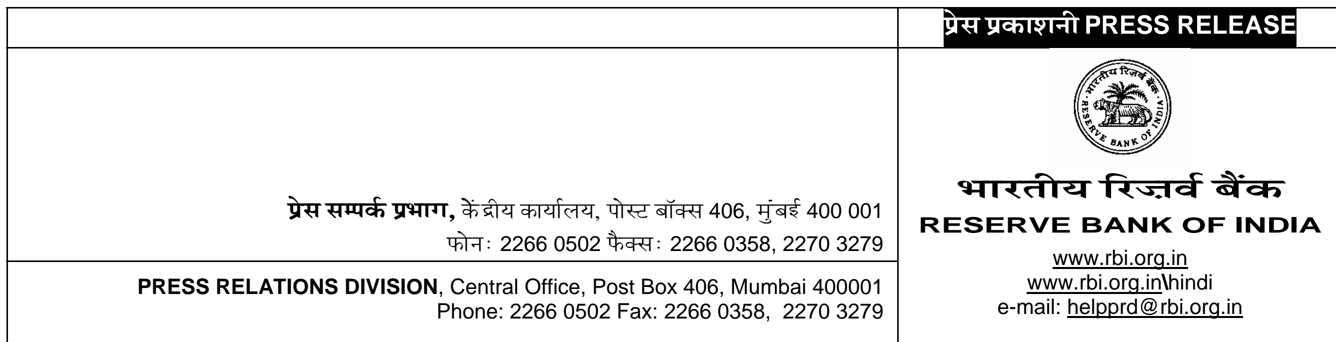

24 Apr, 1998

Summary Recommendations of The Working Group set up by RBI for Harmonising the Role of DFIs and Banks

- **Significant changes suggested in role and operations of DFIs**
- **Sweeping changes proposed with regard to State-level Institutions**
- **Enabling changes proposed in regulatory/supervisory framework**
- **Substantive content of harmonisation between DFIs and Banks spelt out**

The Summary Recommendations of the Report of the Working Group for Harmonising the Role and Operations of DFIs and Banks was submitted by Shri S.H. Khan, CMD, IDBI and Chairman of the Working Group to the Governor, RBI, at Mumbai today. RBI had constituted a seven-member Working Group on December 15, 1997, keeping in view the need for evolving an efficient and competitive financial system. The terms of reference of the Group were as follows:

i. To review the Role, Structure and Operations of DFIs and Commercial Banks in the emerging operating environment and suggest changes;

ii. To suggest measures for bringing about harmonisation in the lending and working capital finance by Banks and DFIs;

iii. To examine whether DFIs could be given increased access to short-term funds and the regulatory framework needed for the purpose;

iv. To suggest measures for strengthening of organisation, human resources, risk management practices and other related issues in DFIs and Commercial Banks in the wake of Capital Account Convertibility.

v. To make such other recommendations as the Working Group may deem appropriate to the subject.

Apart from Shri Khan, the Working Group comprised Shri M.S. Verma, Chairman, SBI, Shri K. V. Kamath, MD and CEO, ICICI, Shri K.D. Agrawal, CMD, IFCI, Shri M.G. Bhide, CMD, Bank of India, Shri A.T. Pannir Selvam, CMD, Union Bank of India and Shri V. Subrahmanyam, ED, RBI as members. IDBI provided the Secretariat for the Group.

The Summary Recommendations attempt to provide a considered and structured response to the opportunities and challenges flowing from continuing internal liberalisation and greater international integration, both for the domestic financial system (including regulatory oversight) as well as for the participants who currently inhabit it. These have been drawn, in substantial measure, from the best available international policies, structures and covenants. Together, they have the potential to provide the blue-print for a robust, yet harmonious, growth of the domestic financial sector. The recommendations relate to the major financial intermediaries viz. Banks, All-India Development Financial Institutions and State-level Financial Institutions.

The Summary Recommendations of the Group are enclosed in the Annexure. The Main Report of the Working Group is currently under preparation and is likely to be submitted shortly.

To all representatives of the Press and Mass Media Changes in Role, Structure and Operations

1. A gradual elimination of extant boundaries between Commercial Banks and Development Financial Institutions (DFIs), both on the assets as well as on the liabilities side, is necessary if Indian financial institutions and commercial banks are to prepare themselves to compete in a deregulated and increasingly global marketplace. **The Group therefore recommends a progressive move towards universal banking and the development of an enabling regulatory framework for the purpose.**

2. **In particular, this implies that a full banking licence be eventually granted to DFIs. In the interim, DFIs may be permitted to have a banking subsidiary (with holdings upto 100%), while the DFIs themselves may continue to play their existing role.**

3. A universal bank can have any of these structures: a single company, a holding company with individually capitalised but wholly-owned subsidiaries, a group of entities with cross-holdings, or a flagship company with subsidiaries which may or may not have independent shareholders. The Group suggests that the appropriate corporate structure should be an internal management/shareholder decision and should not be imposed by the regulator.

4. Size, expertise and reach are now deemed crucial to sustained viability and future survival in the financial sector. **The Group therefore recommends that management and shareholders of Banks and DFIs should be permitted to explore and enter into gainful mergers. These mergers should be possible not only between Banks but also between Banks and DFIs and not only between strong and weak though viable entities but even between two (or more) strong Banks and DFIs**. However, such restructuring/consolidation should be brought about in a market-oriented fashion and should be led by viability and profitability considerations alone. This would require the right legal and industrial relations environment to prevail so that optimum advantage can be derived from the proposed restructuring/consolidation through a process of rationalisation.

5. DFIs in India are already moving in the direction of universal banking and are increasingly operating on commercial as opposed to developmental considerations. However, if the DFIs are required to assume any developmental obligations, **the Group recommends that the RBI/Govt. should provide an appropriate level of financial support to enable them to fulfil these obligations.**

Changes in regulatory and legal framework

6. The Group recommends that the overall objective of regulation should be to facilitate free competition across traditional boundaries and to contain the impact of failure on the financial system rather than to prevent failure.

7. **A function-specific regulatory framework must develop that targets activities and is institution-neutral with regard to the regulatory treatment of identical services rendered by any participant in the financial system. This concept of neutrality should be applicable to both foreign and local entities.**

8. No intermediary (such as a bank, financial institution, mutual fund or insurance company) should be relatively disadvantaged in performing an identical function vis-a-vis other intermediaries because of an unnecessarily high level of net regulatory burden being placed upon it. **The latter must be determined solely by systemic efficiency and risk management concerns and, where necessary, the equalization of the net regulatory burden must be through a reduction of the burden on the over-regulated entity, not through an increase in burden on an adequately regulated entity.** In particular, it must be kept in mind that any fresh regulatory burden that is imposed with a view to creating a level playing field must fulfill certain systemic and supervisory objectives and should not be driven merely by the need to equalize regulatory disadvantage.

9. In view of the increasing overlap in functions being performed by various participants in the financial system, the Group feels that a measure of co-ordination among regulators is desirable. **The Group therefore recommends the establishment of a 'super-regulator' to supervise and co-ordinate the activities of these multiple regulators in order to ensure uniformity in regulatory treatment.**

10. The Group's view is that, at a fundamental level, legal reform is called for in cases of enforcement of contractual obligations and dissolution of companies. **In particular, a speedy implementation of legal reforms in the debt recovery area of Banks and Financial Institutions should be given top priority.** Whilst several attempts have been made in the past to address this issue, it has fallen short of expectations for diverse reasons including the magnitude of cases pending in the various judicial fora. **The Group recommends a thorough revamp of the 1993 Act on Recovery of Debts from Banks and DFIs on the suggested lines in this regard.**

11. In addition, there is a need to redraft other codified laws impacting operations of DFIs/Banks, enacted earlier, on the grounds of redundancy and/or incompatibility. This is essential to ensure that the legal environment moves in tandem with the emerging needs of the financial sector.

12. For effective computerisation of branches, the Group recommends that amendments to the Banking Companies (period of Preservation of Records) Rules, 1985 and other suitable enactments on the lines of Electronic Fund Transfer Act in USA be examined for implementation.

Changes in supervisory practices

13. **The Supervisory Authority should undertake primarily off-site supervision based on periodic reporting by the Banks or DFIs as the case may be.** On-site supervision should be undertaken only in exceptional cases, mainly to oversee the quality of self-regulation by financial sector participants. The assistance of statutory auditors may be taken by the Supervisory Authority to get special reports on selected areas of supervision every year. The emphasis of the supervisory system should be more on macro-management and health of the institution rather than on micro-level regulation at the individual transaction/account level.

14. **Another essential element of the improved supervisory framework should be the ability of the supervisors to supervise the DFIs/Banks on a consolidated basis.** This is one of the recommendations of the Basle Committee on Banking Supervision, released in September 1997. Future accounting standards must consequently include rules on consolidated supervision for financial subsidiaries and conglomerates. **Further, as domestic financial entities assume an international character, banking supervisors should adopt global consolidated supervision** (instead of mere national regulation) adequately monitoring and applying appropriate prudential norms to all aspects of business conducted by banking organisations world-wide, primarily at their foreign branches and subsidiaries. A key component of such global consolidated supervision is establishment of contact and exchange of supervisory and financial information with other supervisors involved, primarily country supervisory authorities.

15. For meaningful consolidated supervision- both domestic and global- **the Group recommends the development of a "risk-based supervisory framework" along the lines of the Report of the Task Force on Conglomerate Supervision, published by the Institute of International Finance, in February 1997.** The Report addresses growing concerns among international financial regulators in the banking, insurance and securities markets that financial market globalisation and conglomerate corporate structure may increase systemic risk. It suggests that, for effective adaptation to global market trends, the international supervisory framework applicable to globally-active financial institutions may be revised in a manner more consistent with firms' risk profiles rather than their corporate structures.

Statutory Obligations

16. Any concerted move towards full-service universal banking, in the Group's view, would have to be prefaced by a thorough examination and review of extant obligations. In particular, the provisions relating to - (a) the Cash Reserve Ratio, (b) the Statutory Liquidity Ratio requirement, (c) obligations relating to priority sector lending and other pre-emptions of resources (e.g. food advances) and (d) Rural Branches - even for existing entities - would need to be reviewed. **Its analysis leads the Group to recommend that:**

17. **Given its twin importance as a standby liquidity support against premature withdrawals from a bank and also as an instrument of monetary policy, the application of CRR should be confined to cash and cash-like instruments.** Further, despite serial reduction in the initial phase of reforms, CRR in India is still very high by international standards. Besides, there will be intense pressure on margins with increased competition, both domestic and global. **CRR should therefore be brought down progressively within a time-bound frame to international levels.**

18. With the establishment of stringent asset classification and provisioning norms and the issuance of Government of India securities at market determined rates, the need for an SLR has declined considerably. **It may, therefore, be useful to consider phasing it out in line with international practice.**

19. The objective of placing a statutory minimum on the proportion of the advances to be given to certain sectors is to ensure that some of the sectors have access to funds at concessional rates and they do not suffer from a paucity of funds. **Rather than impose this obligation on the entire banking system, the Group's view is that there is a need for an alternate mechanism to be developed for financing these sectors. Such a mechanism will aim to balance the need for funds with the need to bring better suited structures and specialised skills to bear in dealing with the sectors. Whenever a need arises for concessional funding for certain sectors, the same can be provided by specifically targeted subsidies to that sector.**

20. **Since, in the interim, the existing obligation with respect to priority sector lending is expected to continue, the Group recommends that the following modifications may be made in its definition: (a)** given the critical role of infrastructure in any future development of the Indian economy (in view of the serious bottlenecks that exist in the current infrastructure which hamper both the growth and competitiveness of Indian exports), the Group feels that infrastructure should be accorded the highest priority in financing. Therefore, if the concept of priority sector lending is to continue in its present form, it becomes necessary to modify its definition to reflect the growing importance of infrastructure finance. One clear alternative is to include infrastructure lending in the definition of priority sector. However, there is a concern that this may crowd out investment in other priority sectors and may relatively disadvantage those in the system who are not lending to the infrastructure sectors. **It may therefore be preferable not to include infrastructure lending in the definition of "net bank credit" used in computing the priority sector obligations.** This is absolutely imperative considering the large volumes involved in infrastructure financing (once it takes off) which would push up the overall credit quantum on which the priority sector lending is based, unnecessarily enlarging the latter obligation; (b) under the present stipulation, the priority sector obligation is linked to 40% of the net bank credit of the current financial year which hampers the process of credit planning. **To facilitate efficient loan disbursals, the priority sector obligation should be linked to the net bank credit at the end of the previous financial year; (c)** at present, the classification of advances to priority sectors is determined mainly with reference to size. **The Group is of the view that the definition of priority sector may be widened to enable the inclusion of a whole industry / class of activities.** This would ensure that a sector which has been identified as priority is accorded due importance without imposing an additional restriction on account of the size of individual beneficiaries.

Re-Organisation of State-level Institutions (SLIS)

21. The Group recommends that **the agenda for reform with regard to SLIs should incorporate the following:**

    i. Eventual merger of SFCs, SIDCs and SSIDCs in each state into a single entity. **While the consolidation of SLIs should form part of the short-term agenda of reforms in the financial sector, an immediate-term imperative is the corporatisation of these entities to improve their competitive efficiency;**

    ii. **Following restructuring/re-organisation, strong SFCs could be encouraged to go public by making IPOs.** In the process, the State Government's holding in these Corporations may be allowed to be brought down to below 50%;

    iii. Since the credit requirements of small scale industries are being taken care of by Small Industries Development Bank of India (SIDBI) since its establishment in 1990, **it would be desirable to transfer the present shareholding of IDBI in these SLIs to SIDBI.** It should be vested with the overall responsibility for enacting policy and procedural guidelines with regard to the operations of SFCs;

    iv. SIDBI should be accorded the same role and status as the nodal / co-ordinating agency for financing of small (and medium) industries as is now available to NABARD in the field of agricultural development. **Ownership in SIDBI should, as a logical corollary, stand transferred to RBI /Govt. on the same lines as NABARD;**

    v. SIDBI's role in the state-level institutions should be both as stake-holder as well as resource provider. **For this purpose, SIDBI should have access to assured sources of concessional funding from RBI;**

    vi. **SLIs should be brought under the supervisory ambit of RBI ;**

vii. With a view to fostering professionalism and efficiency, the CEO of the SLIs should ideally be a professional/ technocrat, appointed by the Board and shareholders (for a fixed term) to whom he should be accountable. The CEO should be able to draw expert advice from an autonomous and professional Board of Directors, elected by shareholders. As an enabling measure, there should be suitable guidelines for representation on these Boards.

Harmonising the role, Operations and Regulatory Framework of DFIs and Banks

22. The profile of asset creation of Banks and DFIs should be motivated by prudential requirements and asset-liability management considerations as well as the need for diversification of business risk through a wide range of products and services. **Having regard to the need for large amount of funding required, the Group feels that both Banks and DFIs (and/or their subsidiaries) could play a role in working capital finance and long-term funding with different levels of emphasis on each segment.** As a number of intermediate steps are needed before the universal banking model becomes a reality, the entire aspect of harmonising the roles of DFIs and Banks is being revisited on the premise that the basic functional differences would continue, at least for the present. **Consequently, the recommendations that follow (Numbers: 24- 30) are of an interim nature and must be viewed as such.**

23. **The considerable amount of overlap between the current business of Banks and DFIs necessitates close co-ordination and harmonisation of their lending policies.** The objective of harmonisation is not to impede competition but to ensure that appropriate quantum of credit is made available to industry at a reasonable cost, there is proper supervision of accounts and a mechanism is built up to detect incipient sickness and take prompt remedial measures in concert for better overall credit administration.

24. In order to achieve close coordination and harmonisation between DFIs and Banks on various issues of mutual interest, **the Group recommends that a Standing (Co-ordination) Committee be set up on which Banks and DFIs would be represented.**

25. Various restrictions have been imposed on DFI borrowings in terms of choice of instruments, maturity and interest rate, ceiling on short term funding and also on their foreign currency operations. These disadvantages have introduced significant financial repression and have eventually contributed towards increased cost of long-term finance for clients. More recently, RBI has stipulated that bond issues by DFIs with either a maturity of less than 5 years or maturity of 5 years and above but with interest rate exceeding 200 basis points over the yield on Government of India securities of equal residual maturity would require its prior approval. The Group feels that such restrictions run counter to the spirit of financial sector liberalisation and should therefore be withdrawn. Further, **the Group recommends that the extant overall ceiling for DFIs' mobilisation of resources by way of term money bonds (having maturities of 3 - 6 months), Certificates of Deposits (maturities of 1-3 years), Term Deposits (fixed deposits from the public with maturity of 1-5 years) and inter-corporate deposits at 100% of net owned funds (NOF) of DFIs may be removed.** The maturity ceiling of five years on deposits from the public, the capping of interest rate on deposits of DFIs at interest rates offered by SBI for similar maturities and the restriction relating to minimum size of deposits that may be accepted by DFIs may also be removed. The current restriction with regard to premature withdrawal not being permitted for two years may be reduced to one year. **With the introduction of the above relaxations and having regard to the minimum maturity of one year for fixed deposits from the public, the Group recommends that a suitable level of SLR may be stipulated for DFIs on incremental outstanding fixed deposits raised from the public (excluding inter-bank deposits).**

26. **The Group recommends that CRR should not be applicable to DFIs under the present structure where they are not permitted to access cash and cash-like instruments.**

27. **The Group felt that there is an urgent need to activate the Term Money market which would, in turn, assist in the rapid development of the rupee derivative market. In this context, inter-bank / DFI investments and deposits should be free from reserve requirements.**

28. **In line with inter-bank deposits, a uniform risk weightage of 20% may be assigned for investment made by commercial banks in bonds of "AAA" rated DFIs.**

29. **The Group recommends that the Banks be permitted to exclude investments in SLR securities issued by a DFI while calculating the exposure to that DFI.**

30. The Group feels that certain restrictions placed on DFIs' foreign currency operations would need to be removed. At present, DFIs operate in the forex markets under a restricted Authorised Dealer's licence which allows them to undertake specific types of foreign exchange transactions incidental to their

main business. **The Group recommends that the DFIs should be granted full Authorised Dealer's licence.** This would help DFIs to manage their FC funds efficiently, offer better rates to clients and add liquidity and depth to foreign exchange markets.

Organisation Redesign

31. A considered response to continuing liberalisation and greater external openness under CAC and WTO framework for an essentially service-driven financial sector implies going beyond mere paradigm shifts in the prospective role and operations of Banks and DFIs. They necessitate a complete transformation in the way these intermediaries do business, particularly in terms of their Organisation and Management Information Systems, Risk-management Practices and Human Resources Development. The Group was therefore asked to suggest suitable measures for strengthening these aspects. The substantive content of reforms in these areas would, of course, vary, depending on the specific requirements of each institution. The Group's recommendations which follow are therefore largely indicative in nature.

32. **Best practices in the area of corporate governance such as imparting full operational autonomy and flexibility to managements and Boards of Banks and DFIs should be implemented.**

33. **On organisational restructuring, the Group recommends that Banks/ DFIs should principally target the following :** a complete redesign of the business system, with the Top Management spelling out the strategic objectives for principal stakeholders (clients, employees, shareholders etc.). The corporate culture must undergo an attitudinal change in favour of a **pro-active relationship-based approach**, with Relationship Managers serving as the single contact point. **A consensus-driven committee-based approach** is recommended for loan sanctions to get the benefit of pluralistic views and at the same time eliminate individual biases. Finally, decisions on organisation structure should be allowed to be based purely on commercial judgement.

Risk Management

34. The increased menu of risks in the progressively deregulated and globalised scenario would require Banks/DFIs to assign primacy to risk management in its strategic initiatives. In this connection, **the Working Group recommends a clear emphasis on the following as part of a prudent risk-return optimisation strategy :**

    i. There should be **a clear strategy approved by the Board of Directors as to their risk management policies and procedures.** The Senior Management should ensure that the structure of Banks/DFIs' business and the level of risk it assumes are effectively managed with a well-defined system and based on a clear definition of individuals/committees responsible for managing such risks.

    ii. **An Integrated Treasury and a proactive Asset-Liability Management (ALM)** , which considers both on- and off-balance sheet items, would be central to future prosperity of financial sector participants under the changed scenario.

    iii. **Robust (internal) operational controls** as well as strong firm-wide support functions - **including audit** - must be in place to ensure that risk management policies are being supported, controls are in effect and that complex areas are being appropriately dealt with.

Information Technology and MIS

35. An upgraded Information Technology (IT) and a vastly improved and efficient Management Information System (MIS) are both mandatory to support the new organisational structures and redesigned processes. **The Group is of the view that the following would facilitate the establishment of IT systems and MIS of international standards :**

    i. Existing laws may not be adequate or have the clarity to deal with some of the key issues that are likely to emerge following introduction of computerisation and technologically advanced communications in banking. **There is compelling logic to revisit the legal framework in this area and render it compatible with the requirements of a technology-driven banking environment.**

    ii. DFIs/Banks should urgently establish, **create employee/customer awareness and familiarity with e-mail, Internet and Intranet Banking, Smart Cards and Electronic Data Interchange (EDI) in a strategically sequenced fashion.**

36. **The Group considers that it would be worthwhile going into the details of the requirements and drawing up a perspective plan / blue-print for a robust automation in the financial sector.**

37. In particular, the Group is of the view that financial sector participants would need to implement computerised decision-support systems.

Human Resources Development

38. The Group feels that the success of any organisational change in a service-oriented industry like financial services will depend on the initiatives taken in the area of Human Resources Development. **The Group therefore recommends that the reformed HRD agenda of DFIs/Banks should encompass the following :**

    i. **Prescient management and leadership**, with accent on teamwork.

    ii. Broad-based recruitments, both at entry level from campus as well as lateral entry of professionals at higher levels to fill skill gaps, particularly in the areas of:

        - Economic Research & Industry Analysis
        - Risk Management
        - Treasury and Financial Derivatives
        - Investment Banking
        - Human Resources Management
        - Information Technology
        - Relationship Management

    iii. **Systematic training programs** (including exchange programmes), with focus on practical skills, and expertise linked to career development as well as real-time familiarisation of staff with the latest developments

    iv. **Skill-building and skill-upgradation**, including moving staff across functions selectively to develop Top Management talent

    v. **Market-related compensation packages**, with financial rewards for strong performance and superior skills

    vi. **Viable and enforceable exit option for employees** who are unable to cope with the radical cultural and technological change. An enabling legal framework thus needs to emerge fairly early in the organised labour market area.

    vii. In order to facilitate pro-active decision-making and make vigilance function more meaningful, **a Special Vigilance machinery exclusively for the financial sector** on the lines of Serious Fraud Office (SFO) of the U.K. may be set up.