above the prescribed level of 9 per cent. At the individual bank level, while the CRAR of as many as 77 banks was above 10 per cent, that of two other banks was in the range of 9-10 per cent. Overall, 41 banks migrated to Basel II norms by end-March 2008, of which 40 banks had CRAR of more than 10 per cent and one bank had close to 10 per cent.

8.36 The full implementation of the Basel II accord, even under the basic/standardised approaches, would remain a major challenge for some time to come, for both the banks and the Reserve Bank as the banking supervisor. At the banks' level, the implementation would require, *inter alia*, upgradation of the bank-wide information system through better branch-connectivity, which would entail cost and may also raise some IT-security issues. The implementation of Basel II also raises several issues relating to development of human resource skills and database management. The banks which require higher amount of capital under the Basel II framework would also need to explore various capital raising options.

8.37 The Basel II framework also offers multiple options of increasing sophistication, for computing capital requirements for the three major categories of risks. While for the present, banks are required to adopt the relatively simpler approaches available under the framework, they are likely to be permitted by the Reserve Bank to migrate to the advanced approaches envisaged under the Basel II framework, though a definite timeframe for the purpose is yet to be firmed up. Given the greater complexity of the advanced approaches, a progressive improvement in the quality of human resources in the banks, particularly for equipping them with the necessary quantitative skills, would be a pre-requisite for the migration. As under the advanced approaches, the Reserve Bank would also be required to approve the internal models of the banks, developing the required expertise within the Reserve Bank would also be a significant challenge. Under Pillar 2 of the framework, the Reserve Bank would be required to review the internal capital adequacy assessment process of the banks to ensure that the internal capital held by the banks under Pillar 2 adequately reflects all their material risk exposures. This would be a challenge for the Reserve Bank too and may require a review of its supervisory processes.

Risk Management Systems in Banks

8.38 Banks are confronted with various kinds of financial and non-financial risks *viz.*, credit, market, operational, liquidity, concentration and reputational risk, among others. These risks are highly interdependent and events that affect one area of risk can have ramifications for a range of other risk categories. Recognising the importance of risk management, the Reserve Bank has been encouraging banks to strengthen and upgrade their risk management systems with due emphasis on developing an integrated approach to managing risks. Basel II framework provides opportunities to banks to further improve their risk management systems as it provides incentives by way of capital relief to well managed banks.

8.39 The ongoing market turmoil has re-emphasised the importance of risk management, especially liquidity risk management, to the functioning of financial markets and the banking sector. The reversal in market conditions has illustrated how quickly liquidity can evaporate and that illiquidity can last for an extended period of time. Further, the financial market developments in the recent past have increased the complexity of liquidity risk faced by banks and thus its management. Since international operations are considerably ring fenced, liquidity mismatches in other jurisdictions do not immediately affect domestic liquidity position. But persistent liquidity problems in other jurisdictions could affect the overall liquidity position and solvency of banks. In terms of the asset-liability management (ALM) guidelines prescribed by the Reserve Bank to banks, their liquidity is tracked through traditional maturity or cash flow mismatches. Underlining the importance of liquidity risk management, certain changes have been initiated recently in these guidelines. In due consideration of the international practices in this regard and the need for sharper assessment and better liquidity management, the first bucket in the structural liquidity statement, *viz.*, 1-14 days has been made more granular. Banks have been advised that they may undertake dynamic liquidity management and should prepare the structural liquidity statement on a daily basis.

8.40 The Reserve Bank is examining the issue of banks establishing a more robust liquidity risk management framework that is well integrated into the bank-wide risk management process. The BCBS published 'Principles for Sound Liquidity Risk Management and Supervision' in September 2008, which materially raises standards for sound liquidity risk management. It provides detailed guidance, *inter alia*, on the importance of establishing liquidity risk tolerance, maintenance of an adequate level of liquidity through a cushion of liquid assets, identification and measurement of a full range of liquidity risks, including contingent liquidity risks, design and use of severe stress test scenarios and need for a robust and operational contingency funding plan by banks. The guidance also emphasises the importance of supervisors assessing the adequacy of a bank's liquidity risk management framework and its level of liquidity and suggests steps that supervisors should take if these are deemed inadequate. The Reserve Bank is studying the guiding principles contained in the document for early implementation. Furthermore, enhancing market and institutional resilience requires ensuring that capital and liquidity buffers by banks and financial institutions are large enough to face any internal and external shocks. This will also minimise the pro-cyclicality effect, *viz.*, the tendency of banks of glossing over risk during good times and becoming extremely risk averse during bad times.

8.41 The root of the problems for many financial institutions around the world affected by the financial markets turmoil was their inability to adequately assess the risks associated with the exposures they held. Imperfections in risk management systems as well as in risk governance proved to be substantial contributing factors to the accumulation of exposures whose long-term risk characteristics were not properly identified in advance. As such, evaluation of risk management techniques in banks as well as enhancing firm-wide oversight will be the cornerstone of the Reserve Bank's supervisory policy for some time to come.

8.42 Implementation of Basel II would ensure revision in banks' stress testing practices in the context of liquidity and credit risk management as well as addressing the weaknesses in the management of securitised assets and other off-balance sheet exposures.

Notwithstanding the important role to be played by the supervisors, the primary responsibility to address the serious weaknesses in business practices would rest with the banking institutions.

8.43 The recent crisis, as other crises in the past, also proved that asset/financial bubbles are built during times of relative economic uptrend and availability of easy credit. Poor credit standards during such periods also result in large delinquencies, thus, contributing to the crisis. During the year, the Reserve Bank had conducted supervisory review of banks' exposure to the real estate sector, capital market and advances against agricultural commodities. Regulators and supervisors will be facing such disturbances from time to time, and will have to remain vigilant. Supervisory review of the exposure of the banking system to specific sectors may become an integral part of ongoing supervision of banks.

8.44 Strengthening regulation on capital adequacy is key to promoting financial stability. Implementation of Basel II in the Indian banks is aimed at precisely achieving this objective. However, the challenge in this regard is that it needs to be seen how well prepared the banks are in this respect in terms of their ability to assess accurately the risks they are faced with, the robustness of IT infrastructure available to them for the purpose and the capital allocation process *vis-a-vis* these risks.

NPA Management

8.45 The level of NPA of the Indian banking industry has declined significantly in recent years. The improvement, generally observed across all bank groups as well as among individual banks, continued in 2007-08. At end-March 2008, net NPA level of 75 banks was less than 2 per cent and of only two banks was more than 2 per cent. During 2007-08, the gross NPAs, in absolute terms, however, increased by around 12 per cent, reversing the declining trend noticed since 2001-02. This was partly on account of the high credit growth during the period 2004-05 to 2006-07 and partly on account of hardening of interest rates as most of the housing loans are on a floating rate basis. The reduction in NPAs over the years has been the result of concerted efforts made by the Government, the Reserve Bank and banks themselves and it needs to be ensured that recent gains are not frittered away. The turbulence in the global financial markets and its likely macroeconomic impact on the Indian economy, *albeit* marginal, are likely to have adverse impact on credit risk environment. It is, therefore, critical for the strength of the banking system that fresh accretion to NPAs remain at a minimum and the recovery process of existing NPAs is expedited. In this regard, the Reserve Bank is in the process of finalising the names of companies that could commence business as credit information companies in the country and help bring about an improvement in the credit culture.

8.46 The Reserve Bank and the Government have undertaken a number of initiatives to establish a strong institutional framework to facilitate the recovery of loans. The rise in NPAs (in absolute terms) in 2007-08, however, suggests the need and scope for further improvement in the recovery mechanism. In the critical area of NPA management, banks' boards are now required to lay down policies and guidelines covering, among others, the valuation procedure to be followed to ensure that the economic value of financial assets is reasonably estimated based on the assessed cash flows arising out of repayment and recovery prospects on purchase/sale of NPAs among banks. In order to protect their balance sheets, banks are now required to work out the net present value of the estimated cash flow associated with the realisable value of the available securities while selling NPAs and in compromise settlements.

8.47 The Reserve Bank has, in a calibrated manner, introduced and revised prudential norms, risk weights and provisioning relating to sensitive sectors with the objective of ensuring asset growth with minimum volatility. In view of the recent developments in the global financial markets and for ensuring financial stability, stipulations regarding conversion factors, risk weights and provisioning requirements for specific off-balance sheet exposures of banks were revised. For the purpose of exposure norms and capital adequacy, banks are required to compute their credit exposures and credit equivalent amounts, respectively, arising on account of the interest rate and foreign exchange derivative transactions and gold using the current exposure method. Credit exposures computed as per the current marked-to-market value of the contract arising on account of the interest rate and foreign exchange derivatives transactions, and gold now attract provisioning requirements as applicable to loan assets in the standard category. In respect of derivative transactions, any amount due to a bank, which remains unpaid in cash for a period of 90 days from the specified due date for payment, is classified as NPA as per the stipulated prudential norms on income recognition, asset classification and provisioning pertaining to advances portfolio.

8.48 Keeping in view the difficulties faced by the real estate sector, the Reserve Bank, on December 6, 2008, extended the exceptional/ concessional treatment of retaining the asset classification of the restructured standard accounts in standard category to the commercial real estate exposures which are restructured up to June 30, 2009. In the face of current economic downturn, there are likely to be more instances of even viable units facing temporary cash flow problems. To address this problem, as a one time measure, the second restructuring done by banks of exposures (other than to commercial real estate, capital market and personal/consumer loans) up to June 30, 2009, would be eligible for exceptional regulatory treatment.

Financial Data Reporting System

8.49 As the regulator of the financial system, the Reserve Bank receives financial information from banks and other financial entities. The recent financial crisis underlines the critical importance of timely receipt of financial information in a standardised and transparent format and at the most disaggregated level, which would facilitate a quicker and more qualitative analysis of the financial information, thereby enabling the regulator to closely monitor the financial entities and undertake certain immediate corrective policy measures, whenever required. This would necessitate putting in place a data reporting system that has standardised accounting norms and a system that simplifies disclosures. Moreover, not just the Reserve Bank, but other financial regulators and repositories of financial information in India and across the world also need to move towards a standardised and transparent data reporting system. It would then be possible to evolve closer regulatory coordination among the various regulatory authorities at the domestic and global levels.

8.50 A culture of transparency and disclosures needs to be inculcated among the market participants through regulatory guidelines and moral suasion. The Reserve Bank has already issued guidelines on Pillar 3 (market discipline) of Basel II and it needs to be ensured that this develops into a form of management ethics within the banks, especially large and complex banks and those which are systemically important. The Reserve Bank has taken a number of steps to improve the disclosure standards of Indian banks to bring them closer to the international best practices. The disclosure norms introduced for enhancing the transparency in banking were further enhanced by requiring banks to disclose full particulars of all letters of comfort (LoCs) issued by them during the year, including their assessed financial impact, as also their assessed cumulative financial obligations under the LoCs issued by them in the past and outstanding, in its published financial statements as part of the 'notes to accounts'.

8.51 The Reserve Bank has already taken the first step in the direction of a more efficient financial data reporting system by implementing the online returns filing system (ORFS). The implementation of this system has significantly enhanced the speed of data reporting and data dissemination. With the spread of electronic technology, it would be possible for all the banks in the country to adopt the ORFS. The Reserve Bank proposes to expand the scope of the ORFS by bringing into its ambit more returns, including even the OSMOS returns in the near future. This would facilitate closer monitoring of the banking system by the Reserve Bank. The next major step towards a more efficient, standardised and transparent reporting system for financial data has been the recent adoption of the eXtensible Business Reporting Language (XBRL) by the Reserve Bank. The XBRL-based data reporting would also facilitate more accurate and reliable extraction of data. It would improve the usage as well as transparency of information received from financial entities. The Reserve Bank, to begin with, has introduced the XBRL reporting system for the Basel II reports from banks. It is in the process of extending the XBRL reporting system to a number of other returns, including the Financial Statement Reports.

Corporate Governance

8.52 The role of corporate governance in providing financial stability can hardly be over emphasised. It plays an important role in maintaining the health of the financial system and its ability to withstand economic shocks. Any weakness in corporate governance could lead to a serious crisis. It has been the endeavour of the Reserve Bank to establish a strong corporate governance culture in Indian banks. In this regard, 'fit and proper' criteria were prescribed for elected directors of private sector banks in 2004. During the year, the 'fit and proper' criteria for elected directors of nationalised banks and associate banks of the SBI were also laid down. To build in social and environmental accountability, banks have been advised to keep themselves up to date with international best practices in the areas of corporate social responsibility and sustainable development. Social and environment responsibility assumes greater importance as banking finance may sometimes be utilised for projects which have adverse impact on ecology. Banks need to pay greater attention to ensure that such projects are financed carefully as it may affect the medium to long term business prospects through inviting criticism from various agencies and consequent erosion in credibility.

8.53 To reduce the burden on boards of banks on account of the calendar of reviews to be undertaken by them and to ensure that the calendar of reviews reflects the present day concerns, the calendar items were revised in April 2008. The revised calendar items outline the critical minimum requirements of review and the bank boards will have the discretion to prescribe additional reviews to suit their requirements. The revised schedule, which is required to be in force with effect from June 2008, would be under the two heads, *viz.*, 'review of operations' and 'review of strategy'. Banks were also advised that in every board meeting, a separate time slot should be allocated for taking up strategy review for business plan – targets and achievement, review of non-fund business, human resources management, training and industrial relations, new prospective business/products lines and closure of existing business/products lines.

Derivatives Markets in India

8.54 Financial derivatives have been present in the Indian financial markets for a few decades now. The market players have been extensively using forward contracts, perhaps the oldest derivative product in the country, as a tool for hedging their exchange rate exposures. Over the years, foreign currency options, range forwards, range accruals, forward rate agreements, interest rate swaps, interest rate futures and currency futures were introduced, in a phased manner in the Indian markets, to provide a wider choice of instruments to the market players. The options and futures segments in the equity and commodity markets in India have also been functioning for some time now. Thus, derivatives as a product category have been in vogue in the Indian markets and the products have been used by a variety of market players.

8.55 However, certain categories of derivative products, such as credit derivatives, are yet to be permitted in the Indian markets. It may be recalled that the draft guidelines on credit derivatives were first issued by the Reserve Bank for public comments in March 2003. However, taking into account the status of the risk management practices then prevailing in the banking system, the issuance of final guidelines was deferred. Subsequently, it was announced in the Annual Policy Statement for 2007-08 that as a part of the gradual process of financial sector liberalisation, it was considered appropriate to introduce credit derivatives in a calibrated manner in India. Modified draft guidelines on Credit Default Swaps were, therefore, issued in May 2007. Based on the feedback received, a second draft of the guidelines was issued in October 2007, for another round of consultation. The final guidelines in this regard have, however, been held in abeyance and would take into account the experience of other countries and the lessons emerging from the current financial market turbulence.

Competition and Consolidation

8.56 With the intensification of competition through deregulation, privatisation and entry of foreign banks in the emerging markets, consolidation has become more market-driven. The Reserve Bank has been encouraging the consolidation process, wherever possible, given the inability of small banks to compete with large banks which enjoy enormous economies of scale and scope. The consolidation drive witnessed by the Indian banking industry during the past few years has gathered further momentum with the first acquisition of a subsidiary bank by a public sector bank to reap the benefits of synergy. The business, geographical, technological and personnel synergies offered by the consolidation process could act as a strong motivating factor for the banking sector in the coming future.

8.57 Despite the mergers and amalgamations that have taken place in the recent past, the competition in the banking sector has increased as mergers involved smaller banks. However, going forward, the scenario could change. The Government may have to allow public sector banks to raise capital from the market. Also, the roadmap for foreign banks is due for review in 2009. These developments, as and when they occur, would need to be monitored and guided carefully so that competitive pressures in the banking system are maintained in the interests of overall banking efficiency.

8.58 The RRBs have a vast untapped potential in providing financial services to the rural people. Recent measures taken by the

Reserve Bank, such as providing greater flexibility in operations of RRBs, allowing them greater flexibility in opening new branches subject to their making operational profits, encouraging growth in all business parameters and technological upgradation of RRBs and effecting a process of amalgamation of RRBs, are expected to strengthen these institutions. Also, the ongoing implementation of the Government of India's revival package, based on the Vaidyanathan Committee recommendations, is expected to bring the rural co-operative banks back to sound financial health. In order to strengthen the capital structure in the context of financial stability of the system, state/district central co-operative banks and RRBs were advised to disclose their level of CRAR as on March 31, 2008 in their balance sheets and thereafter every year as 'notes on accounts' to their balance sheets.

Payments and Settlement

8.59 The safety, soundness and efficiency of payment systems assume critical importance from the angle of systemic stability. The Reserve Bank has taken a number of initiatives for smooth operation and proper conduct of the payment systems. The Payment and Settlement Systems Act provides a sound legal framework and the base for efficient operation of the payment systems. The focus would be on authorising new systems based on requirement and continuing to operate those which are needed. The emphasis would be on effective oversight of the payment and settlement systems.

8.60 Smooth operation of the electronic payment systems, *viz*., real time gross settlement (RTGS) and national electronic funds transfer (NEFT), have facilitated transfer/receipt of funds on a real time/near to real time basis. National electronic clearing services (NECS) aimed at centralising the electronic clearing service operation and bringing in uniformity and efficiency to the system, has been implemented. The NECS implemented at present is only for credit transfers. NECS (debit) would be introduced subsequently, based on the experience and feedback received from member banks. To contain risk in payment systems, the focus would be on migrating all large value payments to electronic mode.

8.61 Leveraging on technology developments, the implementation of the cheque truncation system (CTS) and 'speed clearing' brought in efficiency in paper-based systems. While speed clearing has brought in faster realisation of inter-city cheques drawn on core banking solutions (CBS)-enabled branches, CTS, when used to its full potential, besides enabling speedier realisation, would facilitate multiple settlements and reduce settlement cycles, which, in turn, would reduce risk in this mode of the payment system. The availability and reach of mobile telephones, combined with its ease of use for faster transfer of funds, necessitated issue of guidelines for safe operation of this system. The infrastructure created for the various payment systems, including cards/ATMs, has opened various options for financial inclusion.

8.62 The objective of the Reserve Bank has been to standardise the procedure and processes for each payment system operated in the country. With more and more systems now dependent on use of technology, each system needs to have a proper business continuity plan (BCP). Banks, while providing various services to their customers levy service charges, which vary across banks. There is a need to rationalise and bring in uniformity in the mode and amount of service charges for various payment systems. A beginning has been made by prescribing the maximum charges which could be levied on the customer for collection of outstation cheques, as well as for NEFT and RTGS transactions. Pooling the clearing and settlement data at a centralised system, which would collect, collate and disseminate the relevant information, is under consideration.

Non-Banking Financial Companies

8.63 Financially sound, prudently governed and effectively regulated non-banking financial companies (NBFCs) can contribute to the stability and soundness of an efficient financial system as NBFCs participate actively in the financial sector and play a complementary role by offering varied financial products and dispersing risk. The shift in focus from deposit taking NBFCs (NBFCs-D) to non-deposit taking NBFCs continued during the year. NBFCs with eligibility to accept deposits can cause crisis of confidence in the case of failure to repay the deposits as and when they mature. Failure of non-deposit taking systemically important NBFCs (NBFCs-ND-SI) can trigger systemic stress. In order to strengthen both the segments to enhance their comfort levels for meeting deposit liabilities and withstand shocks, the Reserve Bank is taking proactive stance on various issues which have a direct bearing on the financial soundness and effective regulation of NBFCs.

8.64 Re-emphasising the need to strengthen the financial system in general and deposit taking entities in particular, the quantum of deposit in respect of those NBFCs-D which have not achieved minimum net owned fund of Rs.2 crore, has been frozen at the current level for protecting depositors' interest. To address the systemic concerns arising from minimal regulation in the case of NBFCs-ND-SI, requirements relating to capital adequacy, liquidity and disclosure norms were made more stringent. A reporting system on ALM discipline in respect of NBFC-ND-SI has also been prescribed for monitoring the liquidity and interest rate risks. The Reserve Bank has also prescribed off-site monitoring return for NBFCs-ND with asset base of Rs.50 crore or more but less than Rs.100 crore to make the MIS in this regard more robust and enhance information on these companies which are sizeable in number. In order to address the issue of their funding requirements, NBFCs-ND-SI were permitted to augment their capital funds by issuance of perpetual debt instruments in rupees, subject to certain conditions. To address the transient liquidity strain being faced by NBFCs-ND-SI, they were, as a temporary measure, also permitted in October 2008 to raise short-term foreign currency borrowings, under the approval route, subject to certain conditions such as end-uses of funds and maturity. A temporary facility has been introduced that allows banks to offer liquidity support to NBFCs and mutual funds through relaxation in maintenance of SLR up to 1.5 per cent of banks' NDTL.

8.65 To enable investors to make informed investment decision in security receipts (SRs), the disclosures by securitisation/ reconstruction companies in the offer document have been modified to include disclosure of date of acquisition of the assets, valuation of the assets and the interest of securitisation/asset reconstruction companies in such assets at the time of issue of the SRs. Mortgage guarantee companies have been recognised as NBFCs and a regulatory framework has been put in place for them.

8.66 The Reserve Banks' interaction with large NBFCs has been enhanced through periodic meetings and video conferencing. The regional offices of the Reserve Bank were advised to frequently interact with the companies within their jurisdiction. Such interaction, undertaken on a regular basis, would enable the Reserve Bank to take prompt action in response to problems faced by NBFCs which would facilitate healthy growth and effective regulation of the NBFC sector.

Regulatory and Supervisory Challenges

8.67 The Reserve Bank has taken several wide-ranging measures at the systemic level over the years to strengthen the regulation and supervision of the banking sector. The prudential measures taken by the Reserve Bank in recent years in anticipation of some vulnerabilities in areas such as housing, retail trade and securitisation, among others, have largely helped in protecting the Indian banking sector from the problems that have afflicted banks in advanced economies. In addition to the normal prudential requirements on banks, the Reserve Bank has also successively imposed counter-cyclical prudential measures in respect of exposures to sensitive sectors, akin to a policy of dynamic provisioning. Recognising the importance of liquidity risk management in the Indian banking system, guidelines on ALM system were also issued, besides guidance notes to banks on management of credit, market and operational risks.

8.68 The global financial system is undergoing an unprecedented crisis. While the impact on Indian banks has not been significant, the turmoil has underscored the importance of a sound, efficient and well-functioning banking system with robust risk management mechanism in place. A few Indian banks were affected, to a certain extent, mainly due to the exposure of their overseas branches and subsidiaries. In recent times, the global financial integration process has resulted in substantial increase in cross-border banking operations. While, on the one hand, the enhancement of cross-border banking operations broadens and deepens financial markets, increases the efficiency of the banking system and reduces cost of funding for the productive sectors by increasing availability of liquidity, banks are also increasingly exposed to contagion risks as financial disturbances are transmitted more easily across borders. This prompted the supervisors to have an approach of consolidated supervision of the banking system covering the entire operations of the banking group across all jurisdictions. One of the major requirements to achieve the goal is enhanced cross-border supervision and supervisory cooperation. The Reserve Bank has been supervising the overseas operations of Indian banks through off-site returns, informal interaction and exchange of information with host country supervisors and occasional on-site visits. Presently, an Internal Working Group in the Reserve Bank is examining these aspects with a view to enhancing and strengthening the existing mechanism.

8.69 The banking system is exposed to all segments of the financial market through the exposures of their subsidiaries and associates, while the number of financial conglomerates (FCs) has grown over the years. Recognising the potential of FCs to cause systemic turbulence in financial markets, the Reserve Bank had initiated a system of monitoring of FCs in June 2004. The supervisory process focusses on regulatory/supervisory arbitrage, 'non-arm’s length' dealings in the conduct of intra-group transactions and exposures, contagion or reputation effects, risks posed by unregulated entities, moral hazard associated with ‘too big to fail’ syndrome, complex and opaque corporate structures of conglomerates. Based on the experience gained, a suitable framework for monitoring and supervision of FCs is being developed.

8.70 The co-operative banking sector with more than a century of existence, plays an important role in enlarging the reach of institutional credit both from geographic and socio-economic perspectives. However, the financial health of most co-operative banks has been a cause of concern and has so far proved to be a serious handicap in reaching out to the larger population. Owing to the complex structure of the sector, the regulation and supervision of urban co-operative banks (UCBs) has been a major challenge. Recognising the importance of UCBs, the Reserve Bank in March 2005 drafted a vision document for UCBs pointing out the problem of dual control as constraining its ability to effectively deal with the weaknesses of the entities within the sector. In terms of the document, 23 State Governments and the Central Government (in case of multi-State

UCBs) so far have signed the MoUs with the Reserve Bank covering 98.6 per cent of the total number of the UCBs and representing 99.2 per cent of deposits of the sector. As part of the MoU, the State level Task Forces for Co-operative Urban Banks (TAFCUBs) have been set up to identify the potentially viable and non-viable UCBs in the State and to chart out the revival path and non-disruptive exit route for the two sets of banks, respectively. These measures instilled public confidence in the sector which is evident from the increase in their deposits for three successive years, *i.e.*, from 2005-06 to 2007-08. During 2007-08, the Reserve Bank continued with its policy of encouraging States to sign MoUs to establish a coordinated supervisory/regulatory structure, by further incentivising the scheme in the form of additional business opportunities, opening of new ATMs and conversion of exchange counters into branches, among others. The process of consolidation through mergers of UCBs progressed further during the year with a total of 54 mergers being effected upon the issue of statutory orders by the Central Registrar of Co-operative Societies/Registrar of Co-operative Societies concerned. Further, as on March 31, 2008, 269 UCBs were under various stages of liquidation. All these measures appeared to have had a positive impact on the performance of the UCBs as a whole. Their businesses expanded at impressive rates while both operating profit and net profit increased during the year.

Debt Management

8.71 In order to create a more robust and vibrant PD system, commercial banks were allowed to take up PD business as a departmental activity. Many banks have adopted this business model. This has strengthened the PD system. In 2006, PDs were permitted to diversify their activities, even while maintaining their business profile predominantly in the Government securities business. This provided an opportunity to the PDs to enter into certain permitted activities, other than Government securities business, and benefit from alternative streams of income, as a de-risking strategy. The Reserve Bank has also been taking steps to ensure that non-bank PDs are adequately capitalised and that their risk-taking is within prudential limits. In the context of the recent global financial turmoil, if the overseas parent of an Indian arm were to face solvency or liquidity problems, efforts would be made to ensure that the Indian arm is ring fenced with adequate capital and that its domestic counter-parties are not adversely affected.

Summing Up

8.72 India's financial sector is stable and healthy. Financial strength indicators such as capital adequacy and return on assets of commercial banks continue to be robust. A major challenge is how to meet the credit demand without impairing credit quality. Banks have to monitor their credit portfolios closely in the context of persisting high growth in bank credit at the system level and take corrective action as appropriate in order to prevent undue asset-liability mismatches or deterioration in the quality of credit, recognising the reality of business cycles and counter-cyclical monetary policy measures. The Reserve Bank has been monitoring the functioning of systemically important NBFCs and banks' exposure to them. In the light of international developments and increasing exposure of banks to these systemically important NBFCs, more stringent regulations in respect of capital adequacy, liquidity and disclosure norms for these entities were issued in August 2008.

8.73 Though emerging market economies, including India, do not have direct or significant exposure to stressed financial instruments and troubled financial institutions, they are facing significant indirect impact of the financial crisis. There are a number of lessons that can be drawn from the crisis. One, financial supervision should not lag behind financial innovations and emerging new business models. However, it needs to be ensured that in the process of staying ahead of innovation through continually upgrading skills and instruments for financial regulation and supervision, innovations should not be stifled. A second lesson relates to inter-agency coordination. The origins of the current crisis can be traced to both the build up of macro-global imbalances as well as the mis-pricing of risks in the financial system, which in turn, was encouraged by excess liquidity. The respective roles of central banks, regulators, supervisors and fiscal authorities regarding financial stability need to be revisited such that central banks have the necessary informational base to play a central and effective role in maintaining financial stability. The third lesson is that the large scale bailout packages would have implications for the regulatory architecture of the financial system and for the fiscal condition of countries. A relevant issue in this context is the efficacy and coverage of deposit insurance. Fourth, the unfolding crisis has revealed the weaknesses of structured products and derivatives in the credit markets, including the "originate-to-distribute" model, which need to be addressed. Also, the near meltdown of the US financial sector should not be construed as evidence that markets and competition do not work. The right lesson is that markets and institutions occasionally succumb to excesses, so that regulators have to be vigilant, constantly finding the right balance between attenuating risk-taking and inhibiting growth. Further, inasmuch as emerging and developing economies are likely to be increasingly impacted by the crisis, going forward, two issues become important. First, in managing the crisis, the implications of that management for emerging and developing economies should be explicitly factored in. Second, in terms of global financial architecture, emerging and developing economies should be taken into confidence for policies and actions of the developed countries that have significant implications for them.

8.74 There is a need to deliberate on the issue of coping with liquidity stresses under unusual circumstances. The role of 'pro-cyclicality' of capital requirements needs to be examined as a factor that escalates the impact of booms and busts. The role of non-banks in the financial system also needs to be examined from a regulatory perspective. It also needs to be assessed whether institutions should be allowed to become so big and so complex that their problems could have system-wide repercussions.

8.75 The Reserve Bank accords considerable importance to financial stability which is also recognised as one of the objectives of monetary policy. The Reserve Bank has been keenly observing the latest developments in regulation and supervision and would continue to adapt institutional best practices to domestic conditions. Banks, on their part, would need to ensure that their business strategies and decisions are guided by the longer-term perspective of systemic and macroeconomic developments and are not unduly influenced by the current stream of exceptional events. It needs to be recognised that as banks have a key role in successfully countering the adverse impact of the recent developments, their continued safety and soundness and financial health would be of utmost importance for preserving financial stability so that the momentum of growth could be maintained.