Chapter 8

Summary of recommendations

8.1 This chapter contains a summary of the recommendations made in different chapters of the report. Most major recommendations have been brought together and an effort has been made to place the recommendations in such a sequence that these have a flavour of the full report. The recommendations have been mentioned in brief. For knowing full details and rationale thereof, a reference to the relevant chapter and paragraphs would be necessary.

Definition and identification of weakness in banks

8.2 The definitions of weakness prescribed by the Committee on Banking Sector Reforms (CBSR) stress on solvency and profit earning capacity of banks. These definitions are well considered and acceptable. In order to identify a bank's weakness or strength with some degree of certainty, it would be desirable to use a few more specific tests in conjunction with the two suggested by the CBSR. (Paragraph 3.15)

8.3 Seven parameters have been selected for assessing a bank's strength/weakness covering three major areas, namely, (a) solvency, (b) earning capacity, and (c) profitability. These are (i) capital adequacy ratio, (ii) coverage ratio, (iii) return on assets, (iv) net interest margin, (v) ratio of operating profit to average working funds, (vi) ratio of cost to income, and (vii) ratio of staff cost to net interest income (NII) + all other income. (Paragraph 3.16)

8.4 The tests provided in the CBSR report supplemented by an analysis of performance based on the seven parameters detailed above, should serve as the framework for identifying weakness in banks in future. (Paragraph 3.22)

8.5 These parameters can also be used to evolve benchmarks for competitive levels of performance by public sector banks. To begin with, these benchmarks should be set at the median levels of ratios relating to these parameters obtaining in the 24 public sector banks (excluding Indian Bank, UCO Bank and United Bank of India). (Paragraph 3.24)

8.6 Median levels of performance of public sector banks as benchmarks are only the initial benchmarks which these banks need to set for themselves. Gradually, these will have to be raised to be able to meet the compulsions of competition. (Paragraph 3.25)

8.7 The above approach serves the immediate objective of setting the criteria for diagnosing weaknesses in banks in general and for identifying the potentially weak banks. A database may, therefore, be built in respect of banks on an ongoing basis for the purpose of benchmarking and on the basis thereof identifying signals of weakness. (Paragraph 3.35)

Restructuring strategy

8.8 For restoring weak banks to strength, restructuring is needed. Such restructuring is generally attempted by (a) merger or closure, (b) change of ownership, (c) operating the bank(s) as narrow bank(s), or (d) undertaking comprehensive operational, financial and systemic restructuring. (Paragraph 7.6)

8.9 In our situation, merger or privatisation will not succeed unless the banks are brought to a minimum level of competitive efficiency. Narrow banking can, at best, be only a temporary phase and cannot, by itself, be adopted as a restructuring strategy. (Paragraphs 7.11, 7.15 and 7.22)

8.10 Closure has a number of negative externalities affecting depositors, borrowers, other clients, employees and, in general, the areas served by the banks being closed. This is an extreme option and would need to be exercised only after all other options have been ruled out. (Paragraph 7.12)

8.11 Comprehensive restructuring could succeed but it will involve firm and decisive actions in exercise of hard options. There will have to be a clear commitment from the owner, the government. It must display firm political will and generate an all-round consensus that the restructuring will go ahead without any let up or hindrance. The government, management of the banks and the employee unions must agree upon every important condition of the proposed restructuring programme before it is begun. (Paragraph 7.26)

8.12 The restructuring should cover operational, organisational, financial and systemic restructuring. Operational restructuring should involve basic changes in the mode of operations, adoption of modern technology, resolution of the problem of high non-performing assets and a drastic reduction in cost of operations. Organisational restructuring would include improved governance of the banks and enhancement in management involvement and efficiency. Financial restructuring involves recapitalisation which may be done for specific purposes and with conditions which the banks' management, including its Board of Directors, and the employee unions will agree to fulfil before the restructuring is begun. Systemic restructuring would provide for, *inter alia,* legal changes and institution building for supporting the restructuring process. (Paragraph 7.28)

Main features of the restructuring programme for Indian Bank, UCO Bank and United Bank of India

8.13 Restructuring of the weak banks should be a two-stage operation. In stage one, focus should be on operational, organisational and financial restructuring aimed at restoring competitive efficiency. In stage two, the options of privatisation and/or merger will assume relevance. (Paragraph 7.29)

Operational Restructuring

<u>Improving and diversifying sources of revenue</u>

8.14 The weak banks cannot afford to lose further share in business and require to develop urgently capabilities to launch new products, attract new customers and bring about an overall improvement in housekeeping, MIS and risk management. (Paragraphs 7.34 and 7.35)

8.15 Each of the banks needs to develop strengths in chosen areas and build its skills and business strategy around those strengths. (Paragraph 7.36)

8.16 The three banks need to take urgent steps to reintroduce credit culture and ensure a rapid growth in non-fund based earnings. The large network of branches can be leveraged well to increase fee-based earnings by laying stress on selected services, particularly, movement and management of funds. (Paragraph 7.37)

8.17 The three banks must select areas of credit in which they have had experience and those where it is possible to develop expertise within a short time. The appropriate markets for them will be the middle and lower segments of the credit market as they need to concentrate more on the retail end of the business. (Paragraph 7.38)

8.18 Indian Bank and UCO Bank would find it extremely difficult to run their foreign branches in the short and medium term. These could be sold to prospective buyers including other Indian public sector banks subject to the necessary approvals. The resources so raised could fund some of the restructuring operations. (Paragraphs 7.41 and 7.42)

8.19 In the case of Indian Bank, a decision to pull out from the subsidiaries should be taken urgently. An effort should be made to find buyers for the bank's holdings in the subsidiaries. (Paragraph 7.44)

<u>Introduction of modern technology</u>

8.20 Operational restructuring can be begun best with a technology change. For weak banks, which do not possess either the finances or the skills for managing such a change efficiently, it is recommended that they go in for a common networking and processing facility, an arrangement which will bring the cost down substantially and also reduce the demand for skilled people. This common facility may be outsourced from a reputed IT system and solution provider, which will run the system for the banks. A 'Build Own Operate Transfer' (BOOT) model may also be attempted for the purpose. (Paragraphs 7.48 to 7.50)

8.21 The IT programme should be aimed to be completed within twelve to eighteen months and to cover 70 per cent of the participating banks' present business. Around 250 to 300 of the largest branches from each of the three banks should be networked under the proposed IT plan. The cost of implementing the technology strategy for the three banks is estimated at Rs. 300 to 400 crore which will have to come by way of cash/ transfer of funds. (Paragraphs 7.52 to 7.54)

<u>Handling of NPAs</u>

8.22 Where guarantees have been given by the central or state governments and a demand thereunder has been raised by the banks, these demands should be honoured. (Paragraph 7.60)

8.23 Banks must put greater reliance upon the recommendations of the Settlement Advisory Committees (SAC) in order to make better use of compromises for reduction of

NPAs in their books. (Paragraph 7.62)

8.24 The most effective way of removing NPAs from the books of the weak banks would be to move these out to a separate agency which will buy the loans and make its own efforts for their recovery. (Paragraph 7.63)

8.25 The proper financial vehicle through which non-performing loans can be transferred would be that of the FRA-owned (government) Asset Reconstruction Fund (ARF) managed by an independent private sector Asset Management Company (AMC). (Paragraph 7.65)

8.26 The ownership of the assets will lie with the government and the management thereof with a separate private sector entity having the necessary expertise and organisation. (Paragraph 7.66)

8.27 The ARF's operations will be profit-oriented and its aim will be to recover from the acquired assets (NPAs) more than the price paid for it. (Paragraph 7.67)

8.28 The FRA and the ARF owned by it may be set up under a special Act of the Parliament which while protecting it against obstructive litigation from the borrowers could also provide for quick and effective enforcement of its rights against them. (Paragraph 7.68)

8.29 The fund needed for the ARF will be provided by the government. The size of the fund needed will depend upon the size of business it will handle. Presently, it is proposed that the ARF may restrict its activities to the NPAs of the three identified weak banks. (Paragraph 7.69)

8.30 The ARF should focus on comparatively larger NPAs. It would be desirable not to acquire assets valued below Rs. 50 lakh. NPAs of the three banks with face value above Rs. 50 lakh aggregated around Rs. 3,300 crore. Providing for nearly 35 per cent of the face value of the loan as its price, the ARF may need fund support in the region of Rs. 1,000 crore. (Paragraphs 7.70 and 7.71)

8.31 The payment in respect of the assets purchased from the weak banks may be made by the ARF by issuing special bonds guaranteed by the government and bearing a suitable rate of interest. The bonds may have a lock-in period of at least two years. (Paragraph 7.72)

8.32 The bonds issued by the ARF in payment of the assets acquired as also those which it will issue for raising funds against the security of assets it has purchased and which are in the course of collection may have a maturity of five years. (Paragraph 7.73)

8.33 The ARF should purchase from the banks loans, which are NPAs as on a certain date, say, 31 March 2000. In view of the foregoing it will be adequate for the ARF to have a life of not more than seven years from the date of its commencing business, say, beginning April 2000. (Paragraph 7.74)

8.34 To begin with, the ARF may buy NPAs of only the three identified weak banks.

However, buying NPAs from other banks need not be totally excluded. (Paragraph 7.75)

8.35 If need arises, more ‘Funds’ could be set up later. Such subsequent funds could be area-specific, bank-specific, for a group of banks or for the entire sector. Participation in these funds may be open to both public and private sector. These funds can facilitate growth of secondary market for loans in the country. (Paragraph 7.76)

8.36 Price at which NPAs will be transferred should be arrived at by mutual agreement and in a transparent manner. It is, therefore, not considered necessary to prescribe either a floor price or a formula therefor. (Paragraph 7.79)

8.37 The management of the ARF should be entrusted to an independent Asset Management Company which can be compensated for its services in the form of service commission and incentives. (Paragraph 7.80)

8.38 In the ownership of the AMC, while the government may have a share of up to 49 percent, majority shareholding should be non-government. Institutions like SBI, LIC, GIC, UTI and IFCI and parties from the private sector could be the other shareholders. The possibility of attracting participation of multilateral agencies like IFC or ADB should also be explored. The initial capital requirement of the AMC is not likely to be more than Rs. 15 crore. (Paragraph 7.81)

8.39 The AMC, which must have a lean structure, should be manned by professionals such as bankers, chartered accountants, engineers, lawyers and valuers so that it has the desired expertise and is cost efficient. (Paragraph 7.82)

Cost reduction

8.40 The cost of operations of the three banks has reached unsustainable levels and must be brought down urgently. They must bring it in line with, at least, the average performing public sector banks in terms of its percentage to total operating income. (Paragraph 7.87)

8.41 Unless significant operational, organisational and financial restructuring as suggested takes place, high staff expenses will continue to keep the operating expenses of these banks close to or even in excess of their operating income. (Paragraphs 7.94 and 7.95)

8.42 A 30-35 per cent reduction in staff costs is required in the three banks so that the ratio of staff costs to operating income in these banks comes to the median level of the same ratio in public sector banks. (Paragraph 7.100)

8.43 UCO Bank has also identified a similar surplus in its staff strength. Considering all factors like expected income growth in future and removal of NPAs, initially, a reduction in the staff strength of the order of 25 per cent is recommended. (Paragraph 7.101)

8.44 In order to control their staff costs, the three weak banks will have to resort to a voluntary retirement scheme (VRS) covering at least 25 per cent of the staff strength. A reasonable VRS for the three banks aimed at 25 per cent reduction in overall staff costs is expected to cost anywhere between Rs. 1,100 and Rs. 1,200 crore. (Paragraphs 7.104 and 7.105)

8.45 While giving effect to VRS, the banks should endeavour to maintain in the remaining staff strength a good balance between different categories of staff. (Paragraph 7.106)

8.46 The scheme should be kept open for a period not exceeding six months so that consequential actions to be taken are not delayed. (Paragraph 7.106)

8.47 The banks will also need to undertake considerable retraining and relocation of the post-VRS staff strength and ensure changes in the job content and skills of the different categories of employees so that their services can be put to best use at points where these will be needed most. (Paragraph 7.107)

8.48 In order that the VRS and the needed reduction in staff costs have a real impact on the operating results of the banks concerned, it would also be necessary to place a cap on the staff expenses of the three banks. A five-year freeze on all future wage increase including the one presently under contemplation is considered necessary. (Paragraph 7.108)

8.49 If VRS does not lead to the needed reduction in the banks' operating costs, there will be no alternative to an across-the-board wage cut enabling a 25 per cent reduction in staff costs. (Paragraph 7.109)

Organisational restructuring

8.50 In all the three banks, urgent delayering of the decision making process relating to credit is called for without which loss of business will be very difficult to arrest. (Paragraph 7.114)

8.51 These banks have a larger network of branches than what their level of business needs or can sustain. At a fairly large number of centres, branches of the same bank are only eating into each other's potential. There is, therefore, an urgent need to consider rationalisation of branches in all the three weak banks. (Paragraph 7.115)

8.52 The weak banks must take a hard and careful look at their branches which are unviable and after convincing themselves about their unviability decide to discontinue these operations. By continuing such operations hoping that these will improve in future or by showing them artificially as profitable using a transfer pricing mechanism which favours them unduly, the problem will be compounded and elude solution even in future. It therefore stands to reason that the banks merge two or more unviable operations into one viable operation. (Paragraph 7.118)

8.53 The CMD in a weak bank has to possess special skills and attitude helpful in restructuring of an organisation. Incumbents in these positions need to be proven achievers who can lead from the front. (Paragraph 7.119)

8.54 It is equally important that the CMDs of these banks have a sufficiently long tenure, say, a minimum of four to five years for effectively discharging the complicated task of restructuring a bank and should be in the age group of 50-52 years. In order to ensure uninterrupted progress of the restructuring plan and to commit the top management thereto fully, this tenure should not be ordinarily curtailed. (Paragraph 7.120)

8.55 The right persons for these jobs should be provided with incentives, both monetary and non-monetary, for achieving the restructuring mission successfully even if giving such incentives means making a departure from the existing norms. (Paragraphs 7.121 and 7.122)

8.56 A line of succession should be developed well in time and a system put in place whereby, save exceptions, an ED should succeed the outgoing CMD. Excepting in very small banks, there should be two EDs. (Paragraph 7.123)

8.57 In weak banks, there should be two EDs as it is desirable that a very senior functionary, besides the CMD, should be charged with the responsibility of driving the restructuring process leaving the CMD free to pursue other strategic growth issues. (Paragraph 7.123)

8.58 The Boards of these banks need to be reconstituted to include eminent professionals, industrialists and financial experts with the necessary training, experience and background to provide strategic support to the CMD’s team. Board level support to the banks’ management in strategising, decision making, target monitoring and course corrections has to be regular and extensive and the Boards need to have not only the talent and will but also a cohesive and focused approach to do it. It is important for the weak banks that their boards function as totally cohesive bodies. (Paragraph 7.124)

8.59 There should be a clear distinction between the roles of ownership, which the government has, and that of management, which it doesn’t. As a first step in the direction, the government may consider withdrawing from the banks’ boards its own serving officers and replace them with independent nominees having relevant knowledge and background. (Paragraph 7.125)

8.60 While a longer term training and reskilling programme will have to be undertaken by the banks, they would also need to resort to some recruitment in the senior and middle levels of management from the market. Provision would need to be created for such recruitment by them. Arrangements should also be made for lateral movement of talent. (Paragraph 7.128)

8.61 The training facilities in the banks will have to be considerably strengthened. It is also worth considering whether training facilities created by more than one bank could be pooled for better and optimum utilisation of the facilities and limited training skills. A sub-allocation out of the capital support earmarked for HR including VRS may be made for reskilling and training. (Paragraph 7.129)

Financial restructuring

8.62 For maintaining a good loan book as also a balanced overall asset profile, banks need to maintain at all time CAR at a level comfortably above the minimum required. Financial restructuring of a bank should aim at raising its CAR to at least one per cent above the minimum required so that it can continue with its credit business normally. (Paragraph 7.135)

8.63 A portion of the additional capital requirement would need to be provided in cash. As a measure of introducing some accountability for using additional funds, the weak banks must undertake to provide a return. At least, on such portion of capital funds, which are provided in cash/by transfer of funds, there needs to be an arrangement, even if deferred, for payment of interest. The government may decide to bring in such capital by way of preference capital or subordinated debt forming a part of Tier II capital of banks. (Paragraph 7.137)

8.64 Further recapitalisation must be accompanied by strict conditionalities relating to operational as well as organisational restructuring of the recipient bank. There should also be conditionalities about the manner in which these funds can be deployed and about their servicing. An expectation of continued recapitalisation without any limit is just not sustainable. (Paragraph 7.139)

8.65 Future capital infusions in weak banks should be clearly earmarked for specific purposes indicating the amount that could be used under the head as also the period within which it could be utilised. Funds should become available only when the banks undertake the specific activities for which these have been earmarked. An account with the government or with the RBI could be opened from which earmarked funds could be made available. (Paragraph 7.141)

8.66 Considering the present financial condition of the banks, the government may decide to give them moratorium on payment of interest for one or two years, i.e., until the deployment of these funds starts getting reflected in their operating results. The agreed rate of dividend on such preference shares and interest on subordinated debt may not be market-related and kept low. (Paragraph 7.142)

8.67 All future recapitalisation should be under an agreement, between the government on the one side and the bank’s Board of Directors, its management and staff and employee unions on the other, laying out the restructuring goals. It would also be desirable to assign selected financial indices for the bank to follow within a timeframe. The performance under this agreement will have to be monitored closely. (Paragraph 7.143)

8.68 The cost of comprehensive restructuring of the three banks over the next three years is estimated to be of the order of Rs. 5,500 crore, Rs. 2,500 crore for operational restructuring and about Rs. 3,000 crore to meet the requirements of financial restructuring. Out of this, about Rs. 1,500 crore will be needed in cash and the rest in the form of bonds. (Paragraph 7.111)

8.69 The broad pattern of strategies proposed and the experience gained from their implementation should form basis of future restructuring programmes that may be evolved for other banks which show signs of distress. (Paragraph 7.31)

Systemic restructuring

8.70 It is considered necessary that an independent agency established under a special Act of the Parliament be entrusted with the responsibility of approving bank-specific restructuring programmes, initiating their implementation and monitoring progress. This will be the Financial Restructuring Authority (FRA). (Paragraphs 7.144 to 7.146)

8.71 The FRA set up under an Act of the Parliament and working as an arm of the government will facilitate coordination between the banks being restructured, the government and the regulatory authorities. (Paragraphs 7.144 to 7.146)

8.72 The basic control of banks covered by the restructuring will continue to be with the Ministry and there will be no change in the Reserve Bank of India's role of regulation and supervision. (Paragraph 7.146)

8.73 The FRA will monitor the progress of the restructuring programme and will have the powers to take all decisions relating thereto which the owner needs to take. Its role and functions would need to extend over the policy as well as operational aspects of the restructuring programme. Among other things, it will be the owner of the Asset Reconstruction Fund on behalf of the government and will ensure its proper governance and arrange for the management of the ARF by appointing Asset Management Companies. (Paragraph 7.146)

8.74 The FRA may be established under a special Act of the Parliament with provisions protecting it against avoidable obstructive litigation and also from the necessity of legal procedures in enforcement of mortgages and other contractual rights. (Paragraph 7.149)

8.75 The FRA will not be a permanent body as it is expected that, with the completion of the restructuring process of the weak banks, it would be wound up. (Paragraph 7.150)

8.76 The FRA should be able to ensure a high level of coordination with the regulator on the one hand and the government on the other so that the restructuring programme moves ahead smoothly. The process will be facilitated substantially if within Reserve Bank of India, a specialist wing is formed for regulating and supervising weak banks. On a number of issues like deposit insurance, regulation of subsidiaries, risk management, disclosures and regulatory compliance, the treatment of weak banks would need to be different from those of much stronger normal banks. (Paragraph 7.151)

8.77 The legal provisions, which are out of line with the present day realities, need to be amended and new enactments, particularly in respect of laws relating to bankruptcy, a defaulter's handling of assets which were offered as collateral for a loan, foreclosures and court procedures, are urgently required in order to cater to the requirements of the present changed and far more complex economic and business environment. (Paragraph 7.152)

8.78 A secondary market in loans should be developed but this would be possible only if the legal provisions facilitating hassle-free transfer of loans and recovery of dues are in place. (Paragraph 7.154)

8.79 For speeding up the recovery process of weak banks and the ARF, an arrangement should be worked out so that the DRTs attend to their cases on a priority basis. At least at some select centres, setting up of special benches of DRTs to assist weak banks and the ARF should be considered to give recovery of NPAs the much desired push. (Paragraph 7.156)

8.80 The investigations into accountability both at the bank and at the level of non-bank agencies if completed in a time-bound manner would go a long way in ending uncertainties and help in the overall improvement of morale of the staff. (Paragraph 7.158)

Concluding remarks

8.81 The restructuring programme must be implemented in a time-bound manner. Any delay will add to the cost of the restructuring. (Paragraph 7.160)

8.82 The different measures suggested for operational, organisational, financial and systemic restructuring are a unified package and have to be implemented as such for the desired results to be achieved. Gradualism and a policy of pick and choose from the package should be avoided as it can cause more harm than good. (Paragraph 7.160)