REPORT OF THE COMMITTEE ON BANKING SECTOR REFORMS – A SUMMARY*

Reform of the Indian banking sector is now under way following the recommendations of the Committee on Financial System (CFS) which reported in 1991. Meanwhile, major changes have taken place in the domestic economic and institutional scene, coinciding with the movement towards global integration of financial services. These developments have reinforced the importance of building a strong and efficient financial system.

2. The second generation of reform could be conveniently looked at in terms of three broad inter-related issues: (i) Actions that need to be taken to strengthen the foundations of the banking system; (ii) Related to this, streamlining procedures, upgrading technology and human resource development; (iii) Structural changes in the system. These would cover aspects of banking policy, institutional, supervisory and legislative dimensions.

Measures to Strengthen the Banking System

Capital Adequacy

3. The Committee suggests that pending the emergence of markets in India where market risks can be covered, it would be desirable that capital adequacy requirements take into account market risks in addition to the credit risks.

4. The Committee recommends that in the next three years the entire portfolio of Government securities should be marked to market and this schedule of adjustment should be announced at the earliest. At present Government and other approved securities are subject to a zero risk weight. It would be appropriate that there should be a 5 per cent weight for market risk for Government and approved securities.

5. The risk weight for a Government guaranteed advance should be the same as for other advances. To ensure that banks do not suddenly face difficulties in meeting the capital adequacy requirement, the new prescription on risk weight for Government guaranteed advances should be made prospective from the time the new prescription is put in place.

6. There is an additional capital requirement of 5 per cent of the foreign exchange open position limit. Such risks should be integrated into the calculation of risks weighted assets. The Committee recommends that the foreign exchange open position limits should carry a 100 per cent risk weight.

7. The Committee believes that it would be appropriate to go beyond the earlier norms and set new and higher norms for capital adequacy. The Committee accordingly recommends that the minimum capital to risk assets ratio be increased to 10 per cent from its present level of 8 per cent. It would be appropriate to phase the increase as was done on the previous occasion. Accordingly, the Committee

***The Committee chaired by Shri M. Narasimham submitted its report on April 22, 1998.**

recommends that an intermediate minimum target of 9 per cent be achieved by the year 2000 and the ratio of 10 per cent by 2002. The RBI should also have the authority to raise this further in respect of individual banks if in its judgement the situation with respect to their risk profile warrants such an increase. The issue of individual banks' shortfalls in the CRAR needs to be addressed in much the same way that the discipline of reserve requirements is now applied, *viz.*, of uniformity across weak and strong banks.

8. In respect of public sector banks, the additional capital requirement will have to come from either the Government or the market. With the many demands on the budget and the continuing imperative need for fiscal consolidation, subscription to bank capital funds cannot be regarded as a priority claim on budgetary resources. Those banks which are in a position to access the capital market at home or abroad should, therefore, be encouraged to do so.

Asset Quality, NPAs and Directed Credit

9. The Committee recommends that an asset be classified as doubtful if it is in the substandard category for 18 months in the first instance and eventually for 12 months and loss if it has been so identified but not written off. These norms, which should be regarded as the minimum, may be brought into force in a phased manner.

10. The Committee has noted that NPA figures do not include advances covered by Government guarantees which have turned sticky and which in the absence of such guarantees would have been classified as NPAs. The Committee is of the view that for the purposes of evaluating the quality of asset portfolio such advances should be treated as NPAs. If, however, for reason of the sovereign guarantee argument such advances are excluded from the computation, the Committee would recommend that the Government guaranteed advances which otherwise would have been classified as NPAs should be separately shown as an aspect of fuller disclosure and greater transparency of operations.

11. Banks and financial institutions should avoid the practice of "evergreening" by making fresh advances to their troubled constituents only with a view to settling interest dues and avoiding classification of the loans in question as NPAs. The Committee notes that the regulatory and supervisory authorities are paying particular attention to such breaches in the adherence to the spirit of the NPA definitions and are taking appropriate corrective action. At the same time, it is necessary to resist the suggestions made from time to time for a relaxation of the definition of NPAs and the norms in this regard.

12. So far, a sum of Rs. 20,000 crore has been expended for recapitalisation and to the extent to which recapitalisation has enabled banks to write off losses, this is the cost which the Exchequer has had to bear for the bad debts of the banks. Recapitalisation is a costly and, in the long run, not a sustainable option. Recapitalisation involves budgetary commitments and could lead to a large measure of monetisation. The Committee urges that no further recapitalisation of banks be undertaken from the Government budget. As the authorities have already proceeded on the recapitalisation route it is perhaps not necessary to consider *de novo* the institution of an ARF of the type envisaged by the earlier CFS Report. The situation would perhaps have been different if the recapitalisation exercise had not been

undertaken in the manner in which it has been.

13. The Committee believes that the objective should be to reduce the average level of net NPAs for all banks to below 5 per cent by the year 2000 and to 3 per cent by 2002. For those banks with an international presence, the minimum objective should be to reduce gross NPAs to 5 per cent and 3 per cent by the year 2000 and 2002 respectively and net NPAs to 3 per cent and 0 per cent by these dates. These targets cannot be achieved in the absence of measures to tackle the problem of backlog of NPAs on a one time basis and the implementation of strict prudential norms and management efficiency to prevent the recurrence of this problem.

14. The Committee is of the firm view that in any effort at financial restructuring in the form of hiving off the NPA portfolio from the books of the banks or measures to mitigate the impact of a high level of NPAs must go hand in hand with operational restructuring. Cleaning up the balance sheets of banks would thus make sense only if simultaneously steps were taken to prevent or limit the re-emergence of new NPAs which could only come about through a strict application of prudential norms and managerial improvement.

15. For banks with a high NPA portfolio, the Committee suggests consideration of two alternative approaches to the problem as an alternative to the ARF proposal made by the earlier CFS. In the first approach, all loan assets in the doubtful and loss categories–which in any case represent bulk of the hard-core NPAs in most banks–should be identified and their realisable value determined. These assets could be transferred to an Asset Reconstruction Company (ARC) which would issue to the banks NPA Swap Bonds representing the realisable value of the assets transferred, provided the stamp duties are not excessive. The ARC could be set up by one bank or a set of banks or even in the private sector. In case the banks themselves decide to set up an ARC, it would need to be ensured that the staff required by the ARC is made available to it by the banks concerned either on transfer or on deputation basis, so that staff with institutional memory on NPAs is available to ARC and there is also some rationalisation of staff in the banks whose assets are sought to be transferred to the ARC. Funding of such an ARC could be facilitated by treating it on par with venture capital for purpose of tax incentives. Some other banks may be willing to fund such assets in effect by securitising them. This approach would be worthwhile and workable if stamp duty rates are minimal and tax incentives are provided to the banks.

16. An alternative approach could be to enable the banks in difficulty to issue bonds which could form part of Tier II capital. This will help the banks to bolster capital adequacy which has been eroded because of the provisioning requirements for NPAs. As the banks in difficulty may find it difficult to attract subscribers to bonds, the Government will need to guarantee these instruments which would then make them eligible for SLR investment by banks and approved instruments by LIC, GIC and Provident Funds.

17. Directed credit has a proportionately higher share in NPA portfolio of banks and has been one of the factors in erosion in the quality of bank assets. There is continuing need for banks to extend credit to agriculture and small scale sector which are important segments of the national economy, on

commercial considerations and on the basis of creditworthiness. In this process, there is scope for correcting the distortions arising out of directed credit and its impact on banks' assets quality.

18. The Committee has noted the reasons why the Government could not accept the recommendation for reducing the scope of directed credit under priority sector from 40 per cent to 10 per cent. The Committee recognises that the small and marginal farmers and the tiny sector of industry and small businesses have problems with regard to obtaining credit and some earmarking may be necessary for this sector. Under the present dispensation, within the priority sector 10 per cent of net bank credit is earmarked for lending to weaker sections. A major portion of this lending is on account of Government sponsored poverty alleviation and employment generation schemes. The Committee recommends that given the special needs of this sector, the current practice may continue. The branch managers of banks should, however, be fully responsible for the identification of beneficiaries under the Government sponsored credit linked schemes. The Committee proposes that given the importance and needs of employment oriented sectors like food processing and related service activities in agriculture, fisheries, poultry and dairying, these sectors should also be covered under the scope of priority sector lending. The Committee recommends that the interest subsidy element in credit for the priority sector should be totally eliminated and even interest rates on loans under Rs. 2 lakh should be deregulated for scheduled commercial banks as has been done in the case of Regional Rural Banks and co-operative credit institutions. The Committee believes that it is the timely and adequate availability of credit rather than its cost which is material for the intended beneficiaries. The reduction of the pre-empted portion of banks' resources through the SLR and CRR would, in any case, enlarge the ability of banks to dispense credit to these sectors.

Prudential Norms and Disclosure Requirements

19. With regard to income recognition, in India, income stops accruing when interest or instalment of principal is not paid within 180 days. The Committee believes that we should move towards international practices in this regard and recommends the introduction of the norm of 90 days in a phased manner by the year 2002.

20. At present, there is no requirement in India for a general provision on standard assets. In the Committee's view a general provision, say, of one per cent would be appropriate and RBI should consider its introduction in a phased manner.

21. The Committee believes that in the case of all future loans, the income recognition and asset classification and provisioning norms should apply even to Government guaranteed advances in the same manner as for any other advance. For existing Government guaranteed advances, RBI, Government and banks may work out a mechanism for a phased rectification of the irregularities in these accounts.

22. There is a need for disclosure, in a phased manner, of the maturity pattern of assets and liabilities, foreign currency assets and liabilities, movements in provision account, and non-performing assets. The RBI should direct banks to publish, in addition to financial statements of independent entities, a consolidated balance sheet to

reveal the strength of the group. Full disclosure would also be required of connected lending and lending to sensitive sectors. Furthermore, it should also ask banks to disclose loans given to related companies in the banks' balance sheets. Full disclosure of information should not be only a regulatory requirement. It would be necessary to enable a bank's creditors, investors and rating agencies to get a true picture of its functioning - an important requirement in a market driven financial sector.

23. As an incentive to banks to make specific provisions, the Committee recommends that consideration be given to making such provisions tax deductible.

24. Banks should also pay greater attention to asset liability management to avoid mismatches and to cover, among others, liquidity and interest rate risks.

25. Banks should be encouraged to adopt statistical risk management techniques like Value-at-Risk in respect of balance sheet items which are susceptible to market price fluctuations, forex rate volatility and interest rate changes. While the Reserve Bank may, initially, prescribe certain normative models for market risk management, the ultimate objective should be that of banks building up their own models and RBI backtesting them for their validity on a periodical basis.

Systems and Methods in Banks

26. Banks should bring out revised Operational Manuals and update them regularly, keeping in view the emerging needs and ensure adherence to the instructions so that these operations are conducted in the best interest of a bank and with a view to promoting good customer service. These should form the basic objective of internal control systems, the major components of which are: (1) Internal inspection and audit, including concurrent audit, (2) Submission of Control Returns by branches/controlling offices to higher level offices, (3) Visits by controlling officials to the field level offices, (4) Risk management systems, (5) Simplification of documentation, procedure and of inter-office communication channels.

27. An area requiring close scrutiny in the coming years would be computer audit, in view of large scale usage and reliance on information technology.

28. There is enough international experience to show the dangers to an institution arising our of inadequte reporting to and checking by the back offices of trading transactions and positions taken. Banks should pay special attention to this aspect.

29. There is need to institute an independent loan review mechanism especially for large borrowal accounts and systems to identify potential NPAs. It would be desirable that banks evolve a filtering mechanism by stipulating in-house prudential limits beyond which exposures on single/group borrowers are taken keeping in view their risk profile as revealed through credit rating and other relevant factors. Further, in-house limits could be thought of to limit the concentration of large exposures and industry/sector/geographical exposures within the Board approved exposure limits and proper overseeing of these by the senior management/boards. It would be appropriate if the management committees are reconstituted to have only whole time functionaries in it, somewhat on the pattern of Central Office Credit Committee constituted in the State Bank of India. All

decisions taken by these committees could be put up to the Board of Directors for information.

30. It would be appropriate to induct an additional whole time director on the board of the banks with an enabling provision for more whole time directors for bigger banks.

31. The Committee feels that the present practice of RBI selecting the statutory auditors for banks with Board of Directors having no role in the appointment process, is not conducive to sound corporate governance. The RBI may review the existing practice in this regard.

32. The Committee notes that public sector banks and financial institutions have yet to introduce a system of recruiting skilled manpower from the open market. The Committee believes that this delay has had an impact on the competency levels of public sector banks in some areas and they have consequently lost some ground to foreign banks and the newly set up private sector banks. The Committee urges that this aspect be given urgent consideration and in case there are any extant policy driven impediments to introducing this system, appropriate steps be taken by the authorities towards the needed deregulation. Banks have to top up their skills' base by resorting, on an ongoing basis, to lateral induction of experienced and skilled personnel, particularly for quick entry into new activity/areas. The Committee notes that there has been considerable decline in the scale of merit-based recruitment even at the entry level in many banks. The concept of direct recruitment itself has been considerably diluted by many PSBs including the State Bank of India by counting internal promotions to the trainee officers' cadre as direct recruitment. The Committee would strongly urge the managements of public sector banks to take steps to reverse this trend. The CFS had recommended that there was no need for continuing with the Banking Service Recruitment Boards insofar as recruitment of officers was concerned. This Committee, upon examination of the issue, reaffirms that recommendation. As for recruitment in the clerical cadre, the Committee recommends that a beginning be made in this regard by permitting three or four large well-performing banks, including State Bank of India, to set up their own recruitment machinery for recruiting clerical staff. If the experience under this new arrangement proves satisfactory, it could then pave the way for eventually doing away completely with the Banking Service Recruitment Boards.

33. It seems apparent that there are varying levels of overmanning in public sector banks. The managements of individual banks must initiate steps to measure what adjustments in the size of their work force is necessary for the banks to remain efficient, competitive and viable. Surplus staff, where identified, would need to be redeployed on new business and activities, where necessary after suitable retraining. It is possible that even after this some of the excess staff may not be suitable for redeployment on grounds of aptitude and mobility. It will, therefore, be necessary to introduce an appropriate Voluntary Retirement Scheme with incentives. The managements of banks would need to initiate dialogue in this area with representatives of labour.

34. The Committee feels that the issue of remuneration structure at managerial levels prevailing in public sector banks and financial institutions needs to be addressed. There is an urgent need to ensure that public sector banks are given flexibility to determine

managerial remuneration levels taking into account market trends. The Committee recommends that the necessary authority in this regard be given to the Boards of the banks initially in the case of profit making public sector banks which have gone public, for they would, in any case, be required to operate with an accountability to the market. The forthcoming wage negotiations provide an opportunity to review the existing pattern of industry-wise negotiations and move over to bank-wise negotiations.

35. This Committee is of the view that in today's increasingly challenging business environment, a large institution can only be led effectively by a Chief Executive who has a reasonable length of tenure, which the Committee believes should not be less than five years. Since, however, moving over to this tenure may be difficult, we suggest that in the first instance, the minimum tenure should be three years. The Committee feels that there is now a need to delink the pay scales of the Chief Executives of public sector banks and financial institutions from the Civil Service pay scales and that this should be left to be decided by the individual banks, not excluding the possibility of performance based remuneration. The Committee would like to add that these observations and recommendations also apply to the whole time Directors on the Boards of banks and financial institutions appointed by the Government.

36. The Committee would urge the managements of Indian banks to review the changing training needs in individual banks keeping in mind their own business environment and to address these urgently. The Committee would suggest that they explore, wherever appropriate, the feasibility of entering into collaborative arrangements with universities and other institutions in India and abroad, offering specialised training to the financial services industry, so that there can be an arrangement in place for ongoing inflow of emerging training packages and methodologies.

37. There may be need to redefine the scope of external vigilance and investigative agencies with regard to banking business. External agencies should have the requisite skill and expertise to take into account the commercial environment in which decisions are taken. The vigilance manual now being used has been designed mainly for use by Government departments and public sector undertakings. It may be necessary that a separate vigilance manual which captures the special features of banking should be prepared for exercising vigilance supervision over banks. The Committee feels that this is an extremely critical area and arrangements similar to the Advisory Board for Bank Frauds be made for various levels of staff of banks. A suggestion has been received by the Committee that the banks should put in place a system where a record of all credit decisions made by an individual officer together with his successful performance is maintained. Public sector banks should consider the suggestion and try to devise a system suited to their needs.

38. Globally, banking and financial systems have undergone fundamental changes because of the ongoing revolution in information and communications technology. Information technology and electronic funds transfer systems have emerged as the twin pillars of modern banking development. This phenomenon has largely bypassed the Indian banking system although most technologies that could be considered suitable for India have been introduced in some diluted form. The Committee feels that requisite success in this

area has not been achieved because of the following reasons:

* Inadequate bank automation,
* Not so strong commercially oriented inter-bank platform,
* Lack of a planned, standardised, electronic payment systems backbone,
* Inadequate telecom infrastructure,
* Inadequate marketing effort,
* Lack of clarity and certainty on legal issues and
* Lack of data warehousing network.

The Committee has tried to list out series of implementation steps for achieving rapid induction of information technology in the banking system. Further, information and control systems need to be developed in several areas like –

* Better tracking of spreads, costs and NPAs for higher profitability,
* Accurate and timely information for strategic decisions to identify and promote profitable products and customers,
* Risk and asset-liability management, and
* Efficient treasury management.

Structural Issues

39. The Committee has taken note of the twin phenomena of consolidation and convergence which the financial system is now experiencing globally. In India also banks and DFIs are moving closer to each other in the scope of their activities. The Committee is of the view that with such convergence of activities between banks and DFIs, the DFIs should, over a period of time, convert themselves to banks. There would then be only two forms of intermediaries, viz., banking companies and non-banking finance companies. If a DFI does not acquire a banking licence within a stipulated time it would be categorised as a non-banking finance company. A DFI which converts to a bank can be given some time to phase in reserve requirements in respect of its liabilities to bring it on par with the requirements relating to commercial banks. Similarly, as long as a system of directed credit is in vogue a formula should be worked out to extend this to DFIs which have become banks.

40. Mergers between banks and between banks and DFIs and NBFCs need to be based on synergies and locational and business specific complementaries of the concerned institutions and must obviously make sound commercial sense. Mergers of public sector banks should emanate from the managements of banks with the Government as the common shareholder playing a supportive role. Such mergers, however, can be worthwhile if they lead to rationalisation of work force and branch network; otherwise the mergers of public sector banks would tie down the management with operational issues and distract attention from the real issue. It would be necessary to evolve policies aimed at "rightsizing" and redeployment of the surplus staff either by way of retraining them and giving them appropriate alternate employment or by introducing a VRS with appropriate incentives. This would necessitate the co-operation and understanding of the employees and towards this direction, managements should initiate discussions with the representatives of staff and would need to convince their employees about the intrinsic soundness of the idea, the competitive benefits that would accrue and the scope and potential for employees' own professional advancement in a larger institution. Mergers should not be seen as a means of bailing out weak banks. Mergers

between strong banks/FIs would make for greater economic and commercial sense and would be a case where the whole is greater than the sum of its parts and have a "force multiplier effect".

41. A 'weak bank' should be one whose accumulated losses and net NPAs exceed its net worth or one whose operating profits less its income on recapitalisation bonds is negative for three consecutive years. A case by case examination of the weak banks should be undertaken to identify those which are potentially revivable with a programme of financial and operational restructuring. Such banks could be nurtured into healthy units by slowing down on expansion, eschewing high cost funds/borrowings, judicious manpower deployment, recovery initiatives, containment of expenditure, etc. The future set up of such banks should also be given due consideration. Merger could be a solution to the problem of weak banks but only after cleaning up their balance sheets. If there is no voluntary response to a take over of these banks, it may be desirable to think in terms of a Restructuring Commission for such public sector banks for considering other options including restructuring, merger, amalgamation or failing these closure. Such a Commission could have terms of reference which, inter alia, should include suggestion of measures to safeguard the interest of depositors and employees and to deal with possible negative externalities. Weak banks which on a careful examination are not capable of revival over a period of three years, should be referred to the Commission.

42. The policy of licensing new private banks (other than local area banks) may continue. The start up capital requirements of Rs. 100 crore were set in 1993 and these may be reviewed. The Committee would recommend that there should be well-defined criteria and a transparent mechanism for deciding the ability of promoters to professionally manage the banks and no category should be excluded on a priori grounds. The question of a minimum threshold capital for old private banks also deserves attention and mergers could be one of the options available for reaching the required capital thresholds. The Committee would also, in this connection, suggest that as long as it is laid down (as now) that any particular promoter group cannot hold more than 40 per cent of the equity of a bank, any further restriction or voting rights by limiting it to 10 per cent may be done away with.

43. The Committee is of the view that foreign banks may be allowed to set up subsidiaries or joint ventures in India. Such subsidiaries or joint ventures should be treated on par with other private banks and subject to the same conditions with regard to branches and directed credit as these banks.

44. The Committee attaches the greatest importance to the issue of functional autonomy with accountability within the framework of purposive, rule bound, non-discretionary prudential regulation and supervision. Autonomy is a prerequisite for operational flexibility and for critical decision making whether in terms of strategy or day-to-day operations. There is also the question whether full autonomy with accountability is consistent and compatible with public ownership. Given the dynamic context in which the banks are operating and considering the situational experience further capital enhancement would be necessary for the larger Indian banks. Against the background of the need for fiscal consolidation and given the many demands on the budget for investment funds in areas

like infrastructure and social services, it cannot be argued that subscription to the equity of public sector banks to meet their enhanced needs for capital should command priority. Public sector banks should be encouraged, therefore, to go to the market to raise capital to enhance their capital. At present, the laws stipulate that not less than 51 per cent of the share capital of public sector banks should be vested with the Government and similarly not less than 55 per cent of the share capital of the State Bank of India should be held by the Reserve Bank of India. The current requirement of minimum Government of India/Reserve Bank of India shareholding is likely to become a constraint for raising additional capital from the market by some of the better placed banks unless Government also decides to provide necessary budgetary resources to proportionately subscribe to the additional equity, including the necessary premium on the share price, so as to retain its minimum stipulated shareholding. The Committee believes that these minimum stipulations should be reviewed. It suggests that the minimum share holding by Government/ Reserve Bank in the equity of the nationalised banks and the State Bank should be brought down to 33 per cent. The Reserve Bank as a regulator of the monetary system should not be also the owner of a bank in view of the potential for possible conflict of interest. It would not be necessary for the Government/ RBI to divest their stake in these nationalised banks and in the State Bank of India. A reduction in their shares would come about through additional subscription by the market to their enhanced capital. A proportion of upto 5 or 10 per cent of the equity of the bank concerned may be reserved for employees of the bank with a provision at some later date for the introduction of stock options. The appointment by the Government of Boards and top executives of banks derives from its majority holding and if, as suggested above, the majority holding itself were to be given up, the appointment of Chairmen and Managing Directors should be left to the Boards of the banks and the Boards themselves left to be elected by shareholders. Needless to say, with a significant stock holding of not less than 33 per cent. Government would have a say in the election of Boards and indirectly of the chief executives without their being seen as administrative appointments. The reduction in the minimum holding of Government below 51 per cent would in itself be a major and clear signal about the restoration to banks and financial institutions of autonomy in their functioning. The Committee makes this recommendation in the firm belief that this is essential for enhancing the effectiveness and efficiency of the system and not on any other consideration.

45. To provide the much needed flexibility in its operations, IIBI should be corporatised and converted into a Joint Stock Company under the Companies Act on the lines of ICICI, IFCI and IIBI. For providing focused attention to the work of State Financial Corporations, IDBI shareholding in them should be transferred to SIDBI which is currently providing refinance assistance to State Financial Corporations. To give it greater operational autonomy, SIDBI should also be delinked from IDBI.

46. All NBFCs are statutorily required to have a minimum net worth of Rs. 25 lakh if they are to be registered. The Committee is of the view that this minimum figure should be progressively enhanced to Rs. 2 crore which is permissible now under the statute and that in the first instance it should be raised to Rs. 50 lakh.

47. Deposit insurance for NBFCs could blur the distinction between banks, which are much more closely regulated and the non banks as far as safety of deposit is concerned and consequently lead to a serious moral hazard problem and adverse portfolio selection. The Committee would advise against any insurance of deposits with NBFCs.

48. Urban Co-operative Banks are an important link in the credit delivery system and ensuring their sound health is important. The current entry norms, specially the capital requirements are much too liberal. RBI should urgently undertake a review of these norms and prescribe revised prudent minimum capital norms for these banks. Further, with a view to achieving an integrated system of supervision over the financial system, the Committee recommends that urban co-operative banks (UCBs) should also be brought within the ambit of the Board of Financial Supervision. One of the problem areas in supervision of the UCBs is the duality in control by the State Government and the Reserve Bank of India. Though co-operation is a state subject, since UCBs are primarily credit institutions meant to be run on commercial lines, the Committee recommends that this duality in control should be dispensed with. It should be primarily the task of the Board of Financial Supervision to set up regulatory standards for UCBs and ensure compliance with these standards through the instrumentality of supervision.

49. The Committee is of the view that there is need for a reform of the deposit insurance scheme. In India, deposits are insured upto Rs. 1 lakh. There is no need to increase the amount further. There is, however, need to shift away from the 'flat' rate premiums to 'risk based' or 'variable rate' premiums. Under risk based premium system all banks would not be charged a uniform premium. While there can be a minimum flat rate which will have to be paid by all banks on all their customer deposits, institutions which have riskier portfolios or which have lower ratings should pay higher premium. There would thus be a graded premium. As the Reserve Bank is now awarding CAMELS ratings to banks, these ratings could form the basis for charging deposit insurance premium.

50. The Committee is of the view that the inter-bank call and notice money market and inter-bank term money market should be strictly restricted to banks. The only exception should be the primary dealers who, in a sense, perform a key function of equilibrating the call money market and are formally treated as banks for the purpose of their inter-bank transactions. All the other present non-bank participants in the inter-bank call money market should not be provided access to the inter-bank call money market. These institutions could be provided access to the money market through different segments.

51. There must be clearly defined prudent limits beyond which banks should not be allowed to rely on the call money market. This would reduce the problem of vulnerability of chronic borrowers. Access to the call market should be essentially for meeting unforeseen swings and not as a regular means of financing banks' lending operations.

52. The interest rates movements in the inter-bank call money market should be orderly and this can only be if the RBI has a presence in the market through short term Repos for as short a period as one day. The RBI support to the market should

be through a Liquidity Adjustment Facility under which the RBI would periodically, if necessary daily, reset its Repo and Reverse Repo rates which would in a sense provide a reasonable corridor for market play. While there is much merit in an inter-bank reference rate like a LIBOR, such a reference rate would emerge as banks implement sound liquidity management facilities and the other suggestions made above are implemented. Such a rate cannot be anointed, as it has to earn its position in the market by being a fairly stable rate which signals small discrete interest rate changes to the rest of the system.

53. Non-bank parties can be provided free access to bill rediscounts, commercial paper (CP), Certificates of Deposits (CD), Treasury Bills (TB) and Money Market Mutual Funds (MMMFs). The issue arises of the minimum period for the issue of these instruments. At present, the minimum period for bills rediscounting by scheduled commercial banks is 15 days. The minimum lock-in period for CDs, CPs and MMMFs is 30 days. In the restructuring of the market, proposed by the Committee, the minimum period of fixed deposit could, in the first instance, be reduced to 15 days and all money market instruments should likewise have a similar reduced minimum duration. There is reason for keeping a minimum duration for fixed deposits as in the absence of such a minimum all current accounts would become fixed deposits and thereby greatly add to the cost of funds of banks. The question needs to be addressed of the non-bank institutions, which have funds for a duration less than the minimum period stipulated for money market instruments. At the present time, the investors in money market instruments invariably hold the instruments to maturity and as such there is no secondary market in these instruments. In the kind of structure envisaged by the Committee, there will be an active secondary market in money market instruments. The Committee is of the view that these structural changes would result in the development of a strong and stable money market with liquidity and depth.

54. The Committee recommends that the RBI should totally withdraw from the primary market in 91 days Treasury Bills, the RBI could, of course, have a presence in the secondary market for 91 days Treasury Bills. If the 91 days Treasury Bill rate reflects money market conditions, the money and securities market would develop an integral link. The Committee also recommends that foreign institutional investors should be given access to the Treasury Bill market. Broadening the market by increasing the participants would provide depth to the market.

55. With the progressive expansion of the forward exchange market, there should be an endeavour to integrate the forward exchange market with the spot forex market by allowing all participants in the spot forex market to participate in the forward market upto their exposures. Furthermore, the forex market, the money market and the securities should be allowed to integrate and the forward premia should reflect the interest rate differential. As instruments move in tandem in these markets the desiderative of a seamless and vibrant financial market would hopefully emerge.

Rural and Small Industrial Credit

56. The Committee is of the view that the banking system should be in a position to equip itself to identify the eligible clients based on prescribed norms in the

Government sponsored programmes so that the full responsibility for all aspects of the credit decision remains with it. This should also help improve the client-bank relationship instead of the present system of virtually imposed clientele and build a credit culture and discipline.

57. The Committee also recommends that a distinction be made between NPAs arising out of client specific and institution specific reasons and general (agro climatic and environmental issues) factors. While there should be no concession in treatment of NPAs arising from client specific reasons, any decision to declare a particular crop or product or a particular region to be distress hit should be taken purely on techno-economic consideration by a technical body like NABARD.

58. The Committee strongly urges that there should be no recourse to any scheme of debt waiver in view of its serious and deleterious impact on the culture of credit.

59. As a measure of improving the efficiency and imparting a measure of flexibility the Committee recommends consideration of the debt-securitisation concept within the priority sector. This could enable banks which are not able to reach the priority sector target to purchase the debt from institutions which are able to lend beyond their mandated percentage.

60. Evolution of a risk management system would provide the needed comfort to the banking system to finance agriculture. At present, under the Income Tax Act, provision for bad and doubtful debts not exceeding 5 per cent of income and 10 per cent of the aggregate average advances made by rural branches of a scheduled or a non scheduled bank are allowed as deduction in computing the income chargeable to tax. Consideration could be given to increasing this to 5 per cent of income and 20 per cent of average aggregate advances of rural branches to provide incentive to banks for lending to rural sectors.

61. The Committee recommends that the RRBs and co-operative banks should reach a minimum of 8 per cent capital to risk weighted assets over a period of five years. A review of the capital structure of RRBs should be undertaken with a view to enlarging public subscription and give the sponsor banks greater ownership and responsibility in the operation of RRBs. While considering the issue of salaries of employees of RRBs, the Committee strongly urges that there should be no further dilution of the basic feature of RRBs as low cost credit delivery institutions. Co-operative credit institutions also need to enhance their capital through subscription by their members and not by Government. There should be a delayering of the co-operative credit institutions with a view to reducing the intermediation cost and thus providing the benefit of cheaper NABARD credit to the ultimate borrowers.

62. The supervisory function over rural financial institutions has been entrusted to NABARD. While this arrangement may continue for the present, over the longer term, the Committee would suggest that all regulatory and supervisory functions over rural credit institutions should vest with the Board for Financial Regulation and Supervision.

63. The present duality of control over the co-operative credit institutions by State Government and RBI/NABARD should be eliminated and all the co-operative banking institutions should come under the

discipline of Banking Regulation Act, under the aegis of RBI/NABARD/BFS. This would require amendments to the Banking Regulation Act. The control of the Registrar of Co-operative Sector over co-operatives would then be somewhat on the lines of control that Registrar of Companies has over the Banking Institutions, registered under the Companies Act.

64. Banking policy should facilitate the evolution and growth of micro credit institutions, including LABs which focus on agriculture, tiny and small scale industries, including such specialist institutions as may be promoted by NGOs for meeting the banking needs of the poor. Third-tier banks should be promoted and strengthened to be autonomous, vibrant, effective and competitive in their operations.

65. Banks should devise appropriate criteria suited to the small industrial sector and be responsive to its genuine credit needs but this should not be by sacrificing canons of sound banking. Borrowers also need to accept credit discipline. There is also need to review the present institutional set up of state level financial/industrial development institutions.

Regulation and Supervision

66. The Committee recommends that to improve the soundness and stability of the Indian banking system, the regulatory authorities should make it obligatory for banks to take into account risk weights for market risks. The movement towards greater market discipline in a sense would transform the relationship between banks and the regulator. By requiring greater internal controls, transparency and market discipline, the supervisory burden itself would be relatively lighter.

67. The Committee notes that there is insufficient awareness of the Core Principles in India and perhaps even a complacent feeling that these are being implemented. This is not the case. There is, in fact, a need for all market participants to take note of the new guidelines. It is essential to formally announce full accession to these principles, their prescription to the financial institutions and their full and effective implementation.

68. Proprietorial concerns in the case of public sector banks impact on the regulatory function leading to a situation of 'regulatory capture' where the regulators tend to identify regulatory activity with banking interests and as a consequence of which the quasi fiscal impact of appropriate regulation affects the quality of regulation.

69. The Committee recommends that the regulatory and supervisory authorities should take note of the developments taking place elsewhere in the area of devising effective regulatory norms and to apply them in India taking into account the special characteristics but not in any way diluting the rigour of the norms so that the prescriptions match the best practices abroad. It is equally important to recognise that pleas for regulatory forbearance such as waiving adherence to the regulations to enable some (weak) banks more time to overcome their deficiencies could only compound their problems for the future and further emasculate their balance sheets.

70. An important aspect of regulatory concern should be ensuring transparency and credibility particularly as we move into a more market driven system where the market should be enabled to form its judgement about the soundness of an

institution. There should be punitive penalties both for the inaccurate reporting to the supervisor or inaccurate disclosures to the public and transgressions in spirit of the regulations.

71. The Committee is of the view that banks should be required to publish half-yearly disclosure requirements in two parts. The first should be a general disclosure, providing a summary of performance over a period of time, say 3 years, including the overall performance, capital adequacy, information on the bank's risk management systems, the credit rating and any action by the regulator/supervisor. The disclosure statement should be subject to full external audit and any falsification should invite criminal procedures. The second disclosure, which would be a brief summary aimed at the ordinary depositor/investor should provide brief information on matters such as capital adequacy ratio, non performing assets and profitability, vis-a-vis, the adherence to the stipulated norms and a comparison with the industry average. This summary should be in a language intelligible to the depositor and be approved by the supervisors before being made fully public when soliciting deposits. Such disclosure, the Committee believes, will help the strong banks to grow faster than the weaker banks and thus lead to systemic improvement.

72. The Committee recommends that an integrated system of regulation and supervision be put in place to regulate and supervise the activities of banks, financial institutions and non bank finance companies (NBFCs). The functions of regulation and supervision are organically linked and we propose that this agency be renamed as the Board for Financial Regulation and Supervision (BFRS) to make this combination of functions explicit. An independent regulatory supervisory system which provides for a closely co-ordinated monetary policy and banking supervision would be the ideal to work towards.

73. The Board for Financial Regulation and Supervision (BFRS) should be given statutory powers and be reconstituted in such a way as to be composed of professionals. At present, the professional inputs are largely available in an advisory board which acts as a distinct entity supporting the BFS. Statutory amendment which would give the necessary powers to the BFRS should develop its own autonomous professional character. The Committee, taking note of the formation of BFS, recommends that the process of separating it from the Reserve Bank qua central bank should begin and the Board should be invested with requisite autonomy and armed with necessary powers so as to allow it to develop experience and professional expertise and to function effectively. However, with a view to retain an organic linkage with RBI, the Governor, RBI should be head of the BFRS. The Committee has also set out specific measures to ensure an effective regulatory/supervisory system.

Legal and Legislative Framework

74. A legal framework that clearly defines the rights and liabilities of parties to contracts and provides for speedy resolution of disputes is essential for financial intermediation. The evolution of the legal framework has not kept pace with the changing commercial practices and with the financial sector reforms. The Transfer of Property Act enacted in 1882 is a case in point.

75. Given the unsatisfactory state of the law of mortgage, the response has been to vest through special statute the power of sale in certain institutions like Land Development Banks and State Finance Corporations. This approach could be extended to other financial institutions and, if possible, to banks. The other approach is to set up special tribunals for recovery of dues to banks and financial institutions. These tribunals need to have powers of attachment before judgement, for appointment of receivers and for ordering preservation of property. For this purpose, an amendment to the concerned legislation may be necessary. The Committee would like to emphasise the importance of having in place a dedicated and effective machinery for debt recovery for banks and financial institutions.

76. Securitisation of mortgages is also critically dependent on the ease of enforcement and the costs associated with transfer of mortgages. The power of sale without judicial intervention is not available to any class of mortgages except where the mortgagee is the Government or the mortgage agreement so provides and the mortgaged property is situated in Mumbai, Chennai and Calcutta and other towns so notified. Even if the power of sale without judicial intervention were available there would need to be measures to put the buyer in possession.

77. The question of stamp duties and registration fees also requires review. There is a case for reducing stamp duties and registration fees substantially.

78. In view of the recent amendments to Section 28 of Indian Contract Act, banks have expressed a fear that they can no longer limit their liabilities under bank guarantees to a specified period and that they would have to carry such guarantee commitments for long periods as outstanding obligations. Government departments do not generally return the original guarantee papers even after the purpose is served. This whole issue needs to be re-examined and bank guarantees exempted from the purview of the recent amendment to Section 28 of the Indian Contract Act. The issue of enforcing securities in the form of book debts also calls for review. The Committee also agrees with the proposal to amend the Sick Industrial Companies Act, seeking to trigger off the remedial mechanism on the sight of incipient sickness.

79. With the advent of computerisation there is need for clarity in the law regarding the evidentiary value of computer generated documents. The Shere Committee had made some recommendations in this regard and the Committee notes that the Government is having consultations with public sector banks in this matter. With electronic funds transfer several issues regarding authentication of payment instruments, etc., require to be clarified. The Committee recommends that a group be constituted by the Reserve Bank to work out the detailed proposals in this regard and implement them in a time-bound manner.

80. Certain legislative requirements would also be needed to implement some of the Committee's recommendations regarding the structure of the banking system and matters pertaining to regulation and supervision. The Banking Regulation Act is structured on the premise that bank supervision is essentially a Government function and that the Reserve Bank of India's position is somewhat on the lines of an agent. The Act also provides appellate powers to Government over the decisions

of the RBI in this regard. It also provides original powers in certain instances. The Committee feels that these provisions should be reviewed.

81. With respect to recommendations regarding constitution of a Board for Financial Regulation and Supervision, it would be necessary for amendments in the Banking Regulation Act and Reserve Bank of India Act. Amendments would also be needed in the Bank Nationalisation Acts to enable grant of greater managerial autonomy to public sector banks, for lowering the minimum requirements of 51 per cent Government ownership and as regards the constitution of Boards of Directors and of the Management Committees. The provisions relating to prior approval of Government for regulations framed under the Act would also need to be reviewed. In line with the above, amendments would also be needed in the State Bank of India Act with regard to shareholding of the RBI and constitution of its Central Board.

82. These suggestions are not exhaustive and we would recommend that the legal implications with reference to each of these recommendations be examined and detailed legislative steps identified by the Ministry of Finance, Banking Division in consultation with the Ministry of Law. In view or the wide-ranging changes needed in the legal framework, the Committee recommends setting up of an expert committee comprising among others, representatives from the Ministry of Law, Banking Division, Ministry of Finance, RBI and some outside experts to formulate specific legislative proposals to give effect to the suggestions made above.

Concluding Observations

83. The previous Chapters have indicated the Committee's approach to the issues that will be presenting themselves in the second phase of banking sector reform even as we are still to complete some of the unfinished agenda of the first phase. In that phase the focus was appropriately on arresting the qualitative deterioration in the functioning of the system and a measure of success has attended these efforts. We now need to consolidate these gains and move forward.

84. The central theme underlying our various recommendations is thus on strengthening of the system within the framework of purposive regulation and a strong and effective legal system. Fundamental to the strengthening the system is the improvement in the quality of the banks' assets portfolios. Banks as repositories of the community's savings have an economic and even a moral responsibility to deploy these resources in a manner which ensures their soundness even while making their contribution to the furtherance of investment, production and national wealth creation. The quality of assets of our banking system though somewhat better than what it was five years ago still leaves room for further improvement. Some of the external constraints in the functioning of the banks which affected their asset portfolio in the form of pre-emption of resources and an administered interest rate structure are now no longer present though one form of such an external constraint continues in the requirements of priority sector credit. These reductions in the pre-empted use of bank resources have, in the process, increased the 'franchise value' of the banking system with its concomitant of the greater need to

manage the loan asset portfolio with greater care and diligence.

85. Nothing illustrates the erosion of asset quality over the years than the level of NPAs. We have commented on it somewhat extensively and have indicated also the reduction that we should aim at. NPAs constitute a real economic cost to the nation in that they reflect the application of scarce capital and credit funds to unproductive uses. The moneys locked up in NPAs are not available for productive use and to the extent that banks seek to make provisions for NPAs or write them off, it is a charge on their profits. To be able to do so, banks have to charge their productive and diligent customers a higher rate of interest. It thus becomes a tax on efficiency. It is the customer who uses credit efficiently that subsidises the inefficiency represented by NPAs. This also raises the transaction costs in the system thus denying the diligent credit customers the benefit of lower rates which would help them to be more efficient and competitive. NPAs in short, are not just a problem for banks. They are bad for the economy.

86. Given the legal system's delays, recoveries of NPAs are not likely to be quick. Provisioning to reduce the net NPA figures would also take time and call for a higher level of bank earnings. There will have to be, therefore, a one time surgical solution through a 'carve out' or some other form of asset exchange. Recapitalisation of financial institutions in distress has, however, been the route taken. There is not much point in our commenting at this stage on whether this was the right approach. Recapitalisation has not been particularly effective as seen in the continuing high levels of net NPAs of some banks which have had such capital infusion. It has been costly and, given our budgetary constraints, further recourse to it is not sustainable. Banks with high NPAs are also unlikely to attract investor interest should they approach the market. Some form of asset exchange, therefore, suggests itself.

87. Capital adequacy standards are now better than they were a few years ago, but the Committee has proposed that consideration be given to further enhancement of capital ratios, especially, for the large banks even while widening the definition of risk assets that should go into the denominator. The reform in accounting policies and practices has made the balance sheets and other statements more credible and transparent though there is still scope for fuller disclosure to ensure even greater transparency and correcting information asymmetry. Prudential norms, we believe, should be kept under constant review in the light of the perceptions of new forms of risk and use of risk management devices. Asset liability management has now been accorded appropriate emphasis. Involved as they are in various forms of transformation of assets and liabilities in terms of maturity, size and risk, there is now appreciation of the need for banks to take a total view of their operations in terms of their asset liability management in view of the growing incidence of market and income risk in a deregulated environment. These qualitative improvements need to go hand in hand with and indeed be reflected in a reduction in the current high levels of transaction costs in the system.

88. Soundness and strength would come about through strict adherence to statutory and prudential requirements. It is here that regulation and supervision assume importance. Regulation should appropriately be concerned with the prevention of problems rather than attempting a cure once the problems have surfaced in several

individual institutions or in the system. Not that we can avoid altogether instances of institutions getting into financial distress but we need to have a framwork for their early detection and measures to tackle the problems. Cures depend on their efficacy on the effective functioning of the legal system. It is also important, as the previous Chapters have indicated, that regulation be concerned with the critical areas of banks' operations and not get involved in administrative trivia which should be left to the management of banks. As the system is liberalised, there is in fact more need now for purposive regulation. Financial liberalisation without proper regulation and surveillance would be an invitation to financial anarchy. We have enough examples of this from international experience. Regulation, it needs to be stressed again, has to be rule-bound, non-discretionary and non-discriminatory and has to concentrate on the essentials and be clearly codified and strictly enforced through supervision.

89. Financial sector management and reform is a process rather than an event. It cannot be separated from reform in the real sector. They are mutually reinforcing, sustaining and sustained by each other. Thus an important outcome of financial sector reform is that it could contribute to greater flexibility in the factor and product markets. Reforms in the real sector, in the last few years in the areas of industrial and trade policy have perhaps moved somewhat ahead of reforms in the financial sector. With the real sector becoming increasingly market-driven, outward looking and with a premium on competitive efficiency, there would be need for a dynamic response from the banking and financial sector to match the evolving and diversified needs of the real sector. Banks and financial institutions would be called upon to increase not only the total volume of their business and the range of their services but do so in an increasingly technologically sophisticated environment even while keeping abreast of developments in both the internal and international economy. Banks cannot be expected to remain cloistered in the way they were sheltered from competition under the protective umbrella of State ownership. In the new milleu that the Committee envisages we need a qualitative transformation of management skills to learn about new financial instruments and new modes of financial engineering. Credit appraisal skills, for instance, would need to be refashioned to factor in market uncertainties, external competition and, cyclical and structural changes in the economy. Even as investment and production decisions in the real sector assume a different qualitative character, credit decisions by banks would also need to be suitably responsive. New appraisal skills based not only on traditional aspects such as collateral evaluation but an appraisal of the client's total financial position and his capital and credit needs would be needed. This is what relationship banking is about. As they enter new areas of activity, such as project financing in the infrastructure area, which they should do in larger measure, banks would need to hone their skills in terms of appraisal of cash flows rather than rely on more traditional working capital assessments. As banks develop these skills development financial institutions would also need in turn to fashion their appraisal processes with respect to short term and working capital requirements of customers. Over the years, we have set up different institutions with different objectives and focus of interest. The lines separating them, as has been indicated, are getting somewhat blurred now. Universal banking is catching on but this should not have as its casualty the interest, experience and expertise in

development financing of projects which our DFIs have built up over the years. Rather they need to build on this experience over a wider range of services. With more players in the financial sector and with non-banking financial companies also increasing their market share, there might result a measure of banking, as distinct from financial, disintermediation. Even so, banks would still be far and away the largest segment of the financial system apart from being responsible for managing the country's payments system. A more efficiently run banking system reflected in a reduction of transaction costs would help the payments system to be managed in a more cost effective manner. This should continue to remain an object of policy.

The role of Government remains important even in an increasingly deregulated environment. Government responsibility would be to create and nurture a diversified and functionally efficient financial system through an appropriate incentive framework and a legal system rather than through direct interventionist policies.

90. As we move into the second generation of reforms, our objective has to be to evolve in this country a level of banking services which is efficient, effective and customer-oriented and which should seek to emulate the 'best practices' in the industry the world over. For too long the customer has been taken for granted. In a competitive and market driven situation this has to change. Best practices cover a range of activities starting with the functioning of the Boards, of management, human resource development, risk management, technology development and regulatory policies and supervisory procedures–all of which we have discussed at some length earlier.

91. Reforms cannot be entirely painless. The strengthening of the system will take its toll on the weak and inefficient. Competition is a stern taskmaster and there is no room for laxity in its lexicon. The ultimate result of a stress on competitive efficiency would be a more productive and profitable banking system. If we are to derive the full benefits of a strong and viable financial system we need a sound macro economic policy framework. A sound macro economic environment and a strong financial system are the sure guarantees for progress and for growth with a reasonable measure of internal and external stability. This is all the more so as we tread cautiously towards a more open capital account regime. Globalisation of financial markets poses opportunities but in the absence of these prerequisites could also pose dangers. With improved strength and structural changes and with greater functional autonomy and operational flexibility, there is every reason to expect that our banking system will rise to the challenges of the next millennium. Our recommendations are designed to meet this strategic objective.