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List of Abbreviations

ABBF	Advisory Board on Bank Frauds
ACLF	Additional Collateralised Lending Facility
ADFC	Agricultural Development Finance Company
AIDBs	All India Development Banks
AIFI	All India Financial Institution
ALCO	Asset-Liability Committees
ALM	Asset-Liability Management
AMC	Asset Management Committee
APEC	Asia Pacific Economic Co-operation
ARC	Asset Reconstruction Company
ARDR	Agriculture and Rural Debt Relief
ARF	Asset Reconstruction Fund
ARF	Automatic Refinance Facility
ATM	Automated Teller Machine
BER	Burden Efficiency Ratio
BFS	Board for Financial Supervision
BIS	Bank for International Settlement
CV	Coefficient of Variation
CABBF	Central Advisory Board on Bank Frauds
CAMELS	Capital Adequacy, Asset Quality, Management, Earnings, Liquidity and Systems
CAMELSC	Capital Adequacy, Asset Quality, Management, Earnings, Liquidity, Systems and Controls and Compliance
CBI	Central Bureau of Investigation
CCBs	Central Co-operative Banks
C-D Ratio	Credit - Deposit Ratio
CD	Certificate of Deposit
CDF	Co-operative Development Fund
CIS	Collective Investment Scheme
CLB	Company Law Board
CLF	Collateralised Lending Facility
COR	Certificate of Registration
CP	Commercial Paper
CPPD	Computer Policy and Planning Department
CRAR	Capital to Risk-Weighted Assets Ratio
CRR	Cash Reserve Ratio
CVC	Central Vigilance Commission
DAP	Development Action Plan
DCA	Department of Company Affairs
DDO	Drawing and Disbursement Officer
DEA	Data Envelopment Analysis
DFIs	Developmental Financial Institutions
DICGC	Deposit Insurance and Credit Guarantee Corporation
DoT	Department of Telecommunication
DP	Discussion Paper
DRTs	Debt Recovery Tribunals
DTP	Development of Tribal Population
DvP	Delivery versus Payment
ECGC	Export Credit Guarantee Corporation
ECNOS	Export Credit Not Otherwise Specified
ECR	Export Credit Refinance
EFT	Electronic Funds Transfer
EFTPoS	Electronic Funds Transfer at Point of Sale
EL/HP	Equipment Leasing and Hire Purchase Finance Companies
ELC	Equipment Leasing Company
EPS	Earning Per Share
EXIM Bank	Export Import Bank of India

FCNR (B)	Foreign Currency Non-Resident Accounts (Banks)
FEDAI	Foreign Exchange Dealers' Association of India
FIIs	Foreign Institutional Investors
FIs	Financial Institutions
FPB	Focal Point Branch
FRAs	Forward Rates Agreements
GATs	General Agreement on Trade in Services
GDP	Gross Domestic Product
GIC	General Insurance Corporation
GLC	General Line of Credit
GOI	Government of India
GRF	General Refinance Facility
HFCs	Housing Finance Companies
HUDCO	Housing and Urban Development Corporation Ltd.
IBA	Indian Banks' Association
IC	Investment Company
ICAI	Institute of Chartered Accountants of India
I-D Ratio	Investment Deposit Ratio
IDBI	Industrial Development Bank of India
IDC	Institutional Development Cell
IDFC	Infrastructure Development Finance Company
IDRBT	Institute for Development and Research in Banking Technology
IFCI	Industrial Finance Corporation of India
IIBI	Industrial Investment Bank of India Ltd.
ILAF	Interim Liquidity Adjustment Facility
IMF	International Monetary Fund
INFINET	Indian Financial Network
IRDP	Integrated Rural Development Programme
IRS	Interest Rates Swaps
IT	Information Technology
LAB	Local Area Bank
LAF	Liquidity Adjustment Facility
LBS	Lead Bank Scheme
LC	Loan Company
LCs	Letters of Credit
LCVs	Light Commercial Vehicles
LIBOR	London Inter-Bank Offer Rate
LIC	Life Insurance Corporation of India
LTPLR	Long-Term Prime Lending Rate
MBCs	Mutual Benefit Companies
MBFC	Mutual Benefit Financial Company
MFs	Mutual Funds
MLI	Minimum Level of Involvement
MICR	Magnetic Ink Character Recognition
MIS	Management Information System
MMMFs	Money Market Mutual Funds
MOF	Ministry of Finance
MoU	Memorandum of Understanding
MTPLR	Medium - Term Prime Lending Rate
MTPS	Multiple Transfer Price System
NABARD	National Bank for Agriculture and Rural Development
NAV	Net Asset Value
NBC	Net Bank Credit
NBFCs	Non-Banking Finance Companies
NCDC	National Co-operative Development Corporation
NGO	Non-Government Organisation
NHB	National Housing Bank
NHC (LTO)	National Housing Credit (Long Term Operations)

NIC (LTO)	National Industrial Credit (Long Term Operations)
NOF	Net Owned Funds
NPA	Non-Performing Asset
NRC (LTO)	National Rural Credit (Long Term Operations)
NRE	Non-Resident External Accounts
NSE	National Stock Exchange
OMO	Open Market Operations
OP	Operating Profit
PACS	Primary Agricultural Credit Societies
PAO	Pay and Accounts Officer
PCARDBs	Primary Co-operative Agriculture and Rural Development Banks
PCB	Primary Co-operative Bank
PCFC	Pre-shipment Credit in Foreign Currency
PDs	Primary Dealers
PEP	Productivity, Efficiency and Profitability
PFIs	Public Financial Institutions
PLR	Prime Lending Rate
PMRY	Prime Minister's Rozgar Yojna
PSBs	Public Sector Banks
PSU	Public Sector Undertaking
RAM	Ratio Analysis Model
RCTC	Risk Capital and Technology Finance Corporation
RFI	Rural Financial Institution
RIB	Resurgent India Bonds
RIDF	Rural Infrastructure Development Fund
RNBCs	Residuary Non-Banking Companies
RRA	Regulations Review Authority
RRB	Regional Rural Bank
RTGS	Real Time Gross Settlement
SAC	Settlement Advisory Committee
SAO	Seasonal Agricultural Operation
SBI	State Bank of India
SCARDBs	State Co-operative Agriculture and Rural Development Banks
SCB	Scheduled Commercial Bank
SCRA	Securities Contracts (Regulation) Act
SDs	Satellite Dealers
SEBI	Securities and Exchange Board of India
SFCs	State Financial Corporations
SGL	Subsidiary General Ledger
SGSY	Swarnajayanti Gram Swarojgar Yojna
SHG	Self Help Group
SIDBI	Small Industries Development Bank of India
SIDCs	State Industrial Development Corporations
SLR	Statutory Liquidity Ratio
SPNS	Shared Payment Network System
SRTO	Small Road Transport Operators
SSI	Small Scale Industry
StCBs	State Co-operative Banks
STPLR	Short-Term Prime Lending Rate
STRIPS	Separate Trading of Registered Interest and Principal Securities
SWIFT	Society for Worldwide Inter-bank Financial Telecommunication
TFCI	Tourism Finance Corporation of India
TPM	Transfer Price Mechanism
UTI	Unit Trust of India
UTPS	Unitary Transfer Pricing System
VaR	Value at Risk
VSAT	Very Small Aperture Terminal
WTO	World Trade Organisation
Y2K	Year 2000

Chapter I

Banking Developments and Policy Perspectives

Introduction

The banking system which constitutes the core of the financial sector, plays a critical role in transmitting monetary policy impulses to the entire economic system. Its efficiency and development, therefore, are vital for enhancing growth and improving the chances for price stability. A number of steps were taken in 1998-99 to highlight the importance of undertaking reforms in the banking and allied sectors and improving the allocative efficiency of resources. The second Narasimham Committee which submitted its report in April 1998 was the first to devote maximum attention to all those aspects of banking where policy actions are considered necessary. Almost around the same time, the Working Group (Chairman: Shri S.H. Khan) constituted by the Reserve Bank for exploring the possibilities of harmonising the role and operations of development financial institutions and banks came out with recommendations in May 1998 for evolving a system of universal banking. As a sequel to the recommendations of the Khan Working Group, the Reserve Bank released a 'Discussion Paper' in January 1999 to place some of the issues raised in the Group's report in a proper perspective so that development of universal banking takes place in a smooth and an orderly manner.

1.2 Besides these assessments, there were other initiatives, significant among them being the release of the Report by an Expert Group on DRTs (Chairman: Shri N.V. Deshpande, August 1998), and the submission of (i) the Report of the Task Force on Non-Banking Finance Companies (Chairman: Shri C.M. Vasudev, October 1998), (ii) the Report of the Expert Committee on Unit Scheme–1964 (US-64) of the Unit Trust of India (Chairman: Shri Deepak Parekh, February 1999), (iii) the Report of the Committee on Technology Upgradation in the Banking Sector (Chairman: Shri A. Vasudevan, July 1999), and (iv) the Report of Working Group on Restructuring of Weak Public Sector Banks (Chairman: Shri M.S. Verma, October 1999). The Report of the Working Group constituted by the Reserve Bank in April 1999 to review the role of Deposit Insurance in India (Chairman: Shri J. Capoor) has been released for discussion. Among these, several recommendations of the Task Force on NBFCs and those of the Expert Committee on US-64 Scheme have been implemented, while the recommendations of the Expert Group on DRTs and those of the Working Group on Restructuring of Weak Public Sector Banks are under consideration. In the area of primary co-operative banks, the Reserve Bank has constituted a High Power Committee (Chairman: Shri K. Madhav Rao, May 1999) to review the policies relating to these banks. To help safeguard against the problems of illiquidity and insolvency arising due to mismatches between assets and liabilities in the banking sector, guidelines were issued by the Reserve Bank to commercial banks to put in place an asset-liability management system with effect from April 1, 1999. In addition, the Reserve Bank also issued guidelines on risk management on October 21, 1999 for the benefit of banks.

1.3 Against the background of the work done by a number of expert groups and the initiatives taken to bring about structural changes, this Chapter presents perspectives on some of the crucial issues that need attention for evolving a

sounder and a more resilient banking system in India. The policy environment for operation of the banking system is elaborated in sections 2 to 8 of this Chapter.

2. Monetary and Credit Policy Measures

1.4 The monetary and credit policies have addressed various issues pertaining to the financial sector reform process and as a result substantial improvements have taken place. Among the short term credit policy measures, the important areas relate to the changes in the Bank Rate, Cash Reserve Ratio (CRR), and other rate variables such as the repo rate, the refinance rate, the deposit and lending rates. Major policy changes during 1998-99 and as announced in April 1999 are given in Table I.1. The Mid-term review of Monetary and Credit Policy for the second half of 1999-2000 announced on October 29, 1999 is given in Box I.1. The Mid-term Review continued with the overall stance of policy that was announced in April 1999. In essence, the stance of policy for 1999-2000 would continue to be: provision of reasonable liquidity; stable interest rates with preference for softening to the extent possible within the existing operational and structural constraints; orderly development of financial markets and ensuring financial stability.

Table I.1: Monetary and Credit Policy Measures

Sr. No.	Item	Measures	Effective date
1	2	3	4
1.	**Interest Rates**		
a.	Bank Rate	Reduced from 10.5 per cent to 10 per cent	April 2, 1998
		Reduced to 9 per cent	April 29, 1998
		Reduced to 8 per cent	March 1, 1999
b.	Fixed Rate Repos	Reduced from 9 per cent to 5 per cent in stages	By June 1998
		Increased to 8 per cent	August 21, 1998
		Reduced to 6 per cent	March 3, 1999
c.	Domestic Deposit Rates	The minimum period of maturity of term deposits reduced from 30 to 15 days	April 29, 1998
		Banks were allowed to determine penal interest rates for pre-mature withdrawal of domestic term deposits	
		Banks were allowed to offer varying interest rates on domestic term deposits of identical maturities for deposits of Rs.15 lakh and above.	
d.	Non-Resident Deposits	Interest rate ceilings on FCNR(B) deposits of one year and above was increased by 50 basis points and that on such deposits below one year was reduced by 25 basis points.	April 29, 1998
		Banks were allowed to fix their own overdue interest rates in respect of FCNR(B) and NRE deposits remaining overdue for more than 14 days subject to these deposits being renewed.	
		Banks were allowed to fix penal rates of interest on pre-mature withdrawal of FCNR(B) and NRE deposits.	

(Contd.......)

(.....Concld.)

Sr. No.	Item	Measures	Effective date
1	2	3	4
e.	Lending Rates	Interest rates on credit limits upto Rs.2 lakhs stipulated at not exceeding PLR	April 29, 1998
		Board of Directors of banks was allowed to delegate powers to ALM Committee to fix interest rates on deposits	April 20, 1999
		Banks were allowed to offer fixed rate for all term loans subject to conformity to ALM guidelines.	April 24, 1999
		Banks were allowed to operate different PLRs for different maturities.	April 24, 1999
f.	Advances against Domestic/NRE term deposits	Interest rates on loans and advances granted against domestic/NRE term deposits stipulated not to exceed PLR.	April 29, 1998
		Banks were allowed to charge suitable rates of interest on advances against domestic/ NRE term deposits without reference to the ceiling of the PLR in case where deposit rates are equal to or more than PLR or less than one percentage point below PLR.	April 24, 1999
2.	**Reserve Requirements**		
a.	Cash Reserve Ratio (CRR)	Reduced from 10.25 per cent to 10 per cent	April 11, 1998
		Increased to 11 per cent	August 29, 1998
		Reduced to 10.50 per cent	March 13, 1999
		Reduced to 10 per cent	May 8, 1999
b.	Release of Impounded Cash Balances	Remaining part of the impounded cash balance as on April 17, 1992 was released in 12 equal instalments.	Between May 23, 1998 and March 13, 1999
c.	Statutory Liquidity Ratio (SLR)	Remained unchanged at 25 per cent.	—
3.	**Refinance**		
a.	Export Credit Refinance (ECR)		
	i) Limit on ECR	Increased from 50 per cent to100 per cent of the incremental credit over base level (i.e., on February 16, 1996).	May 9, 1998
	ii) Rate of interest on ECR	Reduced from 10 per cent to 9 per cent	April 29, 1998
		Reduced to 7 per cent	August 6, 1998
		Increased to 8 per cent	April 1, 1999
b.	General Refinance	Reduced to 0.25 per cent of each bank's fortnightly average outstanding deposits in 1996-97	January 17, 1998
		The facility was withdrawn with introduction of Collateralised Lending Facilty (CLF).	April 21, 1999

Note : Measures relating to Export Credit are discussed separately.

Box I.1: Major Policy Measures announced in the Mid-term Review of Monetary and Credit Policy

The important policy measures announced in the Mid-term Review of Monetary and Credit Policy 1999-2000 are summed up as follows:

(i) The Cash Reserve Ratio (CRR) to be maintained by the Scheduled Commercial Banks (SCBs) is to be reduced by one percentage point from 10 per cent to 9 per cent in two instalments, effective from the fortnight beginning November 6, 1999 and the fortnight beginning November 20, 1999, respectively. In addition, it was decided to introduce a lag of two weeks in the maintenance of stipulated CRR by banks.

(ii) The minimum maturity for FCNR(B) deposits is being raised to one year from six months. Banks, however, will continue to have the freedom to offer floating rate deposits (with a maturity of one year or more, and interest reset period of six months). The requirement by banks to maintain an incremental CRR of 10 per cent on increase in liabilities under FCNR(B) Scheme (over the level prevailing as on April 11, 1997) is being withdrawn, with effect from the fortnight beginning November 6, 1999.

(iii) The interest rate surcharge of 30 per cent on import finance, which has been in force since January 1998, is being withdrawn with immediate effect.

(iv) The stipulation requiring banks to charge a minimum rate of 20 per cent interest on overdue export bills is also being withdrawn with immediate effect, imparting on banks the freedom to decide the appropriate rate of interest on overdue export bills.

(v) It was decided to extend the permission granted to non-bank entities to charge a minimum rate of 20 per cent interest on overdue export bills upto end-June 2000.

In addition, a number of structural policy measures were announced.

(a) It was decided to bring MMMFs within the purview of SEBI Regulations. However, banks and financial institutions desirous of setting up MMMFs will have to seek the necessary clearance from the Reserve Bank. It was also decided to henceforth allow MMMFs to be set up as a separate entities in the form of a 'Trusts' only.

(b) It was decided to permit SCBs to offer 'cheque writing' facility to Gilt Funds and to those Liquid Income schemes of mutual funds which predominantly invest in money market instruments (not less than 80 per cent of their corpus), subject to certain safeguards.

(c) It was decided to permit mutual funds to undertake FRAs/IRS with banks, Primary Dealers and financial institutions for the purpose of hedging their own balance sheet risks.

(d) It was decided to publicise gilt instruments through informative pamphlets.

(e) It was decided to advise PDs that they should have self-imposed reasonable leverage ratios with the consent of their Board of Directors.

(f) It was decided to impart freedom to banks to charge interest rates without reference to PLR, in respect of the following categories :

- Loans covered by refinancing schemes of term-lending institutions.
- Lending to intermediary agencies.
- Discounting of bills.
- Advances/Overdraft against domestic/NRE/FCNR(B) deposits.

(g) The risk weight of 2.5 per cent for investments in government and other approved securities was extended to cover all investments, including securities outside the SLR, with effect from the year ending March 31, 2001.

(h) The exposure ceiling in respect of an individual borrower was lowered from the present level of 25 per cent to 20 per cent; it will be 20 per cent of the bank's capital funds effective April 1, 2000. Where the existing level of exposure as on October 31, 1999, is more than 20 per cent, banks would be expected to reduce the exposure to 20 per cent of capital funds by end October, 2001.

Export Credit

1.5 The interest rates charged on both pre-shipment and post-shipment rupee export credit were progressively reduced during 1997-98 and 1998-99 to step up the rate of growth of exports. The structure of interest rates on rupee export credit in the recent period is given in Table I.2.

1.6 With a view to making available credit to exporters at internationally competitive rates linked to LIBOR, the Reserve Bank introduced in 1993

Table I.2: Interest Rates on Rupee Export Credit

(Per cent per annum)

Item	Effective from		
	April 30, 1998	August 6, 1998	April 1, 1999
1	2	3	4
1. Pre-shipment Credit			
i) Upto 180 days	11.00	9.00	10.00
ii) Beyond 180 days and upto 270 days	14.00	12.00	13.00
iii) Against incentives receivable from Government covered by ECGC Guarantee upto 90 days	11.00	9.00	10.00
2. Post-shipment Credit			
i) Demand Bills for transit period (as specified by FEDAI)	Not exceeding 11.00	9.00	Not exceeding 10.00
ii) Usance Bills (for total period comprising usance period of export bills, transit period as specified by FEDAI and grace period wherever applicable)			
a) Up to 90 days	Not exceeding 11.00	9.00	Not exceeding 10.00
b) Beyond 90 days and up to six months from the date of shipment	13.00	11.00	12.00
c) Beyond six months from the date of shipment	- -	- -	- -
iii) Against incentives receivable from Government covered by ECGC Guarantee (up to 90 days)	Not Exceeding 11.00	9.00 10.00	Not Exceeding
iv) Against undrawn balance (up to 90 days)	Not Exceeding 11.00	9.00	Not Exceeding 10.00
v) Against retention money (for supplies portion only) payable within one year from the date of shipment (up to 90 days)	Not Exceeding 11.00	9.00	Not Exceeding 10.00
3. Deferred Credit			
Deferred credit for the period beyond 180 days	Free	Free	Free
4. Export Credit not otherwise specified (ECNOS)			
a) Pre-shipment credit	Free	Free	Free
b) Post-shipment credit	20.00 (Min.)	20.00 (Min.)	20.00 (Min.)

Notes : 1. Min. : Minimum.
- - : Not Applicable.
* : Chronic Cases, i.e. overdues as on July 1, 1997 exempted.
2. 'Free' means banks are free to decide the rate of interest to be charged.

the schemes of Pre-shipment Credit in Foreign Currency (PCFC) and Rediscounting of Export Bills Abroad. The rates of interest to be charged under these schemes are given in Table I.3.

1.7 Banks have been permitted since January 1999 to extend concessional credit for working capital purposes in respect of export-related activities of all agro-products, including purchase of fertilizers, pesticides and other inputs for growing of flowers, grapes, etc. to give a boost to exports of agro-products, provided banks are in a position to clearly identify such activities as export-related and satisfy themselves of the export potential thereof and that the activities are not covered by direct/indirect finance schemes of NABARD or any other agency.

1.8 The Reserve Bank has reviewed the procedures followed by banks while dispensing export credit and accordingly issued guidelines simplifying the procedures for extending export credit. The guidelines relate to the following:

(i) provision of export credit in foreign currency both at pre/post- shipment stages at internationally competitive rates through larger number of bank branches,

(ii) simplification of application forms and procedures, etc. for assessing credit requirements of exporters in a manner most suitable and appropriate to their business operations,

(iii) providing credit for a longer period than one year,

(iv) permitting interchangeability of pre/post-shipment credit limits,

(v) allowing periodical submission of orders, LCs, etc. for availing pre-shipment credit and for handling export documents, and

(vi) streamlining internal systems and procedures.

Table I.3: Interest Rates on Export Credit in Foreign Currency

(Per cent per annum)

Item	Rate
1. Pre-shipment Credit	
(a) Upto 180 days	Not exceeding LIBOR/Euro LIBOR /EURIBOR + 1.5
(b) Beyond 180 days and upto 360 days	Rate for initial period of 180 days prevailing at the time of extension + 2.0
2. Post-shipment Credit	
(a) On demand bills for transit period (as specified by FEDAI)	Not exceeding LIBOR /Euro LIBOR / EURIBOR + 1.5
(b) Usance bills (for total period comprising usance period of export bills, transit period as specified by FEDAI and grace period whereever applicable) Upto 6 months from the date of shipment	Not exceeding LIBOR /Euro LIBOR / EURIBOR + 1.5
(c) Export bills (demand or usance) realised after due date but upto date of crystalisation	Rate as prescribed in (a) or (b) + 2.0
3. Export Credit Not Otherwise Specified (ECNOS)	
(a) Pre-shipment credit	Free
(b) Post-shipment credit	20.0 (minimum)*

Note: 1. * : Rupee credit rate.
2. : Free indicates that the banks are free to decide the rate of interest being rupee credit rate.

For monitoring the progress made in the implementation of the guidelines by banks on an ongoing basis, a Monitoring Group of Bankers has been constituted.

Special Liquidity Support Facility

1.9 With a view to enabling those scheduled commercial banks, which were temporarily deploying the rupee resources available against Resurgent India Bonds (RIB) in Government securities sold by the Reserve Bank through Open Market Operations (OMO), a Special Liquidity Suport Facility by way of refinance was introduced to tide over their unanticipated liquidity problem. Effective September 17, 1998, such banks were provided liquidity support under Section 17(4) (a) of the Reserve Bank of India Act, 1934 to the extent of their excess holdings of Government Securities/treasury bills purchased through OMO window over the Statutory Liquidity Ratio (SLR) required to be maintained. This facility was provided for two blocks of four weeks each. The rate of interest applicable on this refinance was at the Bank Rate (i.e. 9.0 per cent per annum) for the first four weeks and the Bank Rate plus one percentage point (i.e. 10.0 per cent per annum) for the next four weeks upto March 1, 1999. These rates were reduced to ‘8.0 per cent per annum’ and ‘9.0 per cent per annum’ respectively with effect from the close of business on March 1, 1999 due to the change in the Bank Rate. This refinance facility, however, was withdrawn with effect from April 1, 1999.

Interim Liquidity Adjustment Facility

1.10 The Reserve Bank had agreed in principle with the recommendation of the second Narasimham Committee that the Reserve Bank’s support to the market should be through a Liquidity Adjustment Facility (LAF) operated by way of repo and reverse repo providing a reasonable corridor for market players. Pending further upgradation in technology and legal / procedural changes to facilitate electronic transfer and settlement, it was decided to introduce an Interim Liquidity Adjustment Facility (ILAF) through lending against collateral of Central Government securities. Under the ILAF while liquidity is injected into the system through export credit refinance facility, collateralised lending facilities and liquidity support to Primary Dealers, the absorption of liquidity from the market is done through fixed rate repos supplemented by open market operations in dated Government securities and Treasury Bills. The ILAF provides a mechanism by which liquidity is injected at various interest rates, and absorbed when necessary at the fixed repo rate, so that volatility in the money market is minimised and the market operates within a reasonable range.

Collateralised Lending Facility

1.11 Effective April 21, 1999, the General Refinance facility was replaced by a Collateralised Lending Facility (CLF). Under CLF, the scheduled commercial banks (excluding RRBs) are provided refinance to the extent of 0.25 per cent of their fortnightly average outstanding aggregate deposits in 1997-98 and such refinance is available for two weeks at the Bank Rate. An Additional Collateralised Lending Facility (ACLF) for an equivalent amount of CLF is also available at the Bank Rate plus 2 percentage points. Both CLF and ACLF can be availed of for a further period of two weeks at interest rates higher by two percentage points as compared to those applicable for the first two weeks. The policy measure also included the prescription of a cooling period of four weeks during which the banks would not be permitted to draw any refinance. Thereafter, a fresh cycle of two block of two weeks each would begin.

1.12 Effective October 6, 1999, the stipulation of cooling period has been removed altogether so as to enhance the flexibility and effectiveness of the scheme of CLF in meeting the liquidity requirements of banks. Thus, from third week onwards CLF and ACLF will be provided to

banks at the Bank Rate plus 2 percentage points and Bank Rate plus 4 percentage points, respectively. The amount drawn under CLF/ ACLF will have to be paid off within a period not exceeding 90 days from the date of drawal. The entitlement of the banking system under CLF and ACLF is of the order of Rs.1,314 crore each (i.e. total of Rs,2,628 crore).

Liquidity Support to Primary Dealers

1.13 In April 1998, the practice of reverse repos with Primary Dealers (PDs) in specified securities was dispensed with, and instead, liquidity support against the security of holdings in Subsidiary General Ledger (SGL) accounts was provided. This was further modified in the context of the introduction of Interim Liquidity Adjustment Facility (ILAF), in the monetary and credit policy announced on April 20, 1999 for the year 1999-2000. Accordingly, liquidity support against collateral of Government securities, based on bidding commitment and other parameters would be available to PDs at the Bank Rate and the amounts would remain constant throughout the year subject to the usual restriction of repayment within 90 days. Additional liquidity support against collateral of Government securities would also be provided to PDs for periods not exceeding two weeks at a time and the interest rate for such advances would be the Bank Rate plus 2 percentage points.

State Co-operative Banks

1.14 The Reserve Bank's accommodation to State Co-operative Banks towards general banking business such as clearing adjustments, liquidity, etc. which was earlier at 'Bank Rate plus 2.5 percentage points', was reduced to the 'Bank Rate' with effect from April 20, 1999.

Money Market

1.15 Important policy measures pertaining to various segments of the money market during 1998-99 are given in Table I.4.

Standing Committee on Money Market

1.16 Similar to the Standing Committees on Foreign Exchange Market and Government Securities Market, a Standing Committee on Money Market under the Chairmanship of Dr. Y.V. Reddy, Deputy Governor of the Reserve Bank was set up in April 1997 for advising the Reserve Bank on developing the money market in order to make it more efficient. The Standing Committees on Government Securities Market and Money Market were merged in July 1999 to form a Technical Advisory Committee on Money and Government Securities Market, in view of the overlap and strong connectivity between these two markets.

Report of the Sub-Group on Repos

1.17 A Sub Group of the Technical Advisory Committee on Government Securities Market was constituted to study the Repurchase Agreement (Repos) market. The Group submitted its report in April 1999. The Group has proposed several changes in the structure of the repos market, *viz.*, introduction of exchange traded and over-the-counter repos, allowing roll-over of repos and expansion of the repos market in terms of users and instruments. Further, the sub-group has recommended the removal of the ban on forward trading in repos and replacement of the Public Debt Act by a Government Securities Act.

Banks' Investments

Investment in Shares and Debentures

1.18 In the Monetary and Credit Policy statement for the year 1999-2000, it was announced that in order to encourage the flow of finance for venture capital, the overall ceiling of investment by banks in ordinary shares, convertible debentures of corporates and units of mutual funds, etc., which was at 5 per cent of their incremental deposits, would stand automatically enhanced to the extent of banks' investments in venture capital and such investments in venture capital should be treated as priority sector lending.

Table I.4: Money Market Policy Measures

Sr. No.	Item	Measures	Effective from
1.	Call/Notice Money Market	3 mutual funds viz., Kotak Mahindra, Infrastructure Leasing and Financial Services (IL&FS) and Dundee Mutual Funds were permitted to participate as lenders. 17 corporate entities were permitted to lend through PDs. RBI's permission to non-bank entities to lend in the call/notice money market by routing their operations through PDs will be available only upto end December 1999.	1998-99
2.	Certificates of Deposit	Minimum period for transferability of CDs reduced from 30 to 15 days.	May 9, 1998
3.	Money Market Mutual Funds (MMMFs)	Minimum lock-in period reduced from 30 to 15 days. MMMFs permitted to offer 'cheque writing' facility to their investors.	May 9, 1998 April 29, 1999
4.	Repos and Reverse Repos Market	Restriction of minimum period of 3 days for inter-bank repo transactions withdrawn. 35 non-banking entities were permitted to undertake ready forward transactions in notified government securities.	October 31, 1998 July 14,1999
5.	Bill rediscounting Market	3 mutual funds viz., Kotak Mahindra,IL&FS and Dundee Mutual Fund were permitted to participate in the bill rediscounting market as lenders only.	1998-99
6.	Forward Rate Agreements (FRAs)/ Interest Rate Swaps (IRSs)	Guidelines for undertaking FRAs/ IRSs issued Banks, PDs and all-India Financial Institutions were allowed to undertake FRAs/IRSs for their own balance sheet management and for market making purposes.	July 7, 1999

Valuation of Banks' Investments in Approved Securities

1.19 The Reserve Bank, earlier in April 1992, advised the banks to bifurcate their investments in approved securities into 'permanent' and 'current' categories, and to keep not less than 30.0 per cent of their investments in the current category from the accounting year 1992-93. Over time, the ratio of current investments was increased and it was fixed at 70.0 per cent of the approved securities for the year ending March 31, 1999. These measures were put in place with a view to adopting prudent accounting standards and to moving towards "mark to market" valuation of the investments portfolio. Further, it was indicated in April 1998 that the ratio of current investments in approved securities would be increased progressively to 100 per cent in the next three years in line with the international best practices. With effect from the year ending March 31, 2000, banks would have to classify a minimum of 75 per cent of their securities as current investments.

Improving Credit Delivery System

Extending the Coverage of Priority Sector

1.20 During the year 1998-99, the coverage of

Priority Sector credit was widened considerably. Bank credit to NBFCs for the purpose of on-lending to Small Road and Water Transport Operators (i.e. those owning a fleet of vehicles not exceeding ten) is now being treated as priority sector lending provided the ultimate borrowers satisfy the eligibility requirements for being classified under priority sector. Effective October 26, 1998, it was decided that loans to software industry having credit limit upto Rs.1 crore from the banking system would be eligible for inclusion under the priority sector. In view of the escalation in the cost of goods and products sold by retail traders, it was decided, effective November 13, 1998, to increase the existing ceiling of bank advances under priority sector to retail traders from Rs.2 lakh to Rs.5 lakh. In January 1999, it was decided that the food and agro-based processing sector should be included within the definition of priority sector for bank lending. Further, lending by banks to NBFCs or other financial institutions for on-lending to the tiny sector is being classified under priority sector. Banks were advised on April 24, 1999 that investments in venture capital would be eligible for inclusion in priority sector lending.

Credit for Infrastructure

1.21 In view of the national importance attached to infrastructure development, operational guidelines on financing infrastructure projects have been issued to banks/financial institutions on April 23, 1999. Accordingly, banks would be free to sanction term loans for technically feasible, financially viable and bankable projects undertaken by both public and private sector undertakings, subject to prescribed criteria. In this context, four broad modes of financing have been identified and these include (i) financing through funds raised by way of subordinated debt, (ii) entering into take-out financing, (iii) direct financing through rupee term loans, deferred payment guarantees, foreign currency loans, etc., and (iv) investments in infrastructure bonds issued by project promoters/financial institutions. Banks have also been permitted to issue inter-institutional guarantees subject to certain norms.

Increased Allocation for Housing Finance

1.22 Commercial banks have been advised to compute their share of housing finance allocation for the financial year 1999-2000 (April-March) at 3 per cent of their incremental deposits as on the last reporting Friday of March 1999 over the corresponding figure of the last reporting Friday of March 1998 or the amount of housing finance allocation fixed for the financial year 1998-99; whichever is higher. This is the minimum housing finance allocation and banks could exceed this level having regard to their resources position.

3. Government Securities Market

1.23 The Government securities market plays an important role in that it helps banks and financial institutions by providing a collateral that could be utilised for gaining financial support and liquidity without creating a *moral hazard* problem. The Reserve Bank, in close co-ordination with the Government of India, has been pursuing an active internal debt management policy since the fiscal year 1992-93. A number of policy initiatives have been undertaken mainly in the areas of institutional development, instrument development, market efficiency and transparency. Of late, the regulatory and legal aspects have also been pursued. The major policy developments during 1998-99 and thereafter so far are set out in the following paragraphs.

Institutional Development

Primary Dealers

1.24 In order to further deepen the Government securities market and also to increase competition among the existing Primary Dealers (PDs), the Reserve Bank granted approval to 7 more entities to be accredited as PDs in the Government securities market. With the addition of these 7 PDs, the total number of PDs increased to 13.

1.25 As a step towards the Reserve Bank's ultimate objective of moving away from the primary market and facilitatating a larger absorption of Government securities by PDs, the system of underwriting by PDs was changed in the Monetary and Credit Policy statement for the year 1999-2000. In consultation with PDs, it has been decided (a) to obtain a minimum bidding commitment from each PD for each auction of Treasury Bills, so that together they absorb 100 per cent of the notified amount, and (b) to offer an enhanced underwriting option to PDs for the entire notified amount in auctions of dated securities.

Satellite Dealers

1.26 Satellite Dealers (SDs) are expected to play a significant role as a second tier in trading and distribution of Government securities and they need to be therefore, provided with necessary liquidity support. With a view to enabling the SDs to have access to short term borrowings, the Reserve Bank had decided to permit them to issue Commercial Paper (CP) since June 23, 1998, subject to fulfilment of certain preconditions.

Foreign Institutional Investors

1.27 Following the policy decisions taken by the Reserve Bank and the Securities and Exchange Board of India (SEBI) and the amendments to SEBI (FIIs) Regulations, 1995, Foreign Institutional Investors (FIIs) have been permitted since May 18, 1998 to invest in Government dated securities and Treasury Bills within their overall approved debt ceilings. The FIIs would include 100 per cent debt funds and FIIs with a ceiling of 30 per cent investment in debt instruments. The RBI guidelines issued on March 8, 1997 specifying the manner of transactions by the FIIs were amended on June 11, 1998 to enable FIIs, as mentioned above, to invest in Government dated securities (both Government of India and State Governments) and Treasury Bills, both in the primary and the secondary markets.

Gilt Funds

1.28 In the Monetary Policy for the first half of 1996-97, it was indicated that with a view to encouraging the schemes of Mutual Funds which are dedicated exclusively to investments in Government securities (Gilt Funds), the Reserve Bank would provide liquidity support to such dedicated funds floated with the approval of SEBI. The guidelines were issued on April 20, 1996. To operationalise these guidelines and on setting up of the first Gilt Fund in the country by Kotak Mahindra Finance Co. Ltd., a detailed scheme for availing the liquidity support was also framed by the Reserve Bank on December 24, 1998.

Instrument Development

Developments in the Treasury Bills Market

1.29 The facility of notifying the amount which has been prevalent in the case of 91-day Treasury Bills was extended, in the case of all auctions including 364-day and 14-day Treasury Bills with effect from April 1, 1998. Non-competitive bids, however, were continued to be kept outside the notified amount so as to provide certainty to the amounts acceptable from competitive bidders since April 1, 1998.

1.30 A Uniform price auction method was introduced on November 6, 1998 in the auctions for 91-day Treasury Bills on an experimental basis. On April 20, 1999, as part of Monetary and Credit Policy statement for the year 1999-2000, the following policies were announced:

(i) In order to provide a greater certainty in the timing and quantum of primary issues so as to give the market participants sufficient time to plan their investments in Government securities, a calendar for issue of Treasury Bills for the entire year would be announced. In pursuance of this, the following calendar of Treasury Bills Auction was announced (Table I.5). Although, this calendar was initially valid only till

Table I.5: Calendar of Treasury Bills Auction

Type of T-Bills	Periodicity	Notified Amount (Rs. crore)	Day of Auction	Day of Payment
1	2	3	4	5
14-day	Weekly	100	Every Friday	The Following day
91-day	Weekly	100	Every Friday	The Following day
182-day	Fortnightly	100	Wednesdays preceding the non-reporting Fridays	The Following day
364-day	Fortnightly	500	Wednesdays preceding the non-reporting Fridays	The Following day

September 1999, it is being continued for the rest of the current financial year.

(ii) 182-day Treasury Bills, would be reintroduced and would be issued every fortnight as part of the calendar. Accordingly, 182-day Treasury Bills were reintroduced from May 26, 1999.

Development in Dated Securities Market

1.31 The Government issued a long-term paper with a maturity of 20 years on November 24, 1998 after a gap of nearly 7 years. Consolidation of outstanding loans was necessary for ensuring sufficient volumes and liquidity in any one issue. Such consolidation also facilitates the emergence of benchmarks and development of Separate Trading of Registered Interest and Principal Securities (STRIPS). Accordingly, the option of issuing new loans on price basis instead of on yield basis as is done currently was introduced through a revised notification on April 5, 1999 from Government of India.

Regulatory and Legal Aspects

Repeal and Replacement of Public Debt Act

1.32 Over the years, a number of rigidities have been noticed in the Public Debt Act and Rules. The procedures prescribed therein were time-consuming and some of the provisions had ceased to be of relevance in the present context. Therefore, a new legislation titled the Government Securities Act has been proposed to repeal and replace the Public Debt Act, 1944. The Government Securities Bill has already been approved by the Cabinet and is awaiting Parliament clearance. However, since the Public Debt Act, 1944 is applicable for marketable loans raised by the RBI on behalf of both the Central and State Governments, the proposal requires consent of all State Governments. Once the new Act is enacted, the RBI will have a substantive instrument of transfer suited to computer environment. The new Act will also give flexibility to allow Government Securities to be held in Depositories while at the same time specifically excluding Government Securities from the purview of Depositories Act, 1996. The draft of the Act is being vetted by the State Governments.

Amendments to Securities Contracts (Regulation) Act, 1956

1.33 The Reserve Bank had proposed to the Government of India to amend the section 29(A) of the Securities Contracts (Regulation) Act (SCRA) to add an enabling provision to provide jurisdiction to the Reserve Bank in the regulation of the debt markets. With this, the respective

regulatory roles of SEBI and the Reserve Bank in the debt market will be formalised. The proposed changes in the SCRA will pave the way for a more active repos market and help in introducing new market feature of 'when-issued trading'. The proposed amendment is presently under consideration of the Government.

Amendment to Indian Stamp Act, 1899

1.34 To facilitate trading in financial instruments, it is necessary that the transfers in dematerialised form are exempted from stamp duty. Therefore, an amendment has been made in the Indian Stamp Act, 1899. In the Indian Stamp Act, 1899, in section 8A, after clause (e), the following clause has been inserted, namely, "(f) transfer of beneficial ownership of debentures, such debentures being debentures of a company formed and registered under the Companies Act, 1956 or a body corporate established by a Central Act, dealt with by a depository, shall not be liable to duty under article 27 of schedule 1 of this Act."

1.35 There are other issues regarding which the Reserve Bank has suggested amendments to the Government. These included the (i) stamp duty on PSU bonds, debentures, etc. traded in dematerialised environment, (ii) stamp duty on English mortgage and secondary market non-convertible debentures with respect to infrastructure finance, and (iii) definition of securitised debt instruments and stamp duties thereof.

Other Developments

Flexible Approach to State Borrowings

1.36 A flexible approach to market borrowing programme of State Governments was introduced whereby, the State Governments were offered a facility of raising 5 per cent to 35 per cent of their market borrowing allocation in a flexible manner as regards timing, maturity, and rate of interest. Accordingly, the Punjab Government raised Rs.60 crore through 10 year stock on January 13, 1999 through auction, which was the first of its kind. The State Governments of Goa, Andhra Pradesh and Uttar Pradesh mobilised Rs.850 crore through 12.50 per cent State Development Loan, 2009 on tap during February 10 -12, 1999. Further the State Government of Andhra Pradesh and Tamil Nadu, mobilised Rs.600 crore through 10 year stock on August 19, 1999.

Guarantees by State Governments

1.37 In the interest of prudent financial management and the credibility of the guarantees issued by the States, there was a need for a guarantee policy for each State Government on the basis of certain parameters. Accordingly, the Reserve Bank constituted a technical committee of State Finance Secretaries to examine the issue of State Government guarantees in all its aspects. The report of the Committee was submitted in February 1999. While recommending a ceiling on guarantee, the Committee, *inter alia*, has also set out certain parameters for the ceiling. The Committee has also recommended selectivity in calling for and providing of guarantees. The other recommendations relate to honouring of guarantees, disclosure, transparency and reporting of guarantees, letter of comfort, automatic debit mechanisms, tripartite structured payment agreements, escrow mechanisms for independent power projects, standardisation of documentation, guarantee fee, constitution of a Contingency Fund for Guarantees and monitoring of guarantees and implicit contingent liabilities. Persuant to the Report, the Government of Karnataka has passed a Bill to provide for ceiling on Government Guarantees. The Rajasthan Government has set up a Guarantee Redemption Fund with an initial contribution of Rs.1 crore.

4. Strengthening of Capital and Supervision

Recapitalisation of Public Sector Banks

1.38 The Government of India has been

providing funds to public sector banks (PSBs) to help strengthen their capital. During 1998-99, the Government extended recapitalisation facility to three PSBs and provided a sum aggregating Rs.400 crore as compared with Rs.2,700 crore provided last year to three PSBs (Table I.6). So far the Government has contributed an aggregate amount of Rs.20,446.12 crore upto March 31, 1999.

Write-off of Capital

1.39 The Government is encouraging the PSBs to raise capital through public issues. The write-off of accumulated losses against paid-up capital would enable PSBs to have earning per share (EPS) at higher level for making public issues. During 1998-99, Government allowed four PSBs to reduce their capital by writing off accumulated losses equivalent to Rs.2,066.64 crore[1]. Canara Bank was given a capital assistance of Rs.600 crore; of which, it was allowed to write off accumulated losses of Rs.507.1 crore relating to loss in a mutual fund scheme. Till the year ended March 31, 1999, the losses written off against capital amounted to Rs.6,037.18 crore.

Table I.6: Recapitalisation of Public Sector Banks: 1998-99

Sr. No.	Name of the bank	Amount (Rs. crore)
1.	Indian Bank	100
2.	UCO Bank	200
3.	United Bank of India	100
	Total	**400**

Ownership pattern of Nationalised banks

1.40 In recent years, the government made attempts to dilute its holding in public sector banks with a view to broad-base the ownership pattern. In this context it may be mentioned that in the case of State Bank of India, the share holding of the Government and the Reserve Bank constituted 1.8 per cent and 59.7 per cent, respectively during 1998-99. The ownership pattern of nationalised banks varies from bank to bank. A Table I.7 is presented below giving the details of Central Government ownership of capital in nationalised banks.

Public issue of Shares

1.41 The continued depressed conditions in primary market for new issues discouraged banks from floating issues in the market to raise their capital. During 1998-99, the Reserve Bank gave approval for two public issues of South India Bank Ltd. and UTI Bank Ltd. The Reserve Bank has also approved three proposals during the year for rights issues of Ganesh Bank of Kurundwad Ltd., Catholic Syrian Bank Ltd., and Bharat Overseas Bank Ltd. However, Ganesh Bank of Kurundwad Ltd. had not made the rights issue till June 1999. The on-going liberalisation in the banking sector has given more freedom to private sector banks, whose shares are already listed on stock exchanges for floating new issues. Barring bonus issues, the private sector banks have been permitted to directly raise capital in the form of equity issues without the approval of the Reserve Bank.

Issue of Sub-Ordinated Debt Instruments for Inclusion in Tier II Capital

1.42 During the year ended March 1999, four banks raised subordinated debt for inclusion in their Tier II capital (Table I.8).

1. The PSBs allowed to write off their losses against capital during 1998-99 were: (a) Andhra Bank Rs.243.37 crore, (b) Bank of Maharashtra Rs.418.18 crore, (c) Punjab and Sind Bank Rs.462.47 crore and (d) Syndicate Bank Rs.942.62 crore.

Table I.7: Central Government ownership of Capital of Nationalised Banks

(Per cent)

Sr. No.	Name of the Bank	1996-97	1997-98	1998-99
1	2	3	4	5
1.	Allahabad Bank	*	*	*
2.	Andhra Bank	*	*	*
3.	Bank of Baroda	77.1	66.9	66.6
4.	Bank of India	81.9	76.6	76.6
5.	Bank of Maharashtra	*	*	*
6.	Canara Bank	*	*	*
7.	Central Bank of India	*	*	*
8.	Corporation Bank	*	68.4	68.3
9.	Dena Bank	71.0	71.0	71.0
10.	Indian Bank	*	*	*
11.	Indian Overseas Bank	*	*	*
12.	Oriental Bank of Commerce	66.5	66.5	66.5
13.	Punjab & Sind Bank	*	*	*
14.	Punjab National Bank	*	*	*
15.	Syndicate Bank	*	*	*
16.	UCO Bank	*	*	*
17.	Union Bank of India	*	*	*
18.	United Bank of India	*	*	*
19.	Vijaya Bank	*	*	*

Note: * Fully owned by Central Government.

Supervision of Banks

1.43 The main purpose of bank supervision is not only to protect the interests of depositors but also to nurture a healthy and sound banking system. The principal instruments of supervision are on-site examination and off-site surveillance. Based on the recommendations of the Narasimham Committee Report of 1991, the Reserve Bank has set up the Board for Financial Supervision (BFS) in 1993, so as to evolve an integrated approach to supervision of financial institutions (mainly credit institutions). Under the umbrella of BFS, three channels of credit extended by commercial banks, development financial institutions and non-banking-financial companies are supervised by the Reserve Bank on a 'continuous basis' through an off-site surveillance mechanism supplementing the on-site

Table I.8: Raising of Tier II Capital by Banks

Sr. No.	Name of the bank	Amount raised (Rs.crore)
1.	Catholic Syrian Bank	16.60
2.	United western Bank Ltd.	70.00
3.	ICICI Bank	68.00
4.	Federal Bank Ltd.	150.00

examinations. The Reserve Bank has now embarked on a project to upgrade the off-site database by June 2000 with enhanced capabilities, of processing of reports on risk exposures based on submission of recently introduced returns on asset-liability management (ALM).

1.44 The Reserve Bank is also in the process of moving towards a regime of risk based supervision and has begun re-orienting the focus of its on-site examination with this goal in mind. It has also adopted a rating model CAMELS for the evaluation of banks based on on-site inputs which is a variant of the internationally accepted CAMEL approach – Capital adequacy, Asset quality, Management, Earnings and Liquidity, and adding to it 'S' for Systems and procedures. The Bank has also introduced a special supervisory regime for weak banks which includes quarterly reporting by banks and on-site visits at frequent intervals. The housekeeping areas of banks which are prone to operational risks, have come under increased supervisory focus and the reconciliation of interbranch and interbank accounts has been prominent on the supervisory agenda.

1.45 Transparency and public disclosures need to be supplemented with supervisory standards and best practices so as to promote market discipline and ensure a robust banking and financial system. In 1997, the Basle Committee on Banking supervision evolved a set of twenty-five core principles for effective banking supervision which have been endorsed world wide. The Reserve Bank of India is committed to the implementation of these principles and had assessed its own position with respect to them. Based on this assessment, working groups have been set up to make recommendations on strengthening certain areas; the main areas in this regard relate to (a) risk management system for banks, (b) amendments to banking legislation, (c) introduction of consolidated supervision, (d) developing a framework for home and host country relations, and (e) enhancing inter-agency and inter-department co-operation. The groups have since given their recommendations which are being examined for implementation.

1.46 The Basle Capital Adequacy Accord was introduced in 1988 as a means of setting minimum capital asset ratios for international banks. Post Basle 1988, international banking witnessed a gradual blurring of functional distinction among financial intermediaries. The speed and complexity of adjustment made it difficult for the supervisory authorities to effectively regulate financial entities in their countries. Since banks in different countries encountered different degrees of risks, the rule of 'one-size-fits-all' aspect of the capital adequacy ratio of 1988 was therefore subject to intense debate. Besides, the original Accord emphasized only the credit risk aspect of banking operations, ignoring the other relatively important risk factors like interest rate risk, market risk and operational risk. The Basle norms also could not adequately internalize the differences in credit ratings of dissimilar corporate borrowers. Such criticism against the old Accord seems to have led the Basle Committee on Banking Supervision to propose the new Consultative Paper on Capital Adequacy Framework in June 1999 which aims at further strengthening the soundness of the financial system (Box I.2).

1.47 The Reserve Bank has set out the supervisory agenda for the coming year and, in this context, is examining the recommendations of in-house Working Groups on areas such as the impact of the implementation of revised capital adequacy requirements as suggested by the Basle Committee on Banking Supervision and the development of a framework for setting up a credit information bureau.

1.48 The Reserve Bank has introduced and also

Box I.2: The New Basle Norms

The structure and operations of banks and other financial intermediaries has evolved rapidly in recent years, under the impact of revolution in information technology and the associated increase in competition, at both national and international levels. As a result, the erosion of dividing lines among the financial intermediaries has increased. The major financial intermediaries have become increasingly global in geographical coverage and universal in their financial operations, encompassing a wide range of activities including banking, securities markets activities and insurance activities. The increase in competition, combined with difficult financial conditions in the early 1980s, put downward pressure on profit margins and capital ratios. The growing concern of commercial banks regarding international competitiveness and capital ratios led to the formation of the Basle Accord of 1988.

Although the Basle norms helped to arrest the erosion of banks' capital ratios, concerns were raised regarding the applicability of capital ratios in the changed environment of operations. The blurring of functional and national divisions among the financial intermediaries, and the speed and complexity of adjustment (wrought in by information technology, derivatives, etc.) has made it difficult for regulators to keep up with the growing pace of change. In particular, the rule of 'one-size-fits-all' aspect of the capital adequacy ratio has been the subject of intense debate and recent crises have only drilled home the point that baseline capital adequacy norms are not enough to hedge against failures. In a recent study, Goldstein (1996) provides useful statistics relating to actual and required capital (Table 1). He argued that governments in developing countries, with few exceptions, have not set national capital standards much above the Basle minimum norm and their banks have not held actual capital much above that for banks in countries with significantly more stable operating environments.

Such criticism seems to have led the Basle Committee on Banking Supervision to propose the new Consultative Paper on Capital Adequacy Framework in June 1999 which aims at further strengthening the soundness of the financial system. The paper has been released for consultation among national supervisory authorities all over the world. In the light of the comments received by March 2000, the revised Capital Adequacy Framework is sought to be put in place. The primary objectives of the new framework include (a) the promotion of safety and soundness in the financial system, (b) the enhancement of competitive equality, and (c) the constitution of a more comprehensive approach to addressing risks. The current Accord is based on three pillars of (I) *minimum capital requirements*, (II) *supervisory review process,* and (III) *effective use of market discipline*.

Table 1: Required and Actual Capital Ratios: 1995

(Per cent)

Country	Capital Adequacy Ratio (national requirements)	Actual Risk-based Capital Ratio
Argentina	12	18.5
Chile	8[a]	10.7
Brazil	8	12.9
Mexico	8	11.3
Indonesia	8	11.9
Malaysia	8	11.3
Thailand	8	9.3
India	8	9.5[b]
Japan	8	9.1
United States	8	12.8

Note: a. Legislation now before Congress.
b. Relates only to public sector banks.

Source: Goldstein (1996)

(Contd......)

(......Concld.)

Pillar I : Minimum Capital Requirements

Under the first pillar, the Committee has proposed to build on the extant 'minimum regulatory capital requirements' by announcing explicit risk weighting structure for different activities. When the Accord was first established, it was primarily concerned with minimum capital standards to cover credit risk. Insofar as these capital charges covered other types of risk, these were effectively assumed proportional to credit risk. In view of the increasing internationalisation of activities of banks, the Committee has proposed to develop explicit risk weights for other risk categories such as operational risk and interest rate risk, which have assumed significant importance in the deregulated environment. This apart, the Committee has also decided to introduce changes in the extant market risk component of the Accord to enhance consistency of treatment between the banking and trading books and to ensure adequate capital coverage for trading book items.

Pillar II: Supervisory Review of Capital Adequacy

The second pillar of *supervisory review of capital adequacy* envisages a more pro-active role for the regulator by requiring that they ensure that the bank's capital position is consistent with its overall risk profile and strategy. This is to be achieved through supervisory review of bank-specific internal capital assessment processes. In effect, the extant supervisory review process comprising on-site inspection, off-site surveillance and external auditing is being supplanted through the review of the internal capital adequacy assessments of banks.

One important motivation for a supervisory review of a bank's regulatory capital measures is to identify as early as possible the potential for serious erosion of a bank' capital position. The need for such early intervention reflects the relatively illiquid nature of bank's assets and the limited options available to banks in quickly raising capital. The new Accord therefore places significant emphasis on the supervisory authorities for identifying, reviewing and evaluating a bank's internal capital adequacy assessment as well as its compliance with regulatory capital ratios, failing which supervisors are supposed to intervene so as to ensure that banks are able to withstand normal business shocks.

Pillar III: Effective Use of Market Discipline

The third pillar of *market discipline* imposes strong incentives on banks to conduct their business in a safe, sound and efficient manner. Towards this end, the Committee has urged banks to disclose to the public, in a timely fashion, all key features of the capital held as cushion against losses, and the risk exposures that may give rise to such losses. In other words, it seeks to ensure greater levels of disclosure and enhance the role of market participants in encouraging greater capital holdings by banks.

An important rationale behind the pillar of market discipline is to provide sufficient information to enable the user to assess whether the available capital is sufficient to meet credit risk and market risk and other risk requirements. To the extent that such disclosures are comprehensive and objective, it is expected to assist market participants in judging how a bank's management of its capital adequacy relates to its other risk management processes and how well it is able to withstand future volatility.

It thus seeks to create a feedback loop from market assessment (pillar 3) to the credit weighting structure (pillar 1), which is to be monitored through the supervisory review of capital adequacy (pillar 2).

References

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modified the regulatory parameters for NBFCs to effectively monitor, supervise and guide their operations. In exercise of the powers conferred by the Reserve Bank of India Act, 1934 for the purpose of enabling the Bank to regulate the credit system, the Reserve Bank introduced various amendments in NBFCs guidelines issued earlier, in particular, the guidelines notified in January 1998. As per the modified guidelines pertaining to NBFCs' investment restrictions on

land and building and unquoted shares of companies, a return has to be submitted on a half-yearly basis as per the prescribed format. Further, the notification of December 18, 1998 has prescribed amendments in quarterly return for the purpose of ensuring compliance with the maintenance of a certain percentage of assets by NBFCs. The amendments to Non-Banking Financial Companies Acceptance of Public Deposit (Reserve Bank) Directions 1998 brought out (i) changes in acceptance of deposits criteria by Equipment Leasing Company (ELC) and Investment Company (IC) and (ii) relaxation in norms for returning the excess amount of deposit received from the public. Besides, as on April 20, 1999, the requirement of minimum Net Owned Fund (NOF) of Rs.25 lakh has been raised to Rs.200 lakh for those NBFCs which would commence business on or after April 21, 1999.

Regulations Review Authority

1.49 The Reserve Bank has set up the Regulations Review Authority (Dr. Y.V. Reddy as the Regulations Review Authority) on April 1, 1999 for a period of one year with the objective to provide opportunity to public as well as various other agencies to seek relevant modification of any regulations, circulars or returns issued by the Reserve Bank to avoid cumbersome procedures involving duplication, etc. During the period upto September 30, 1999, RRA implemented several suggestions, of which major ones are as follows:

i) As a measure consistent with current accent on competition, the work of fixing the bench mark service charges by the banks, hitherto attended to by IBA and FEDAI (for commercial banks and authorized dealers in foreign exchange respectively) has been decentralized to enable individual banks themselves to work out and levy service charges, based on the cost of providing services.

ii) Arrangements have been made with the regional offices of the Reserve Bank for supplying to general public, information on NBFCs registered with the Bank and to display this information on Bank's Website regularly with periodical updating.

iii) An internal committee, appointed by RRA for working out the modalities for classification and dissemination of various types of information in the Bank in electronic form through e-mail facility has since submitted the report to RRA. The report has been accepted for implementation in ten operational departments. The committee has been asked to implement the recommendations and to submit to RRA an interim report of compliance before December 1999 and the final report of compliance before March 2000.

iv) With a view to mitigating the procedural difficulties faced by banks and its clients, banks' requirements for sample test checking of newly printed MICR instruments, at MICR cheques processing centers in the Bank, before putting them into use, has been done away with.

5. Financial Performance of Scheduled Commercial Banks during 1998-99

1.50 The working results of scheduled commercial banks (SCBs) during the year 1998-99 were somewhat mixed, and elaborate details of the results are given in Chapter II. Here the essence of the financial performance is captured for quick reference. Profits of banks came under pressure due to the rise in interest expended, deceleration in non-interest income, and increase in provisions and contingencies. Bank group-wise analysis indicates that the public sector banks recorded better performance as compared to the private sector banks.

Profitability

1.51 Operating profits of scheduled commercial banks declined by 4.4 per cent from Rs.14,640 crore in 1997-98 to Rs.13,992 crore in 1998-99. However, the operating profits of public sector banks increased by 3.0 per cent from Rs.10,274 crore in 1997-98 to Rs.10,578 crore in 1998-99 (Table I.9). The operating profits of old private sector banks, on the other hand, registered a significant decline of 26.9 per cent from Rs.1,082 crore in 1997-98 to Rs.791 crore in 1998-99. Similarly, the operating profits of new Indian private sector banks declined by 7.5 per cent from Rs.740 crore in 1997-98 to Rs.684 crore in 1998-99. In the case of foreign banks too, operating profits declined sharply by 23.8 per cent from Rs.2,545 crore in 1997-98 to Rs.1,940 crore in 1998-99.

1.52 With the exception of PSBs, provisions and contingencies as a proportion to total assets of all bank groups declined during 1998-99. The net profits of SCBs declined sharply by 28.3 per cent from Rs.6,502 crore in 1997-98 to Rs.4,660 crore in 1998-99. The ratio of net profits to total assets declined from 0.8 in 1997-98 to 0.5 in 1998-99. The net profits (as a percentage of total assets) of PSBs declined from 0.8 per cent in 1997-98 to 0.4 per cent in 1998-99. Among PSBs, the decline in net profit ratio was more pronounced in the case of SBI and its Associate banks.

1.53 Bank group-wise analysis indicated that nearly 50 per cent of both public sector and private sector banks showed rise in their net profits. An analysis of the public sector banks indicated that 13 out of 27 PSBs (48 per cent) have recorded increase in their net profits. Of these profits, the share of the nationalised banks was significant at 77 per cent. As regards foreign banks, 18 banks out of 44 (41 per cent) could achieve increase in their profits.

Spread

1.54 The spread i.e. net interest income (interest income minus interest expended) witnessed a decline in 1998-99 in almost all bank groups, except for the nationalised banks. For the nationalised bank group, the spread increased marginally from 2.78 per cent in 1997-98 to 2.79 per cent in 1998-99. Among other bank groups, foreign bank group witnessed largest decline (46 basis points) followed by old private sector bank group (41 basis points), SBI group (29 basis points), and new private sector bank group (25 basis points). For the SCBs, the spread declined from 2.95 per cent in 1997-98 to 2.78 per cent in 1998-99.

Non-Performing Assets

1.55 An important parameter in the analysis of financial performance of banks is the level of non-performing assets. The information on non-performing assets (NPAs) helps the commercial banking supervisors to monitor and discipline errant banks and helps investors to decide on the true financial worth of the banks. The prudential guidelines on asset classification and income recognition norms of the Reserve Bank have been complied with by all the commercial banks in order to present the real position of loan assets and also to come closer to the international accounting standards of banking operations.

1.56 During the year 1998-99, while Gross NPAs as a percentage to Gross advances of SCBs increased from 14.4 per cent in 1997-98 to 14.6 per cent in 1998-99, the net NPAs as a percentage of net advances also increased from 7.3 per cent in 1997-98 to 7.5 per cent in 1998-99. In absolute terms, NPAs of SCBs at Rs.58,554 crore as at the end of March 31, 1999 showed an increase of Rs.7,739 crore or 15.2 per cent over the previous year (Table I.10). Bank group-wise NPA position is discussed in detail in Chapter II.

Capital to Risk-Weighted Assets Ratio

1.57 One of the major determinants of soundness and viability of banks is the level of

Table I.9: Bank Group-wise Financial Performance of Scheduled Commercial Banks– Some Important Financial Indicators: 1996-97, 1997-98 and 1998-99

(Rs. crore)

Year	Operating Profit (3+10)	Net Profit (4-7)	Income (5+6)	Interest Income	Other Income	Expenditure (8+9+10)	Interest Expended	Operating Expenses	Provisions & Contingencies
1	2	3	4	5	6	7	8	9	10
Scheduled Commercial Banks *									
1996-97	12,239.49	4,504.24	76,225.15	66,483.93	9,741.22	71,720.91	44,838.51	19,147.15	7,735.25
	(1.82)	(0.67)	(11.33)	(9.88)	(1.45)	(10.66)	(6.66)	(2.85)	(1.15)
1997-98	14,640.15	6,501.84	85,856.98	73,750.62	12,106.36	79,355.14	50,299.42	20,917.41	8,138.31
	(1.84)	(0.82)	(10.79)	(9.27)	(1.52)	(9.98)	(6.32)	(2.63)	(1.02)
1998-99	13,992.31	4,659.50	1,00,077.61	87,370.07	12,707.54	95,418.11	60,904.99	25,180.31	9,332.81
	(1.47)	(0.49)	(10.52)	(9.19)	(1.34)	(10.03)	(6.40)	(2.65)	(0.98)
Public Sector Banks (27)									
1996-97	8,887.18	3,152.17	61,260.52	53,900.34	7,360.18	58,108.35	36,338.62	16,034.72	5,735.01
	(1.60)	(0.57)	(11.01)	(9.69)	(1.32)	(10.45)	(6.53)	(2.88)	(1.03)
1997-98	10,273.72	5,029.67	67,706.58	59,076.17	8,630.41	62,676.91	40,173.57	17,259.29	5,244.05
	(1.58)	(0.77)	(10.42)	(9.10)	(1.33)	(9.65)	(6.19)	(2.66)	(0.81)
1998-99	10,577.50	3,258.09	78,867.07	69,474.31	9,392.76	75,608.98	47,839.75	20,449.82	7,319.41
	(1.37)	(0.42)	(10.24)	(9.02)	(1.22)	(9.82)	(6.21)	(2.65)	(0.95)
Nationalised Banks (19)									
1996-97	4,429.37	1,445.12	37,983.67	33,977.29	4,006.38	36,538.55	23,519.18	10,035.12	2,984.25
	(1.26)	(0.41)	(10.79)	(9.65)	(1.14)	(10.38)	(6.68)	(2.85)	(0.85)
1997-98	5,541.38	2,569.90	42,835.47	37,867.33	4,968.14	40,265.57	26,269.42	11,024.67	2,971.48
	(1.33)	(0.62)	(10.28)	(9.09)	(1.19)	(9.66)	(6.30)	(2.65)	(0.71)
1998-99	5,929.44	1,792.43	49,517.66	44,348.16	5,169.50	47,725.23	30,856.91	12,731.31	4,137.01
	(1.22)	(0.37)	(10.22)	(9.15)	(1.07)	(9.85)	(6.37)	(2.63)	(0.85)
State Bank Group (8)									
1996-97	4,457.81	1,707.05	23,276.85	19,923.05	3,353.80	21,569.80	12,819.44	5,999.60	2,750.76
	(2.18)	(0.84)	(11.39)	(9.75)	(1.64)	(10.56)	(6.27)	(2.94)	(1.35)
1997-98	4,732.34	2,459.77	24,871.11	21,208.84	3,662.27	22,411.34	13,904.15	6,234.62	2,272.57
	(2.03)	(1.06)	(10.68)	(9.11)	(1.57)	(9.63)	(5.97)	(2.68)	(0.98)
1998-99	4,648.06	1,465.66	29,349.41	25,126.15	4,223.26	27,883.75	16,982.84	7,718.51	3,182.40
	(1.63)	(0.51)	(10.27)	(8.79)	(1.48)	(9.75)	(5.94)	(2.70)	(1.11)
Old Indian Private Sector Banks (25)									
1996-97	839.51	405.69	5,388.93	4,732.56	656.37	4,983.24	3,431.20	1,118.22	433.82
	(1.89)	(0.91)	(12.12)	(10.65)	(1.48)	(11.21)	(7.72)	(2.52)	(0.98)
1997-98	1,082.33	442.68	6,437.80	5,496.15	941.65	5,995.12	4,083.77	1,271.70	639.65
	(1.97)	(0.81)	(11.71)	(10.00)	(1.71)	(10.91)	(7.43)	(2.31)	(1.16)
1998-99	790.92	310.99	7,361.03	6,497.75	863.28	7,050.04	5,087.73	1,482.38	479.93
	(1.21)	(0.48)	(11.25)	(9.93)	(1.32)	(10.78)	(7.78)	(2.27)	(0.73)
New Indian Private Sector Banks (9)									
1996-97	481.02	280.08	1,967.20	1,638.55	328.65	1,687.12	1,172.64	313.54	200.94
	(2.98)	(1.73)	(12.17)	(10.14)	(2.03)	(10.44)	(7.26)	(1.94)	(1.24)
1997-98	739.56	399.52	3,015.07	2,395.21	619.86	2,615.55	1,819.79	455.72	340.04
	(2.86)	(1.55)	(11.67)	(9.27)	(2.40)	(10.12)	(7.04)	(1.76)	(1.32)
1998-99	684.28	397.05	4,130.49	3,540.88	589.61	3,733.44	2,776.94	669.27	287.23
	(1.78)	(1.03)	(10.72)	(9.19)	(1.53)	(9.69)	(7.21)	(1.74)	(0.75)
Foreign Banks **									
1996-97	2,031.78	666.30	7,608.50	6,212.48	1,396.02	6,942.20	3,896.05	1,680.67	1,365.48
	(3.62)	(1.19)	(13.57)	(11.08)	(2.49)	(12.38)	(6.95)	(3.00)	(2.44)
1997-98	2,544.54	629.97	8,697.53	6,783.09	1,914.44	8,067.56	4,222.29	1,930.70	1,914.57
	(3.91)	(0.97)	(13.36)	(10.42)	(2.94)	(12.39)	(6.49)	(2.97)	(2.94)
1998-99	1,939.61	693.37	9,719.02	7,857.13	1,861.89	9,025.65	5,200.57	2,578.84	1,246.24
	(2.53)	(0.90)	(12.68)	(10.25)	(2.43)	(11.78)	(6.79)	(3.37)	(1.63)

Notes: 1. * The number of Scheduled Commercial Banks in 1996-97, 1997-98 and 1998-99 were 100, 103 and 105 respectively.

** The number of Foreign Banks in 1996-97, 1997-98 and 1998-99 were 39, 42 and 44 respectively.

2. Figures in brackets are percentages to Total Assets.

Table I.10: Gross and Net NPAs of Scheduled Commercial Banks: 1997 to 1999
(As at End-March)

(Amount in Rs. crore)

Year		Gross NPAs				Net NPAs		
	Gross Advances	Amount	Per cent to Gross Advances	Per cent to Total Assets	Net Advances	Amount	Per cent to Net Advances	Per cent to Total Assets
1	2	3	4	5	6	7	8	9
1997	301,698	47,300	15.7	7.0	276,421	22,340	8.1	3.3
1998	352,696	50,815	14.4	6.4	325,522	23,761	7.3	3.0
1999	401,252	58,554	14.6	6.2	370,397	27,774	7.5	2.9

capital, and more pragmatically the level of capital weighted by the associated risks. As per the prudential norms, the commercial banks are required to achieve 9 per cent Capital to Risk-Weighted Assets Ratio (CRAR) by March 31, 2000. Capital adequacy ratio of public sector banks has declined marginally from 11.5 in 1997-98 to 11.2 in 1998-99.

1.58 In the period ahead, attempts must be made to consolidate the gains of earlier reform measures and in this context, attention needs to be focussed on factors which enhance competitiveness and efficiency of the banking sector (Box I.3). This is essential both to broaden and deepen the sector and enhance its role in economic development.

6. Rural Credit and Credit to Small Scale Industries

Rural Credit

1.59 In the light of the need for rural sector development, the Reserve Bank is taking a series of measures for the timely and adecquate developmental credit flows to the rural sector through the National Bank (NABARD). Consequent to the announcement made by the Finance Minister in his budget proposals for 1996-97, the capital of NABARD has been significantly strengthened. Over a period of 5 years, it was expected to reach Rs.2,000 crore with the contributions from the Central Government and the Reserve Bank. During 1998-99, the Central Government and the Reserve Bank contributed Rs.100 crore and Rs.400 crore, respectively. This would take NABARD's capital to Rs.2,000 crore by March 31, 1999 (the additional contribution released in advance subject to amendment of NABARD Act, 1981). The limit under the General Line of Credit (GLC) to NABARD has also been enhanced. For the year 1998-99 (July-June), the Reserve Bank renewed the General line of credit (GLC) limit of Rs.5,700 crore, consisting of Rs.4,850 crore under GLC I (for seasonal agricultural operations) and Rs.850 crore under GLC II (for various other approved short-term purposes).

Credit to Small Scale Industries

1.60 The assistance provided by PSBs to small-scale industries has shown some improvements during 1998-99. According to available data, the credit facilities extended by PSBs constituted 17.3 per cent of net bank credit and 39.8 per cent of the total priority sector advances. A Committee headed by S.L. Kapur submitted its Report in June 1998 and suggested several measures for improving the credit delivery system and simplifying the procedures for credit to SSI sector. After examining the recommendations of the

Box I.3: Factors Affecting Competitiveness and Efficiency in Banking

The financial sector plays a major role in the mobilisation and allocation of financial savings. Financial institutions, instruments and markets which constitute the financial sector act as a conduit for transfer of financial resources from the net savers to net borrowers. The gains to the real sector of the economy, therefore, depend on how efficiently the financial sector performs this basic function of intermediation so that the transaction cost is kept at the minimum. The banks form the most important segment of the financial sector. However, till the 'seventies, government regulations in most of the countries shielded the banks from the forces of competition. This policy was advocated keeping the 'safety and soundness' aspect of the banking institutions in mind. The market imperfection, however, led to operational inefficiency in the banks as under the administered interest regime, they could earn adequate spreads to cover their high operational costs. Consequent to various developments covering, *inter alia* the tremendous growth in Information Technology which dismantled the geographical boundaries and the prolific growth of the non-bank financial companies which made a dent on the banks' assured clientele, the competitive environment in the banking industry has increased.

Changes in the banking policy further facilitated the creation of a competitive environment. Deregulation of banking industry through abolition of administered rates for deposits and loans gave the banks the freedom in fixing prices for their products. To compete effectively with non-bank intermediaries, the banks were permitted to undertake newer activities like investment banking, securities trading, insurance business, etc., though on a selective basis. The number of players in the market was increased by easing entry barriers. In this set up, margins on traditional banking business declined prompting the banks to look for more fee-based services, and simultaneously, the banks were forced to pay maximum attention to operational efficiency so that their transaction costs remained at the minimum. Increased competitiveness led to inevitable changes in the market. The weak players were either crowded out or they were amalgamated with the strong ones.

Measurement of efficiency is generally done with reference to the production function. Koopmans (1951) provided a formal definition of technical efficiency where an increase in any output requires a reduction in at least one other output or an increase in at least one input and *vice versa*. Farrell (1957) suggested that one could usefully analyse technical efficiency in terms of realised deviations from an idealised frontier isoquant. It is also possible to define the optimum in terms of the behavioural goal of the production unit. In such a case, the efficiency is economic and is measured by comparing actual and optimum cost, revenue or profit – whichever the production unit is expected to pursue. Estimation of the frontier function is at the centre of studies on measurement of efficiency[1]. This approach has been extended to the banking industry also. The major issue in such exercises has been to identify suitable indicators for banks' outputs and inputs. As an alternative to measuring efficiency using frontier function approach, banks' efficiency can also be measured in terms of certain ratios of costs to assets or operating revenues. In a recent study, Rhoades (1998) has examined the efficiency effects of bank mergers using the ratios of (i) non-interest operating expenses/ total expenses to assets, (ii) total expenses to total revenue, (iii) non-interest expenses to adjusted operating revenue (net interest income+non-interest income), and (iv) staff expenses to assets. A decrease in the above ratios post-merger was indicative of improvement in efficiencies.

While different methods have been adopted to estimate the efficiency components, a number of studies have also attempted to explain the efficiency differences among the banks through various bank-specific, market-specific and regulatory characteristics. These studies have important implications for public policy and bank management. A review of these studies indicated that no consistent relationship emerged between variables like asset size, organisational form, market concentration and efficiency; however, the well capitalised banks were found to be more efficient and these efficient banks had lower levels of non-performing loans (Berger and Mester, 1997).

In India, till the 'eighties, the banks were operating in a protective environment characterised by administered interest rates, high levels of pre-emptions in the form of reserve requirements and directed credit. Banking sector reforms were initiated in India in 1992 against the backdrop of challenges faced by the Indian banks from

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1. There are two competing paradigms on how to construct frontiers. One uses mathematical programming techniques; the other employs econometric techniques. The chief advantage of the mathematical programming or Data Envelopment Analysis (DEA) approach is that no explicit functional form need be imposed on the data. However, the calculated frontier may be warped if the data are contaminated by statistical noise. The parametric approach can handle the statistical noise, but it imposes an explicit, and possibly overly restrictive, functional form for technology. Unless panel data are available, an explicit distribution for the inefficiency term must be imposed as well.

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within and outside the banking system in the country as well as forces of globalisation operating worldwide. The accent of the reform process was to improve productivity and efficiency of the financial system. The major policy initiatives taken under the financial sector reform included a planned reduction in the level of statutory pre-emptions and a gradual deregulation of interest rates. As part of financial sector reform, effective pre-emption level has been brought down from 54 per cent to less than 35 per cent (Reddy, 1999). The structure of administered interest rates has been almost totally dismantled. Competition among the banks was sought to be fostered by two different policy measures. First, with the amendment of the Nationalisation Act, State owned banks were allowed to access the market to raise funds from the public. Having public as part of the ownership of the bank makes it more conscious of the need to run the institution efficiently and earn profit. Accountability in that sense increases. Secondly, new banks in the private sector were allowed to be set up and entry of foreign banks was liberalised. The decision to allow the setting up of Local Area Banks was taken with the purpose of creating a more competitive environment in rural and semi-urban areas. Simultaneously with the deregulation measures, capital adequacy measures and prudential norms relating to income recognition, asset quality and provisioning requirements were introduced so as to strengthen the safety and soundness of the banking system.

Induction of information technology and communications networking system is set to change the operating environment of banks drastically. Technology has already enabled some of the banks to introduce innovative products to their customers in the form of ATM facility, telebanking, homebanking, 'anytime' and 'anywhere' banking, etc. Technology can also be harnessed in automating and networking the branches that will ensure timely flow of information and aid decision making process. A proper Management Information System can make a major impact on the pricing of deposits, loans and other services provided by banks. The Committee on Technology Upgradation in the Banking Sector, appointed by the Reserve Bank, in its Report submitted in July 1999 has provided a medium term road map for absorption of technology by banks and financial institutions. The banks that can adopt and absorb the new technology faster will have a competitive edge over their rivals.

While the enabling policy framework and the operating environment provide a platform for improving the efficiency of the banking sector, its ultimate success depends on how individual banks respond to the competitive environment, identify their core competencies and reposition themselves effectively. These issues have been adequately addressed by the Second Narasimham Committee (1998) and according to the Committee will form part of the agenda of the second generation of reforms in the banking sector. One of the major factors affecting efficiency is the organisational structure of the banks. With a view to reaping full benefits of liberalisation, the organisational structures of the banks need to be studied carefully. In this context, the chain of command needs to be shortened with adequate authority delegated to the branches. This would also help to enhance efficiency. In addition to the organisational structure, adoption of proper internal systems and methods can greatly help in efficient functioning of the banks. Another issue that assumes importance in improving the efficiency of the banks is the human resource development. Recruiting the right people, training/ retraining them on a continuous basis keeping in view the changing environment and increasing complexities, and having a remuneration/incentive structure conducive to keeping their morale high, are considered integral part of the process. Another significant factor determining the competitiveness is the customer service. The realisation that customer satisfaction is essential for survival and growth has dawned on all the banks. The banks that will emerge as the winners in the impending era will be truly customer-centric banks.

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Committee, 64 of them have been accepted and recommended to banks for immediate implementation.

7. Technology and Payment System

1.61 Banks play an important role in the payment and settlement system of financial transactions. The introduction of liberalisation measures in the banking sector and the emergence of new private sector and foreign banks equipped with latest technology, led to an increase in competition in the banking sector. Technology upgradation is taking place in PSBs in a phased manner. Computerisation is increasingly being applied in day to day deposits and loan operations, but the pace at which it has moved so far, has been somewhat limited. Moreover, there is a need for computerisation in a large number of areas of operations of banks, with customer service as the main focus. Management information system could be further improved by affecting modern information technology methods. In the case of many industrial countries, due to advancement of information technology, virtual banking has gained more prominence and in the days to come, banks have to hasten the process of the computerisation with a view to improving competitiveness (Box I.4).

1.62 To further upgrade the existing technology in the banking sector and also to suggest measures for implementation, the Reserve Bank appointed a "Committee on Technology Upgradation in the

Box I.4: Virtual Banking

The practice of banking has undergone a significant transformation in the nineties. While banks are striving to strengthen customer relationship and move towards 'relationship banking', customers are increasingly moving away from the confines of traditional branch-banking and are seeking the convenience of remote electronic banking services. And even within the broad spectrum of electronic banking, the aspect of banking that has gained currency is virtual banking.

Broadly speaking, virtual banking denotes the provision of banking and related services through extensive use of information technology without direct recourse to the bank by the customer. The origin of virtual banking in the developed countries can be traced back to the seventies with the installation of Automated Teller Machines (ATMs). Subsequently, driven by the competitive market environment as well as various technological and customer pressures, other types of virtual banking services have grown in prominence throughout the world.

It is possible to delineate the principal types of virtual banking services. These include Automated Teller Machines (ATMs), Shared ATM networks, Electronic Funds Transfer at Point of Sale (EFTPoS), Smart Cards, Stored-Value Cards, phone-banking, and more recently, internet and intranet banking. The salient features of these services are the overwhelming reliance on information technology and the absence of physical bank branches to deliver these services to the customers.

Three evolutionary phases of virtual banking services, which represent the impact that the particular application has achieved within the industry have been described in the literature. These include (a) the *inception phase*, where the technology behind the application is in its infancy and a substantial amount of investment is required so as to make the application widely available commercially; (b) the *growth phase,* where the application is increasingly available to the customers and the technology behind the application is widely available; and (c) the *maturity phase*, wherein the application is in widespread use and institutions not offering such applications are likely to be at a competitive disadvantage.

The financial benefits of virtual banking services are manifold. Firstly, virtual banking has the advantage of having a lower cost of handling a transaction via the virtual resource compared to the cost of handling the transaction via the branch. Secondly, the increased speed of response to customer requirements under virtual banking *vis-à-vis* branch banking can enhance customer satisfaction and, *ceteris paribus*, can lead to higher profits via handling a larger number of customer accounts. It also implies the possibility of access to a greater number

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of *potential* customers for the bank without the concomitant costs of physically opening branches. Thirdly, the lower cost of operating branch network along with reduced staff costs leads to cost efficiency under virtual banking. Fourthly, virtual banking allows the possibility of improved quality and an enlarged range of services being available to the customer more rapidly and accurately and at his convenience. On the flip side of the coin, however, it needs to be recognized that such high-cost technological initiatives need to be undertaken only *after* the viability and feasibility of the technology and its associated applications have been thoroughly examined. It is not the inherent sophistication of technology, but the usefulness it offers to customers and, by extension, the commercial advantage it provides to institutions that needs to be kept in mind before going ahead with such technological practices.

Virtual banking has made some beginning in the Indian banking system. ATMs have been installed by almost all the major banks in major metropolitan cities, the Shared Payment Network System (SPNS) has already been installed in Mumbai and the Electronic Funds Transfer (EFT) mechanism by major banks has also been initiated. The operationalisation of the Very Small Aperture Terminal (VSAT) is expected to provide a significant thrust to the development of INdian FInancial NETwork (INFINET) which will further facilitate connectivity within the financial sector.

The popularity which virtual banking services have won among customers, owing to the speed, convenience and round-the-clock access they offer, is likely to increase in the future. However, several issues of concern would need to be pro-actively attended. While most of electronic banking have built-in security features such as encryption, prescriptions of maximum monetary limits and authorizations, the system operators have to be extremely vigilant and provide clear-cut guidelines for operations. On the larger issue of electronically initiated funds transfer, issues like authentication of payments instructions, the responsibility of the customer for secrecy of the security procedure would also need to be addressed.

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Banking Sector". The Committee in its Report, submitted in July 1999, recommended a new legislation on Electronic-funds-transfer system to facilitate multiple payment systems to be set up by banks and financial institutions. The major recommendations of the Committee are summarised in Box I.5.

8. WTO and Financial Services

1.63 It is well recognised that financial services play an important role in the overall economic development of a country. The scope for international trade in financial services has grown rapidly over the last two to three decades influenced by the development of new technologies, especially in telecommunications, the spread of financial libralisation as a means of achieving the financial policy objectives and the expansion of foreign investments.

1.64 Financial services covered under WTO commitments including insurance, banking telecommunications, and maritime transport were left unfinished at the end of Uruguay round negotiations held in 1993. The delay in reaching commitments in financial services brought about an interim agreement in 1995 negotiations by WTO Members. In this round, improvement took place in the schedules of specific commitments made by 29 WTO Members (counting the European Union as one) in financial services. However, the commitments made by Member countries remained unsatisfactory and finally the

Box I.5: Major Recommendations of Vasudevan Committee on Technology Upgradation in the Banking Sector (1999)

1. Communication infrastructure and usage of INFINET

- The approach that could be considered for improving the effectiveness of VSAT network aim at enhancing the transponder capacity to the extent feasible and the number of outroutes as the demand grows.
- For both inter-bank and intra-bank applications, it is necessary to have an application architecture keeping in mind that the INFINET backbone network will be VSAT based.

2. Standardisation and Security

- There should be an appropriate institutional arrangement for key management and authentication by way of a certification agency. RBI may consider appointing IDRBT as the certification agency for security management.
- Banks should adopt widely used standard of cryptography procedures to prevent data tamper during transmission.
- The technology should be allowed to evolve into standard-based solutions for multi-vendor heterogeneous environment working co-operatively and collectively for EFTPOS, including the debit, credit and Smart cards based operations.

3. Computerisation of Government Transactions

- There is a need to computerise all branches of banks dealing with Government transactions.
- The computerisation of Government departments should be synchronised with the computerisation of bank branches dealing with Government transactions.
- All PAOs/Circle offices should be computerised not later than March 31, 2001 and DDO/Treasury offices before March 31, 2002 in alignment with the computerisation of FPBs and dealing branches.

4. Data Warehousing, Data Mining and Management Information System

- A robust MIS founded on data warehousing and data mining at individual bank level is essential for implementing various regulatory guidelines including the latest one on ALM.
- A Task Force may be set up by IBA to explore feasible methodology for working out a unique identification system for individual customer data bases at banks.

5. Legal Framework for Electronic Banking

- The Reserve Bank may promote amendment to the Reserve Bank of India Act, 1934 and assume the regulatory and supervisory powers on payment and settlement systems. Simultaneously, the RBI may promote a new legislation on Electronic Funds Transfer System to facilitate multiple payment system, to be set up for banks and financial institutions.
- The RBI and IBA should pursue with the Department of Telecommunications (DoT)/ other competent Authority to permit encryption of data files/messages transmitted through communication channels for facilitating easier access to remotely located branches to the INFINET network.

6. Other Related Issues

- Re-engineering: Banks may choose the branches and areas of operation where they have already introduced a certain degree of automation and computerisation and review the systems and procedures in these branches/areas to adapt them to the technology that is newly introduced.
- The newly established private banks which have the advantage of starting with the latest technology from the very beginning, should take up the process re-engineering in right earnest.
- Each bank should chalk out a time-bound programme, synchronising with the level of computerisation being planned by it, stemming from the directions of the top management.

7. Issues Relating to Human Resource Development

- Education of staff on IT should be given due importance. The training establishments of the banks should be strengthened with adequate personnel and other infrastructure facilities, to impart necessary IT training to all levels of staff.

8. Sharing of Experiences on Technology Implementation

- The meetings of CPPD Chiefs should be sufficiently frequent enough to be effective. Meetings by the IBA for this purpose, once in two months would be useful.

negotiations on financial services in the context of the General Agreement on Trade in Services (GATS) were concluded in December 1997 after several rounds of negotiations. These negotiations brought under its umbrella the largest service sector, including all banking and other financial services, and all insurance related services, fully subject to multilateral rules.

1.65 Financial services include two broad categories of services: insurance and insurance-related services and banking and other financial services. These two categories are further sub-divided as detailed below:

Insurance and insurance-related services

1.66 Insurance and insurance-related services cover life and non-life insurance, reinsurance, insurance intermediation such as brokerage and agency services, and services auxiliary to insurance such as consultancy and actuarial services.

Banking and other financial services

1.67 Banking includes all the traditional services provided by banks such as acceptance of deposits, lending of all types, and payment and money transmission services. Other financial services include trading in foreign exchange, derivatives and all kinds of securities, securities underwriting, money broking, asset management, settlement and clearing services, provision and transfer of financial information, and advisory and other auxiliary financial services.

1.68 While certain GATS obligations apply across-the-board, others depend on the sector-specific commitments assumed by individual members. The liberalising content of the GATS depends on the extent and nature of sector-specific commitments assumed by individual members. The core provisions of the GATS in this context relate to *market access*, *national treatment* and *additional commitments*. The GATS Schedule of commitments are complex documents containing, for each member, market access, national treatment and additional commitments, up to sixteen sub-sectors of financial services. WTO commitments of India on Financial Services are given in Appendix Table I.1.

9. Perspectives

1.69 The present section places in perspective both the macro and micro economic issues which have a bearing on the banking (and financial) system *vis-à-vis* the best international standards. The major macroeconomic policy issues in this sphere would relate to (i) strengthing the foundations of the banking system, (ii) streamlining banking procedures, (iii) encouraging human resource development, and (iv) bringing structural change in the banking system.

Strengthening the Banking System

Capital Adequacy

1.70 The efforts at strengthening the capital base of the banking system need to be continued so as to cope up with any additional risk factors. In the Monetary and Credit Policy of October 1998, banks have been advised to achieve a minimum capital adequacy ratio of 9 per cent by March 31, 2000. About the need, as emphasised in the second Narasimham Committee Report, for raising Capital to Risk-weighted Assets Ratio to reach 10 per cent by 2002 is to be duly recognised. The proposed capital accord of BIS (June 1999) further suggests that banks have to provide additional charge on capital for various kinds of risks including credit risk, market risk, operation risk, interest rate risk, etc. at an early date.

Risk Management

1.71 The mismatch between assets and liabilities has serious implications for interest rate risk, liquidity risk, foreign exchange risk, credit risk, etc. To manage these risks properly, risk management skills on the part of banks need to be enhanced. The recent experience of banks

facing assets-liability mismatches in the South East Asian countries provide enough evidence on the need for putting in place necessary asset-liability management (ALM) practices. The second Narasimham Committee has also addressed this issue and brought into focus the dangers to liquidity and solvency due to mismatches between assets and liabilities, in terms of either maturity and currency or value. The Committee recommended that banks are required to put in place ALM System with effect from April 1, 1999. The initial teething problems in adapting ALM would have to be addressed expeditiously. The Reserve Bank has complemented the ALM guidelines with guidelines on risk management on October 21, 1999 (Box I.6). Together the guidelines would serve as a benchmark to banks and help to establish an integrated risk management system.

Non-Performing Assets

1.72 A major issue challenging the performance of banks is the accumulation of non-performing assets (NPAs). While the gross NPAs of the banking sector have been reduced from 23.2 per cent in 1992-93 to 14.6 per cent in 1998-99, efforts need to be continued to reduce the ratio further. Besides, the net NPA ratios need to be brought down from 7.5 per cent in 1998-99. In this context, it may be recalled that for banks with international presence, the Narasimham Committee recommended the reduction of gross NPAs to 5 per cent by 2000 and 3 per cent by 2002; and net NPAs to 3 per cent by 2000 and 0 per cent by 2002 ratio. The feasibility of this recommendation would have to be explored, keeping in view the need to ensure adequacy of credit flows to all production activities of the economy. It is also necessary to work out the levels of NPAs at which the confidence in banking can be maintained at high levels as recommended by the Committee.

Asset Reconstruction Company

1.73 To address the problem of accumulated NPAs, the first Narasimham Committee, suggested the setting up of an Asset Reconstruction Fund, but this suggestion could not be implemented. Reiterating this arrangement, the second Narasimham Committee suggested the setting up of an Asset Reconstruction Company (ARC). The ARC, which would take over all loan assets in the doubtful and loss categories, would issue to the banks NPA Swap Bonds representing the realisable value of the assets transferred, provided the stamp duties are not excessive.

1.74 The international experience with such arrangements has, however, been mixed. In India, progress in setting up of ARCs, is yet to be seen partly because the Debt Recovery Act and other relevant legislations are yet to be strengthened. Besides, the ARCs could engender *moral hazard* problems. It is, therefore, necessary to attempt to make Debt Recovery Tribunals (DRTs) more effective in their operation. More importantly, debt recovery systems need to be improved across the board to ensure efficiency of the financial sector.

Problem of Weak Banks

1.75 While strong banks are able to consolidate the gains of the so far implemented reform measures, weak banks are grappling with the twin objectives of achieving profitability and ensuring compliance with the prescribed norms. The major challenge of the next few years relates to recovery of loans and viability of banks, in particular of those identified as 'weak' ones. Both legal changes and restructuring plans need to be put in place in these areas, recognising that the strength of the banking system is, often, no more than that of the weakest bank allowed to survive through regulatory forbearance. A Working Group (Chairman: Shri M.S. Verma) which was constituted by the Reserve Bank, to identify weak Public Sector Banks (PSBs), undertook a case by case examination and suggested a restructuring plan for the weak PSBs (October 1999) (Box I.7).

Box I.6: Reserve Bank Guidelines for Risk Management System in Banks

According to the guidelines the management of credit risk should receive the prime attention of the top management. The banks should put in place the loan policy, approved by the board of directors covering the methodologies for measurement, monitoring and control of credit risk. Banks should also evolve comprehensive risk rating system that serves as a single point indicator of diverse risk factors of counterparties in relation to credit and investment decisions. The Reserve Bank guidelines have stated that the activities of Asset-Liability Management Committee and Credit Policy Committee for management of credit and market risks need to be integrated.

The guidelines also require banks to evaluate portfolio quality on an on going basis rather than near about balance sheet date. The proposals for investment should be subjected to the same degree of credit risk analysis as loan proposals. The risk evaluation should also include total exposure, including investments. As regards off-balance sheet exposures, the current and potential credit exposures may be measured on a daily basis. Banks have also been asked to evolve a suitable framework to provide a centralised overview of the aggregate exposure on other banks' endeavour to develop an internal matrix that reckons the counterparty and country risks. To manage liquidity risk, banks have been asked to consider putting in place prudential limits on inter-bank borrowings, especially call fundings, purchased funds, core deposits to core assets, off-balance sheet commitments, swapped funds, etc.

Banks have been asked to evaluate liquidity profile under bank-specific and market crisis scenarios. They have also been asked to prepare contingency plans to measure the ability to withstand sudden adverse swings in liquidity conditions. Banks have been asked to fix definite a timeframe for moving over to Value at Risk (VaR) and duration approaches for measurements of interest rate risk. The guidelines also mention that it would be desirable to adopt international standards on providing explicit capital cushion for the market risk to which banks are exposed. Banks should also adopt proper systems for measurement, monitoring and control of operational risk that is emerging in the wake of phenomenal increase in the volume of financial transactions. Banks operating in international markets have been asked to develop by March 31, 2001 suitable methodologies for estimating and maintaining economic capital. The other banks have been asked to formulate a medium-term strategy to comply with these requirements.

The guidelines on risk management have placed the primary responsibility of laying down risk parameters and establishing the risk management and control system on the board of directors. They have, however, stated that the implementation of the integrated risk management could be assigned to a risk management committee or a committee of top executives that reports to the board. The risk management guidelines also require banks to constitute a high level credit policy committee to deal with issues pertaining to credit sanction, disbursement and follow-up procedures and to manage and control credit risk on a whole bank basis. The Reserve Bank has further asked banks to concurrently set up an independent credit risk management department to enforce and monitor compliance of the risk parameters and prudential limits set by the board/credit policy committee.

The Reserve Bank has, however, stated that due to the diversity and varying size of balance sheet items between banks, it may neither be possible nor may it be necessary to adopt a uniform risks management system. The design of risk management framework should, therefore, be oriented towards the bank's own requirement dictated by the size and complexity of business, risk philosophy, market perception and the existing level of capital. In other words, banks can evolve their own systems compatible with the type and size of operations as well as risk perception. While doing so, banks may critically evaluate their existing risk management system in the light of the guidelines issued by the Reserve Bank and put in place a proper system for covering the existing deficiencies and requisite upgradation. The Reserve Bank has also asked banks to place the circular together with the guidelines before the board of directors at its next meeting. The bank should identify the gaps in the existing risk management practices and the policies and strategies for complying with the guidelines. The bank should report to the board the progress in implementation of the guidelines at half-yearly intervals.

Strengthening the Co-operative Structure

1.76 The reform measures adopted so far have focussed mainly on the commercial banking segment of the banking sector, without providing matching attention to the co-operative sector. Financial and managerial weaknesses of co-operatives have been a matter of concern for quite some time. State Governments and co-operatives have been demanding capital infusion for wiping out past losses. Unless the inherent weaknesses

Box I.7: Report of the Working Group on Restructuring Weak Public Sector Banks

One of the major issues confronting the banking sector internationally is how to strengthen the capital base of banks and how to make them resilient to rising risk exposures. Goldstein (1996) had shown that in industrial countries, total capital-asset ratios have fallen from around 50 per cent in the early 'nineties to around 15 per cent presently. The study further argued that this led the Basle Committee on Bank Supervision to impose minimum risk-weighted capital-asset ratio of 8 per cent since 1988 and strengthen the capital base of financial institutions depending on their risk exposures.

It is widely agreed that the build-up of non-performing loans (NPA) has been an important factor that has eroded the profitability of public sector banks (PSBs) in India. As pointed out in the previous year's Report, gross NPAs of PSBs has moved up from Rs.39,253 crore in 1993 to Rs.45,653 crore in 1998. As percent of gross advances, NPAs of public sector banks stood at 16 per cent as at end March 1998, and these were significantly higher than that of the developed economies like the U.S. (1.1 per cent), Finland (2.7 per cent), Norway (3.2 per cent) and even the Asian economies like Malaysia (3.9 per cent) and Japan (3.4 per cent).

Subsequently, the Report of the Committee on Banking Sector Reforms (1998) (Chairman: Shri M. Narasimham) has acknowledged the import of the fact that NPAs of large magnitudes are a major impediment to the healthy performance of the banking sector. The Committee had underlined the need to reduce the average level of net NPAs for all banks to 3 per cent by 2002 and to zero for banks with international presence. Accordingly, the Committee, in its Report, provided two quantifiable definitions of weak banks which internalize the concept of NPA. Accordingly, a weak bank is one whose accumulated losses and net NPAs exceeds its net worth (definition 1); alternately, a weak bank is one whose operating profits less its income on recapitalisation bonds is negative for three consecutive years (definition 2).

Given that a high level of NPAs acts as a major hindrance to the profitability of banks, the Government has resorted to recapitalisation of banks in order to shore up their capital adequacy ratios (CAR). The recapitalisation of 19 nationalised banks was undertaken on January 1, 1994, and the recipient banks were required to invest the Government's capital subscription in Government bonds known as '10 per cent Recapitalisation Bonds, 2006'. Till 1998-99, an amount of Rs.20,446 crore has been expended as part of the process of recapitalisation of nationalised banks. Such recapitalisation has been widely used at different points of time in several countries including Chile (1984), Philippines (1986), Finland (1991), Hungary (1992-94) and Argentina (1994-95). However, as Sundarrajan and Balino (1991) have observed, the use of public money for recapitalisation often endangers efforts to rein in budget deficits. And even if budget deficits are viewed as (domestic) transfers rather than as real economic costs, it can compel the authorities towards less benign ways of deficit financing (e.g., an inflation tax); the rescue process itself can weaken the incentives for creditors to monitor the behaviour of banks in the future.

The problem of weakness in the banking sector has also been recognized in the Indian context. In view of the adverse implications that weak banks might have on the stability of the banking system, the Reserve Bank, in consultation with the Government of India, established a Working Group in February 1999 under the Chairmanship of M. S. Verma to suggest measures for the revival of weak public sector banks. The Working Group, in its Report submitted in October 1999, suggested a combination of seven parameters covering the three major areas of solvency, earnings capacity and profitability for identifying bank weakness. The parameters under solvency included the capital adequacy ratio and the coverage ratio[1] , those under earnings capacity included return on assets and net interest margin, whereas the parameters under profitability included ratios of operating profit to average working funds, cost to income and staff cost to net interest income plus all other income. The Group was of the opinion that criteria for detecting bank weakness, as provided by the Narasimham Committee, supplemented by an analysis of the performance based on the seven parameters detailed above, would serve as the framework for identifying weakness in banks in the future. Based on the aforesaid criteria, PSBs were classified into three categories: banks where none of the seven parameters were met (category 1), banks where all the parameters are met (category 2) and banks where some of the seven parameters are met (category 3).

(Contd......)

1. Coverage ratio is defined as the ratio of equity capital and loan loss provisions, less non-performing loans to total assets.

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The primary focus of the Group was restructuring of those banks which did not satisfy any (or most) of the seven parameters. For these banks, the Group suggested a two-stage operation. In stage one, the focus was to ensure restoring competitive efficiency through a four-pronged strategy consisting of operational, organisational, financial and systemic restructuring. Operational restructuring would comprise (i) basic changes in the mode of operations, (ii) adoption of modern technology, (iii) resolution of the problem of high non-performing assets through the setting up of a government-owned Asset Reconstruction Fund (ARF) and (iv) drastic reduction in the cost of operations, through, among others, staff rationalisation measures. Organisational restructuring encompassed improved governance practices of the banks and enhancement in management involvement and efficiency. Financial restructuring was sought to be tackled via the recapitalisation route, which may be done for specific purposes and with conditions which the banks' management, including its Board of Directors, and the employee unions agree to fulfill before the restructuring process is initiated. Finally, systemic restructuring necessitated, *inter alia,* changes in the legal system and formulation of appropriate measures aimed at institution-building so as to support the restructuring exercise. The overall cost of restructuring of weak banks over the next three years is estimated to be of the order of Rs.5,500 crore, of which capital infusion would constitute Rs.3,000 crore, the NPA buyout process would constitute Rs.1,000 crore, the staff rationalisation measure would constitute Rs.1,100-1,200 crore and the remaining Rs.300-400 crore would be required for technology upgradation. Of these, the amounts for technology upgradation and staff rationalisation would be required to be provided in cash. For speeding up the recovery process of weak banks and the ARF, the Committee suggested that an arrangement should be worked out so that the Debt Recovery Tribunals (DRTs) attend to their cases on a priority basis. The options of privatisation and/or merger would assume relevance only in stage two of the restructuring process.

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are adequately addressed, funds infusion alone may not solve the problem. In this respect, the areas that need careful examination include: (i) the existing branch network of co-operatives, (ii) the pattern of resources of co-operatives (owned funds, deposits, borrowings), (iii) the deployment of resources, (iv) the management and supervision, (v) the role of co-operative banks in the financial system and (vi) the regulatory framework for co-operatives. These issues relate to both urban and rural co-operatives. The essential spirit of the regulatory and reform measures adopted for the commercial banks should be extended to the co-operatives as well with necessary adaptations to suit the circumstances in which co-operative banks operate. This would imply that areas such as (i) strengthening of the regulatory and supervisory framework, and (ii) enhancing transparency and disclosure norms as the points of supervisory and regulatory reform should be focussed on in respect of co-operative banking system as well.

1.77 Improving the credit delivery system of co-operatives is vital for reaping productivity and employment gains and for strengthening the co-operative credit structure. The second Narasimham Committee has recommended the delayering of the co-operative credit institutions, keeping in view the need for reducing the intermediation cost and extending the benefit of cheaper RBI credit (through NABARD) to the ultimate borrowers. It is necessary to explore mechanisms by which credit delivery could be

improved and the Primary Agricultural Credit Societies and ultimate borrowers could benefit from such initiatives.

Streamlining the Banking Procedures

Role of Auditors

1.78 In the context of the increasing adoption of international standards in banking operations and accounting methods in India, the system of audit plays an important role in ensuring a proper functioning of the banking system. After the recent experience of many East-Asian countries, external audit has emerged as an important factor in determining the soundness of the banking system. In India, auditors nominated by the Reserve Bank have played an important role in maintaining the overall soundness of the banking system. However, in view of the increasing role and operations of the banking system, the system of audit needs to be made more extensive and accountable, and needs to be in line with the internationally accepted standards.

Assets Classification and Income Recognition

1.79 It is essential to take steps towards proper classification of assets so as to improve efficiency and to ensure proper accounting of transactions into various categories *viz,* standard, sub-standard, doubtful, loss making, etc. as per international norms. The present norm of 18 months for categorising a sub-standard asset as doubtful, needs to be brought down to make it at par with the international practice of 12 months. As regards income recognition norms, it is important to pursue the implementation of international norm of 90 days in a phased manner by 2002, as against the current practice of 180 days, as recommended in the second Narasimham Committee Report.

Transparency and Disclosure in Final Accounts

1.80 Transparency and disclosure of bank accounts play an important role in encouraging healthy competition among the market players. One of the characteristic features of a perfectly competitive market model is the free flow of information or the transparency of business operations. Transparency not only helps the creditors whose funds are at risk to make optimal decisions regarding their investment portfolio, but also imposes market discipline on banks to perform well in a competitive manner. Accordingly, the banking sector's allocative efficiency and the enhanced private sector participation would be best facilitated if there is increased transparency in banking operations. In the case of highly diversified banks, it becomes difficult to make *a priori* judgements regarding their ability to control the risk component. Therefore, public disclosure acts as a speed breaker in funding risky activities by banks. Adequate and timely disclosures can help to reduce the probability of bank failures.

1.81 The second Narasimham Committee has already suggested larger disclosure of accounts by banks in a phased manner. Banks are now required to present classified accounts of both their assets and liabilities including foreign currency holdings in terms of maturity pattern. Banks are also required to disclose information relating to movements in provision accounts, in NPAs, lending to sensitive sectors and lending to related companies. Banks need to publish consolidated balance sheet of all entities whenever banks are subsidiaries in a conglomerate structure. Such disclosures and transparency practices would help to improve the process of expectation formation by the market players and the effectiveness of policies of banks. The progress so far achieved in this area needs to be further accelerated.

Opening of New Banks

1.82 The recent experiment regarding the opening up of new banks, has produced encouraging results and has been quite successful

in enhancing competition in the banking sector in urban/metropolitan areas. However, it is also necessary to look beyond competition and explore possibilities of improving credit delivery in interior areas (rural / semi-urban). Presently, eight 'in-principle' approvals have been given for setting up of Local Area Banks (LABs), of which three have been registered.

Systems and Methods in Banks

1.83 The experience so far shows that the operational rules and norms of banking have not kept pace with the developments taking place in the banking sector. The cumbersome loan and documentation procedures in banks, which partly arise from legislative and regulatory requirements, impinge on the efficient functioning of the banking sector.

1.84 It is, therefore, very vital that the internal controls which consist of a wide spectrum of internal inspection and audit, submission of control returns by branches/controlling offices to higher level offices, visits by controlling officials to the field level offices, risk management systems, simplification of documentation procedures and efficient inter-office communication channels are strengthened. The implementation of such a control system would necessitate revisions in the 'Operational Manuals', audit procedures and better evaluation of clients. Some steps have already been initiated in this direction. The Board for Financial Supervision (BFS) of the Reserve Bank issued guidelines to banks to strengthen the internal control system. Besides, banks have been advised to constitute Audit Committees of the Boards to enable focussed attention by the Boards of the banks on internal control systems.

Setting up of Credit Information Bureau

1.85 Exchange of credit information between banks, and other financial entities is critical for preventing misutilisation of financial resources. A system needs to be developed where entrepreneurs with honesty and integrity are encouraged, and wilful defaulters are denied access to bank credit. Countries like Sri Lanka and Bangladesh have already set up Credit Information Bureau. In the Indian financial system too, there is a widely felt need to establish a Credit Information Bureau for the collection of credit information relating to borrowers from lending institutions and for the provision of such information to the financial system, so as to facilitate better distribution of credit to all sectors of the economy.

1.86 With a view to preparing an outline and exploring the possibilities of setting up a Credit Information Bureau in India, the Reserve Bank of India constituted a Working Group (Chairman: Shri N.H. Siddiqui). The Working Group submitted its report at the end of August, 1999, recommending the setting up of a Credit Information Bureau.

Information Technology Development in Banking

1.87 Information Technology and the Communication Networking Systems have revolutionalised the functioning of banks and other financial institutions the world over. In the highly industrialised countries, access to financial entities is on an on-line basis. Banks as well as other financial entities in India have only recently entered the world of information technology and computer networking.

1.88 Besides, the technology upgradation, an efficient payment system is needed to improve the effectiveness of monetary policy. Accordingly, in his mid-term review of the Monetary and Credit Policy on October 31, 1998, the Governor, Reserve Bank of India had announced that real time gross settlement (RTGS) system would need to be adopted with the help of an appropriate communications backbone (Box I.8).

Box I.8: Preparedness for Technology Upgradation and RTGS

One area that has witnessed a tremendous growth in recent years is one of information technology in the financial sector. And in recent times, information technology and the communications networking systems have virtually transformed the domain of operations of banks and other financial entities all over the world and enabled them to exploit economies of scale and scope through the lowering of transactions costs. Given the enormous volume of funds that are channeled through the payments and settlements system, information technology not only has manifold implications for the efficacy of monetary policy, but it has also a crucial bearing on the stability of the financial system as a whole. The implications of such technology-driven environment for Indian banks are immense. The wherewithal for the business that the banks undertake, the systems and procedures that they adopt, the services and products that they offer and the relationships they build and develop with their customers, both within the organization and outside, is expected to redefine their contours of operations in a world that is increasingly witnessing the rapid internationalisation and universalisation of banking operations.

While advances in information technology have made rapid strides in developed countries, in India, it is only recently that the world of information technology preparedness has made significant inroads in the sphere of banking operations. One can delineate three distinct, though not necessarily exclusive, areas where the application of information technology has been quite substantial.

Firstly, with regards to the *payments and settlement systems*, since the introduction of MICR cheques in the mid-eighties, the Reserve Bank has proceeded to make significant improvements in the functioning of financial entities with respect to their application of information technology. These include, introduction of Electronic Funds Transfer (EFT), introduction of inter-bank electronic payments system, introduction of a clearing bank for extension of delivery versus payment mode of trading in government securities, introduction of Automated Teller Machines (ATMs) by almost all major banks and the putting in place of a Shared Payments Network System (SPNS) termed SWADHAN in Mumbai. The Reserve Bank has also operationalised the Very Small Aperture Terminal (VSAT) network to provide reliable communication backbone to the financial sector. The setting up of the INdian FInancial NETwork (INFINET), based on satellite communication using VSAT technology, being jointly set up by the Reserve Bank, public sector banks and the Institute for Development and Research in Banking Technology (IDRBT) at Hyderabad is expected to facilitate connectivity within the financial sector. Side by side, the Year 2000 (Y2K) problem is being proactively dealt with by the Reserve Bank in co-ordination with the Indian Banks' Association (IBA) and other segments of the financial system. In the light of the recommendations of the Committee on Banking Sector Reforms (Chairman: Shri. M. Narasimham) in 1998, the Reserve Bank had appointed a Committee on Technology Upgradation in the Banking Sector to further undertake a close examination of the issues pertaining to technology and suggest time-bound steps for implementation of the same. The Committee, in its Report submitted in July 1999, recommended several steps including outsourcing of software technology, establishment of a data warehouse on banking and finance for the data collected under the regulatory provisions and furthermore, the establishment of an appropriate institutional arrangement for key management and authentication by way of a certification agency and the appointment of the IDRBT for the purpose.

Against the backdrop of preparedness towards technology upgradation, the Reserve Bank has made a pro-active effort in deciding to move towards a Real Time Gross Settlement (RTGS) System. In line with the announcements in the Monetary and Credit Policy for 1999-2000, the Reserve Bank has constituted a National Payments Council (Chairman: Shri S. P. Talwar) to focus on the broad policy parameters for designing and developing an integrated payments and settlements structure, with the proposed RTGS system at the core of the system. Country experiences with state-of-the-art settlement practices reveal that although most developed countries operate on a combination of Real Time Gross Settlement (RTGS) System, other Gross Settlement (GS) system, Multilateral Netting (N) or combinations of the above, the RTGS is regarded as the backbone of the payments system in the developed countries. RTGS enables real-time and on-line funds transfer and management for the financial system as a whole. The direct finality of gross settlement prevents settlement failures with their potential systemic consequences. Table 1 provides the RTGS system as prevalent in the developed economies and the ratio of transactions to GDP. As is evident from the Table, a substantial amount of transactions is carried out through the RTGS system. Consequently, the transfer to a RTGS has become the main objective of payment reform in most countries of the world. Gross settlement systems have the advantage of significantly reducing risks, as transactions

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Table 1: RTGS in Selected Developed Economies

Country	RTGS system Manager	Owner/ participants	No. of	Processing	Settlement	Membership
1	2	3	4	5	6	7
Belgium	ELLIPS	B+CB	122	RTT	RTGS	RM
France	TCB	CB	158	RTT	RTGS	O
Germany	EIL-ZV	CB	2,947	RTT	RTGS	O
Italy	BI-REL	CB	791	RTT	RTGS	O
Japan	BOJ-NET	CB	426	RTT	RTGS #	RM
Sweden	RIX	CB	130	RTT	RTGS	RM
Switzerland	SIC*	B+CB	221	RTT	RTGS	RM
UK	CHAPS	B	422	RTGS**	N	RM
US	Fedwire	CB	9,967	RTT	RTGS	O

Notes: 1. * Combination of large-value system and retail system.
** Changed to RTGS from April 1996.
# The system has been designed to allow participants to enter funds transfer instructions continuously, in which case the settlement takes place on the central bank's books immediately. It is however, also used to settle on a net basis.
2. B: Bank; CB: Central Bank; N: Multilateral Netting, O: Open membership (any bank can apply). RM: Restricted Membership (subject to criteria).

Source : Statistics on Payments System in the Group of Ten Countries, 1996.

are settled on a bilateral basis in real time frame. In fact, Alan Greenspan, Chairman of the Federal Reserve has advocated the movement towards 'real time gross everything'. Such RTGS systems assume all the more importance in a cross-border context, as cross-country risks are difficult to monitor *vis-à-vis* domestic transactions.

However, several areas of concern still remain to be addressed. On the issue of electronically initiated funds transfer, issues like authentication of payments instructions, responsibility of the customer for secrecy of the security procedure need immediate attention. Similarly, the legal framework for the payments system need careful examination. Mention needs to be made in this context of the Committee on Technology Upgradation in the Banking Sector that has called for the setting up of a Standing Committee of members drawn from legal department of the Reserve Bank, IBA and other banks to examine legal issues on electronic banking and also to scrutinize issues of confidentiality of data in the computerised environment. These issues would need to be examined for improving the overall efficiency of the banking sector.

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1.89 The INdian FInancial NETwork (INFINET) based on satellite communication serves as an important communication backbone; it needs to be augmented by addition to the presently licensed transponder capacity as well as by other communication modes. Such a development would strengthen the technological infrastructure and hence help to improve financial market integrations. To strengthen the communication network and equip the Indian banking system with

modern technology comparable with international standards, the recommendations of the Vasudevan committee (July 1999) need to be implemented.

1.90 A number of initiatives were taken by the Reserve Bank of India to address the year 2000 problem. Apart from ensuring reporting on Y2K status, contingency plans were also prepared. Besides, the Bank has announced several measures to give confidence to the members of the public that there is Y2K readiness in the financial sector. The important announcement, in this regard are detailed out in Chapter II. The banks have also been advised to set up event management centres at the time of the transition to the millenium change.

Human Resource Development

1.91 To obtain optimal results from the increasing sophistication (computerisation and network system) in the banking industry, and to face the challenges posed by an array of risks in business, it is essential to lay emphasis on high quality of bank personnel. Recruitment procedures for hiring at affordable prices and training and managerial responsibility at different levels of the staff structure, etc. are the important issues which need to be undertaken, so that the existing labour market rigidities and restrictive practices could be addressed.

Universal Banking

1.92 As announced in the policy statement of October 30, 1998, the Discussion Paper on Universal Banking was circulated for comments and wider debate. On the basis of intensive discussions and consultations, some of the desirable directions for evolution of policy are the following:

(a) Universal Banking is a desirable goal and some progress has been made by permitting banks to diversity into investments and long-term financing and the Development Financial Institutions (DFIs) to lend for working capital, etc. The process of enabling the provision of diversified services both by banks and DFIs, either in-house or through the subsidiary route as a conglomerate should be continued subject to appropriate regulation by the Reserve Bank.

(b) Banks have certain special characteristics and as such any discriminatory dilution of RBI's prudential norms for conduct of banking business would be inadvisable. Further, any conglomerate, in which a bank is present, should be subject to a consolidated approach to supervision and regulation.

(c) The regulatory framework of RBI in respect of DFIs would need to be strengthened if they are allowed greater access to short term resources for meeting their financing requirements.

(d) Though the DFIs would continue to have a special role in the Indian financial system, until the debt market demonstrates substantial improvements in terms of liquidity and depth, any DFI, which wishes to do so, should have the option to transform itself into a bank (which it can exercise), provided the prudential norms as applicable to banks are fully satisfied. In respect of any DFI which requires a transition path to fully comply with regulatory requirement of a bank, the DFI concerned may consult RBI for such transition arrangements.

(e) Banks and DFIs will be encouraged by the Reserve Bank to have appropriate coordinating mechanisms among themselves for exchange of information and sharing of risks particularly in respect of large and capital intensive projects.

(f) In due course, and in the light of evolution of the financial system, the Narasimham Committee's recommendation that, ultimately there should be only banks and restructured NBFCs may be considered.

(g) Broader issues, relating to sharper differentiation between regulatory and ownership role by the Reserve Bank and between refinancing and supervisory roles of refinancing institutions as also corporatisation of refinancing institutions, will be processed further.

1.93 Consistent with the above approach, the Reserve Bank has already initiated the following steps:

i) A Standing Co-ordination Committee has been constituted by banks and DFIs at their initiative, on September 14, 1999. The Committee, headed by the CMD of IDBI and assisted by representatives from banks, IBA and a few FIs and the UTI, is expected to facilitate co-ordination and resolution of issues relating to projects, assisted jointly by banks and DFIs.

ii) In order to have a systematic approach to management of liquidity and interest rate risk exposures of FIs, the draft guidelines on asset liability management system had been issued in April 1999. On the basis of feedback and comments received on the draft guidelines, the final guidelines will be issued shortly to FIs.

iii) The repo market has been thrown open to DFIs, on both borrowing and lending sides, to provide them with greater access to money market instruments.

iv) In order to ensure integrated financial supervision over the FIs, an off-site surveillance system has been put in place in July 1999. The objective of the reporting system is to monitor aspects of prudential concern to RBI with particular reference to compliance with the prudential, regulatory and supervisory norms.

Legal Issues

1.94 The on-going process of reforms cannot be successful without a supporting and complementary legal framework which can provide for both strong internal governance in the financial system as well as external discipline by market forces, as suggested by the second Narasimham Committee Report. Steps have to be taken up on a priority basis to bring the required changes in legal provisions to usher in automation in banking operations, electronic funds transfers, recovery laws, etc. An effective legal machinery is also required to facilitate the speedy recovery of dues of banks and financial institutions.

1.95 To make banks more efficient and to improve their productivity, the second Narasimham Committee has suggested cost reduction measures by outsourcing some areas in addition to the existing ones, like building maintenance, cleaning, security, and computer-related areas. This necessitates a serious review of the Contract Labour (regulation and abolition) Act, 1970. To improve the recovery climate of bank loans and to dispose of high value claims of banks and financial institutions expeditiously, Debt Recovery Tribunals (DRTs) were established at a number of places following the passing of the Recovery of Debts due to Banks and Financial Institutions Act, 1993. However, the functioning of the Tribunals has not been satisfactory and, therefore, steps need to be taken to make them more effective and quick in producing the desired results. An Expert Group was set up by the Reserve Bank in 1998 to streamline the functioning of DRT whose report, submitted in August 1998, is under consideration of the Government.

Review of Insurance arrangements in Financial Sector: Amendment to the DICGC Act, 1961

1.96 The Deposit Insurance and Credit Guarantee Corporation (DICGC) set up under the Deposit Insurance & Credit Guarantee corporation Act, 1961 provides insurance protection to small

depositors in banks and also guarantee cover to credit facilities extended to certain categories of small borrowers, particularly those belonging to the weaker sections of the society. The Corporation provides insurance cover against loss of all or part of deposits with an insured bank up to Rs.1 lakh per depositor per bank in the same right and capacity for a premium at the rate of 5 paise per Rs.100 per annum. Consequent upon the changes made in the operation of the three Credit Guarantee Schemes operated by the Corporation, a large number of banks have opted out of the Credit Guarantee Schemes. While the viability of the Corporation in relation to credit guarantee has come into focus, there may be need for an alternative arrangement.

1.97 With the gradual deregulation of interest rates on advances to priority sector, there is a need for a re-look into the role and functions of the DICGC. The Second Narasimham Committee has recommended the setting up of a Restructuring Commission to tackle the problem of weak banks.

1.98 The Reserve Bank has set up a Study Group on Reforms in Deposit Insurance in India under the Chairmanship of Shri J. Capoor, Deputy Governor of the Reserve Bank. The terms of reference of the Working Group included (a) to review the role of Deposit Insurance in financial sector and economic developments, including a review of the international experience with regard to Deposit Insurance; (b) to conduct a detailed survey of the nature of Deposit Insurance in India – instruments, institutions and regulatory legal framework; and (c) to propose changes to the existing system. The Report of the Working Group has been released for discussion.

Financial Frauds

1.99 With the diversification of financial instruments and globalisation of the economy resulting in upsurge of cross border financial transactions, an effective system needs to be put in place to tackle money laundering and financial frauds. Such an institution could be modelled on the lines of Serious Frauds Office of UK and Financial Institutions Crime and Enforcement Network in USA to function as an apex agency comprising representatives from investigating agencies like the Central Bureau of Investigation (CBI), the Government of India and the RBI. Such an agency can go into cases of money laundering and financial frauds perpetrated on the banking system. The agency should provide the required expertise and conduct expeditious investigation into cases of financial frauds brought to the notice of the central bank of the country.

1.100 Suspicious activity covers the known or suspected violation of law in relation to a financial transaction so as to establish criminal nature of conduct. Suspicious activities endanger the economy and the fabric of the financial system. An institutionalised framework needs to be put in place covering banks, financial institutions, NBFCs, etc. for reporting transactions relating to suspicious activities. A similar system exists in the United States. All financial institutions operating in the United States including Insured Banks, Savings Associations, Credit Unions, Bank Holding Companies, Non-bank Subsidiaries, etc. are required to submit Suspicious Activities Report in respect of financial transactions above a cut off limit, in the prescribed format.

1.101 In India, the RBI has evolved a mechanism for dealing with frauds and set up the Advisory Board on Bank Frauds (ABBF) (February 1997) (Chairman: Shri S.S. Tarapore), which has been redesigned as the Central Advisory Board on Bank Frauds (CABBF) on March 1, 1999. The Board takes up bank fraud cases of officers at the level of General Managers and above, referred directly or through Ministry of Finance (MOF). The decisions and directions of the Board on the referred cases would enable the banks to enhance staff accountability and prevent the occurrence of frauds.