प्रेस प्रकाशनी PRESS RELEASE

भारतीय रिज़र्व बैंक
RESERVE BANK OF INDIA

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December 17, 2008

RBI releases Report on Trend and Progress of Banking in India, 2007-08

The Reserve Bank of India today released its Report on Trend and Progress of Banking in India, 2007-08. This statutory report provides a detailed account of policy developments and performance of commercial banks, co-operative banks, and non-banking financial institutions during 2007-08. The report includes this year a new chapter on Micro Finance. The report also presents a detailed analysis of the Indian financial system from the financial stability viewpoint.

The Report has eight chapters. Statistical tables appended to the Report provide information on operations and performance of banks/financial institutions both at individual and aggregate levels.

The Report highlights the major challenges facing the banking system in India and the Reserve Bank of India in the context of the ongoing global financial crisis. The major problems which banks and financial institutions have faced internationally are illiquid assets, capital shortages and collapse of counter-party trust. The Reserve Bank has been vigilant about the lessons emerging from the crisis. The crisis suggests that risk management and supervisory practices lagged behind financial innovations and emerging business models. The Report notes that the Reserve Bank has already put in place a system to mitigate liquidity risks at the very short-end, risks at the systemic level and at the institution level. Liquidity risk management in India has been made more granular and prudential norms for off-balance sheet exposure of banks have been prescribed. In order to further strengthen capital requirements, the credit conversion factors, risk weights and provisioning requirements for specific off balance sheet items, including derivatives, have been reviewed. Furthermore, in India, complex structured products such as synthetic securitisation have not been permitted so far. Introduction of such products, when found appropriate, would be guided by the risk management capabilities of the system.

The Report indicates that the challenge for banks is to develop adequate skills for managing emerging risks resulting from innovations in financial products as well as technological advancements. The Reserve Bank has been encouraging banks to develop an integrated approach to managing risk and also undertake stress testing exercises, both for liquidity and credit risk management. In this context, the availability of reliable information is crucial for both banks and regulators/supervisors of the banking system. The Reserve Bank took the first step in the direction of a more efficient financial data reporting system by implementing the online returns filing system. Another important step was the adoption of XBRL-based data reporting for Basel II reports from banks.

The Report notes that a major challenge is how to meet the credit demand without impairing credit quality. Banks have to monitor their credit portfolios closely in the context of persisting high growth in bank credit at the system level and take corrective action as appropriate in order to prevent undue asset-liability mismatches or deterioration in the quality of credit, recognising the reality of business cycles and counter-cyclical monetary policy measures. Banks, on their part, would need to ensure that their business strategies and decisions are guided by the longer-term perspective of systemic and macroeconomic developments and are not unduly influenced by the current stream of exceptional events.

The Report observes that foreign banks operating in India and Indian banks with presence abroad, migrated to the Basel II framework with effect from March 31, 2008. All other scheduled commercial banks (except regional rural banks and local area banks) are expected to migrate to the Revised Framework not later than by March 31, 2009. As noted in the Report, the full implementation of the Basel II framework, even under the basic/standardised approaches, would remain a major challenge for some time to come, for both the banks and the Reserve Bank. At the banks' level, the implementation would require, *inter alia*, upgradation of the bank-wide information system through better branch-connectivity, which would entail cost and may also raise some IT-security issues. The implementation of Basel II also raises several issues relating to development of human resource skills and database management. Banks would require higher amount of capital under the Basel II framework. They would, therefore, need to explore various capital raising options.

The Reserve Bank has urged banks to ensure that even as they give due emphasis to maintaining the credit quality, the flow of credit to productive sectors of the economy does not get affected. To enhance credit flow important initiatives were taken during the year including further fine-tuning of priority sector lending norms and implementation of the Agriculture Debt Waiver and Debt Relief Scheme, 2008, announced by the Government of India.

Operations and Performance of Commercial Banks

The main points emerging from the analysis presented in the Chapter entitled 'Operations and Performance of Commercial Banks' are:

- Deposit growth continued to be strong, though it was marginally lower than the previous year mainly on account of deceleration in term deposits. Growth in bank credit of scheduled commercial banks exhibited some moderation during the year in line with the policy initiatives undertaken by the Reserve Bank. The moderation in credit was observed across all the sectors, barring services (Para 3.10 and 3.17; Pages 91 and 93).
- Lending rates of SCBs across various bank groups showed a generally upward movement during the year (Para 3.59; Page 108).
- Net profit of SCBs increased significantly during 2007-08. Return on assets also increased (Para 3.76 and Para 3.77; Page 115).
- Gross NPAs of scheduled commercial banks increased during 2007-08. This was the first year since 2001-02 that gross NPAs increased in absolute terms. However, gross NPAs as percentage of gross advances continued to decline (Para 3.80; Page 117-118).
- The overall CRAR of all SCBs at end-March 2008 improved further from the level a year ago, reflecting a relatively higher growth rate in capital funds maintained by banks than risk-weighted assets (Para 3.91; Page 122). At the individual bank level, the CRAR of all SCBs was above the prescribed requirement of 9 per cent at end-March 2008 (Para 3.95; Page 123).
- Aggregate income of RRBs increased during 2007-08 on account of higher interest as well as non-interest income (Para 3.133; Page 142).

Developments in Co-operative Banking

The coverage of the Chapter titled 'Developments in Co-operative Banking' has improved by including data on both the balance sheets and financial performance for all UCBs (scheduled as well as non-scheduled). The major points emerging from the analysis are:

- Constitution of TAFCUBs instilled public confidence in the UCB sector which is evident from the increase in deposits for three successive years, *i.e.,* from 2005-06 to 2007-08 **(**Para 4.3; Page 1).

- The total number of Grade I and II banks increased over the past three years, while those in Grade III and IV declined **(**Para 4.64; Page 162).
- The consolidation of the UCBs through the process of merger of weak entities with stronger ones, set in motion by the Reserve Bank, progressed further during 2007-08 (Para 4.11, Box.IV.2; Page 149 and 150).
- The balance sheets of urban co-operative banks (both scheduled and non-scheduled) expanded significantly during 2007-08 (Para 4.71, Para 4.77 and Para 4.80; Pages 165, 167 and 168).
- Net profits of all UCBs declined on account of increase in provisions, contingencies and taxes. While net profits of scheduled UCBs increased during 2007-08, those of non-scheduled UCBs registered a decline (Para 4.72, Para 4.78 and Para 4.81; Pages 166, 167 and 169).
- As at end-March 2008, the CRAR of 1,457 UCBs out of total 1,770 UCBs, was at 9 per cent and above (Para 4.75; Page 167).
- The gross and net NPAs increased in absolute terms. However, as percentage of total advances, both gross NPAs and net NPAs declined (Para 4.76; Page 167).
- Balance sheets of all segments of the rural co-operative banking sector, except for SCARDBs, expanded during 2006-07 (Para 4.6; Page 147).
- In the short-term structure of rural co-operative banks, both the operating profits and net profits of StCBs and DCCBs declined during 2006-07. While the total profits earned by profit-making PACS increased, the losses made by loss making PACS also increased (Para 4.101, Para 4.107 and Para 4.114; Pages 178, 180 and 182).
- In the case of long-term structure, operating profits of state co-operative agriculture and rural development banks (SCARDBs) registered a decline in 2006-07. However, primary co-operative agriculture and rural development banks (PCARDBs) made a turnaround with the operating profits increasing sharply during 2006-07 against a decline in the previous year (Para 4.121 and 4.126; Pages 185 and 187).
- Asset quality of StCBs, DCCBs, SCARDBs and PCARDBs during 2007-08 improved. (Para 4.102, Para 4.108, Para 4.122 and Para 4.127; Pages 178, 180, 185 and 187).

Micro Finance

The micro finance movement has been gaining momentum in India in recent years and it has now developed into an important delivery mechanism for reaching the poor. At present, there are two predominant models for micro finance delivery in India, *viz.,* SHG-bank linkage programme (SBLP) model and the micro finance institution (MFI) model. Recognising the potential of micro finance to positively influence the income and socio-economic conditions of the poor, the Reserve Bank, NABARD and SIDBI have taken several initiatives over the years to give a further fillip to the micro finance movement in India. With a view to providing an account of the progress achieved by this movement against the backdrop of these policy developments, a new chapter on ‘Micro Finance’ has been introduced in this Report. The major points emerging from the analysis presented in the Chapter are:

- The SBLP has made considerable progress since its inception in the early 1990s, both in terms of number of SHGs credit linked with banks as also bank loans disbursed by SHGs (Para 5.58; Page 210).
- In terms of relative shares of different agencies, commercial banks continued to account for the largest share, both in terms of number of SHGs credit linked and bank loans disbursed, followed by RRBs and co-operative banks (Para 5.60; Page 210)
- The region-wise pattern of SHGs linked to banks showed greater concentration in the southern region, although the spatial disparity has declined in the last few years with some increase in the share of other regions (Para 5.63; Page 212).

- As on March 31, 2007, commercial banks held the largest share of SHG's savings, followed by RRBs and co-operative banks. (Para 5.65; Page 212).
- The recovery rates under the SBLP remained high with 37 per cent banks reporting recovery of above 95 per cent (Para 5.66; Page 213).
- The Reserve Bank carried out a survey of MFIs in 2007 which, inter alia, revealed that the products varied widely across MFIs and across states and that the commercial banks remained the most important source of funds for almost all the MFIs. (Box V.6; Page 215).

Non-Banking Financial Institutions

The Chapter outlines major policy developments and analyses the business operations and financial performance of financial institutions (FIs), non-banking financial companies (NBFCs), and primary dealers (PDs). The main points emerging from the analysis in this Chapter are:

- Both financial assistance sanctioned and disbursed by FIs continued to increase during 2007-08, but the increase was more pronounced in respect of sanctions than disbursements (Para 6.17; Page 220).
- The combined balance sheets of select FIs during 2007-08 expanded sharply. On the liabilities side, the resources raised by way of bonds and debentures (which form a major constituent) declined, though deposits and borrowings recorded a sharp increase. On the assets side, loans and advances continued to expand, while the investment portfolio continued to decline (Para 6.18; Page 221).
- Non-interest income of FIs as well as their operating expenses increased significantly during 2007-08. The operating profits as well as net profit of FIs also increased (Para 6.24; Page 223).
- The capital adequacy ratio of FIs continued to be significantly higher than the minimum stipulated norm of 9 per cent (Para 6.28; Page 224).
- Total assets / liabilities of NBFCs (excluding RNBCs) expanded at a higher rate during 2007-08, as compared with 2006-07 (Para 6.52; Page 233).
- Financial performance of NBFCs continued to improve during 2007-08. Both fund based income and fee based income increased sharply (Para 6.64; Page 239).
- Asset quality of various types of NBFCs as reflected in the various categories of NPAs (sub-standard, doubtful, loss) remained broadly at the previous year's level (Para 6.69; Page 241).
- The increase in income of RNBCs during 2007-08 was more than the increase in the expenditure, as a result of which the operating profit of RNBCs increased sharply (Para 6.74; Page 244).
- The liabilities/ assets of non-deposit taking systemically important non-banking finance companies (with asset size of Rs. 100 crore and above) (NBFCs-ND-SI) increased during the year ended March 2008 over the previous year (Para 6.78; Page 246).
- The gross NPAs to total assets ratio of NBFCs-ND-SI remained unchanged during the year ended March 2008 (Para 6.82; Page 247).
- The income earned by PDs declined during 2007-08 due to restructuring of business by PDs and consequent decline in income from other activities that were not allowed to be undertaken by PDs. However, a corresponding sharp decline on the expenditure front and a rise in trading profits restricted the decline in net profit during the year (Para 6.95; Page 252).

- The CRAR of individual stand-alone PDs remained above the prescribed minimum CRAR of 15 per cent (Para 6.97; (Page 252).

Financial Stability

The Chapter reviews and analyses the developments in the Indian financial system from a financial stability perspective, particularly during 2007-08 and April-October 2008. The main points that emerge from the analysis are:

- During the past year and a half, financial stability has occupied a centre stage in policy circles in the wake of ongoing global financial crisis with wide ramifications (Para 7.1; Page 253). The initial impact of global financial contagion in India, however, has been limited for a variety of reasons. However, some impact has been felt through the credit, equity and the foreign exchange markets (Para 7.6; Page 255).
- The financial sector in India is sound and healthy (Para 7.22; Page 260). The banking and non-banking institutions are performing in a competitive environment and their regulatory framework is now aligned with the international best practices (Para 7.16; Page 258).
- Domestic financial markets conditions in general remained orderly during 2007-08, barring a brief spell of volatility in the call money market and occasional bouts of volatility in the equity market during the second-half of August 2007, second-half of December 2007 and beginning of the second week of January 2008. Yields in the Government securities market softened during the large part of the year (Para 7.37; Pages 265-266). The movements in the yields tracked the monetary policy measures (Para 7.53; Page 271). The Indian rupee exhibited two-way movement during 2007-08, and subsequently set on a depreciating trend beginning July 2008 (Para 7.49; Page 270).
- While non-banking finance companies are the major issuers of commercial papers (CPs), mutual funds (MFs) are major investors in CPs. The redemption pressure faced by MFs since September 2008 adversely affected liquidity conditions in the money market, which had a spill-over impact on the CP market (Para 7.45; Page 269).
- Indian depositors enjoy a high degree of protection. About 93 per cent of deposit accounts and 61 per cent of total assessable deposits were fully protected at end-March 2008 (Para 7.123; Page 298).
- The adverse global developments have led to moderation of growth in the industrial and services sectors in the first-half of 2008-09. In recent weeks, the impact on liquidity and credit has also been felt (Para 7.89; Page 285).
- Inflation, in terms of the WPI, softened steadily since August 9, 2008. Globally, pressures from commodity prices, including crude, appear to be abating. The moderation in key global commodity prices, if sustained, would further reduce inflationary pressures (Para 7.88; Page 284).
- While equity prices have since corrected by around 56.1 per cent (as on December 8, 2008) from the peak level, real estate prices continue at their elevated levels, although some reports do suggest some softening of prices in some parts of the country in recent months (Para 7.95; Page 286). In view of the risks posed by accelerated exposures to the real estate sector, the Reserve Bank initiated several regulatory measures (Para 7.98; Page 287).
- The Reserve Bank has been closely following the developments in the international financial regulation and supervision. In the Annual Policy Statement for 2008- 09 released in April 2008, the Reserve Bank indicated its status *vis-à-vis* the action plan devised by the Financial Stability Forum for implementation by the countries affected by the recent financial turbulence (Para 7.105; Page 289; Annex VII.1; Pages 329-332).

- Following the unfolding of events since September 2008 reflected in the form of portfolio outflows by FIIs, sharp decline in the stock markets, lack of liquidity in the market with the inter-bank rates soaring to high levels and depreciating rupee, the Reserve Bank stepped in to restore public confidence by putting in place immediate corrective measures during mid-September and December 6, 2008 (Para 7.107; Page 291).

- India, with its strong drivers of growth, may escape the worst consequences of the global financial crisis. Once the global situation is stabilised, and calm and confidence are restored, India would return to the high growth trajectory (Para 7.144; Page 306).

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Press Release : 2008-2009/907