REPORT OF THE WORKING GROUP

FOR HARMONISING

THE ROLE AND OPERATIONS

OF DFIs AND BANKS

MAY 1998

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I. INTRODUCTION

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I.1 Genesis

I.1.1 Commercial Banks and Development Financial Institutions (DFIs) constitute a dominant segment of India's financial system. Until the initiation of the financial sector reforms in 1991, the operational ambit of these two intermediaries were almost mutually exclusive and they dispensed their designated responsibilities in a largely protected environment. An array of financial sector reforms, operationalised in a phased manner since 1991, has brought about a sea-change in the operating environment of these financial sector participants. In particular, the deregulation of interest rates, emergence of disintermediation pressures from a liberalised domestic capital market, entry of new private sector banks, alongwith an increasing exposure of Banks into project finance and the broad-basing of the product and service portfolio of DFIs to include short-term/working capital loans have progressively intensified competition in the business segments in which Banks and DFIs traditionally operated. In the process, the traditional divide in the operational domain of DFIs and Banks is also getting increasingly blurred.

I.1.2 The progressive liberalisation of the domestic financial regime has been accompanied by a pronounced orientation towards a global integration of the Indian economy. The eventual transition towards Capital Account Convertibility (CAC) and commitments to World Trade Organisation (WTO) towards freer movement in financial services can be viewed as an extension of this agenda. The success of this process in terms of benefits to the Indian financial system will depend as much on the pace and sequencing of India's liberalisation process as on the efficiency and speed with which the financial sector equips itself to deal with the complexities of a globalised economy.

I.1.3 In the changed context, harmonisation or a measure of co-ordination / balance between role and operations of Banks and DFIs has also become an important issue. These would, in turn, call for a measure of flexibility and level-playing field on the resource mobilisation side, both in terms of access and attendant obligations. An equally important concern, from a policy angle, is to bring about an orderly

consolidation of the domestic financial sector and facilitate the growth of a core of sufficiently strong players who can successfully address newer challenges likely to be posed by the further opening up of the financial services sector to foreign participants.

I.2 Terms of Reference

I.2.1 Keeping in view the need for evolving an efficient and competitive financial system in the light of the recent changes, the RBI decided to constitute a seven-member Working Group on December 15, 1997. 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.

I.2.2 The Working Group comprised Shri S.H. Khan, CMD, IDBI as Chairman and 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.

The RBI Memorandum on the Constitution of the Working Group is enclosed at Annexure I.

1.2.3. IDBI provided the Secretariat for the Group. The Secretariat was placed under Shri A. Lahiri, Executive Director, IDBI, who was assisted by Shri Krishnendu Banerjee, DGM, IDBI and Smt. Sharbari Nag-Fernandes, AGM, IDBI. These officials, alongwith a core group, principally comprising Dr. Nachiket Mor, GM, ICICI and

Smt.Rupa Rege-Nitsure, Assistant Vice-President, ICICI, Shri M.V. Subaraman, GM, IDBI, Shri Melwyn Rego, DGM, IDBI, Shri S.J. Balesh, Manager, IDBI and Shri Sandeep Jain, Manager, IDBI, provided invaluable support in the preparation of the Report. Smt.Vishakha Kulkarni and Shri Ashok Konda from IDBI provided very able secretarial assistance.

I.3 Outline of the Report

I.3.1 With a view to addressing the issues aligned to the terms of reference, the Working Group members set up three sub-groups to respectively address Terms of Reference I, combined Terms of Reference II and III and Terms of Reference IV. Each sub-group, consisting of one or more officials drawn from each member-institution, was expected to prepare a Working Paper pertaining to its domain for the consideration of the Working Group. As an aid to addressing the issues in an organised fashion, a nodal person was appointed for each of the sub-groups. For this purpose, Ms. Kalpana Morparia, then General Manager (Resources), ICICI was nominated as Co-ordinator for Sub-Group One, Shri R.M. Malla, GM (Domestic Resources), IDBI for Sub-Group Two alongwith Dr. K. V. Rajan, DGM (DBOD), RBI (for the regulatory framework) and Shri Y. Radhakrishnan, then CGM, Personnel & HRD, SBI for Sub-Group Three. **The detailed composition of the Sub-Groups is given at Annexure** II.

I.3.2 The Group also consulted a select cross-section of informed opinion comprising experts in the field, Industry Associations, and senior RBI officials on issues related to the Terms of Reference. A detailed questionnaire was also circulated to Industry Associations for the purpose. Their viewpoints greatly enhanced the qualitative content of the Report. **A list of Organisations and Individuals with whom the Group had discussions and/or received written submissions is provided at Annexure III.**

I.3.3 It was decided to extend the coverage of the Study Report to include the major financial intermediaries viz. Banks, All-India Development Financial Institutions and State-level Financial Institutions. The envisaged change in role and operations of Banks and DFIs in the globalised scenario was sought to be analysed both in a historical perspective as well as in the light of recent financial sector reforms. An

examination of international financial institutions and their considered responses to similar developments was also covered as these threw up useful insights for possible emulation. The Group members similarly endeavoured to interpret the nuances of harmonisation in the role and operations of Banks and DFIs, wherever feasible, and give a practical shape to the substantive content of such co-ordination.

I.3.4 The Report thus attempts 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, having due regard to Indian conditions. Together, they have the potential to provide the blue-print for a robust, yet harmonious, growth of the domestic financial sector in the coming years. Chapter III analyses the role and operations of Banks and DFIs in a historical perspective. The Best Practices in International Financial Systems are discussed in Chapter IV for suitable adaptation in the role, structure and operations of Banks and DFIs in India, in Chapter V. The core issues of harmonisation of operations of Banks and DFIs on the asset and funding side are explored in Chapter VI. Chapter VII through Chapter X addresses issues related to organisation structure, risk containment. IT and MIS and Human Resources Development in the context of CAC recommendations and India's commitments on liberalisation of financial services sector to WTO.

I.4 Acknowledgements

The Group would like to acknowledge the myriad services rendered by the Secretariat at IDBI in the preparation of the Report. The Group also wishes to record its appreciation of the unstinted support provided by the Sub-Group Convenors, the Sub-Group members and resource persons within each of these Sub-Groups. These officials brought to bear their knowledge of the issues relating to their assigned areas, actively participated in the deliberations and presentations to the Working Group and provided valuable support in the preparation of the Report of the Working Group.

II. SUMMARY RECOMMENDATIONS

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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 (*Sec V. 2.4*)**.

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 *(Sec V.2.4)*.**

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 ***(Sec V.2.8)***.

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 (*Sec V.2.11*).**

5. 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 *(Sec V.2.13)*.

6. 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 recuired 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** (*Sec V.2.15)*.

CHANGES IN REGULATORY AND LEGAL FRAMEWORK

7. 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 *(Sec V.3)*.

8. **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** (*Sec V.3*)

9. No intermediary (such as a bank, financial institution, mutual fund or insurance company) should be relatively disadvantaged in performing an identical function vis-à-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 burcen 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 *(Sec V.3)*.

10. 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 (*Sec V.3*).**

11. 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 *(Sec V.4.2)*.** 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 (*Sec V.4.5*)**.

12. 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 ***(Sec V.4.6)***.

13. 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 ***(Sec V.4.7)***.

CHANGES IN SUPERVISORY PRACTICES

14. **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 *(Sec V.5.1)*.

15. **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 *(Sec V.5.1)*.

16. 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 *(Sec V.5.1)*.

STATUTORY OBLIGATIONS

17. 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:**

18. **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** ***(Sec V.6.3- V.6.5)***.

19. 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** ***(Sec V.6.6-V.6.8)***.

20. 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** ***(Sec V.6.10)***.

21. **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 (***Sec V.6.11)***.

RE-ORGANISATION OF STATE-LEVEL INSTITUTIONS (SLIS)

22. 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** *(Sec V.2.16-V.2.17)*;

(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% ***(Sec V.2.18)***;

(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 ***(Sec V.2.19)***;

(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** ***(Sec V.2.20)***;

(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** ***(Sec V.2.21)***;

(vi) **SLIs should be brought under the supervisory ambit of RBI** ***(Sec V.5.3)***;

(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 ***(Sec V.2.23-V.2.24)***.

HARMONISING THE ROLE, OPERATIONS AND REGULATORY FRAMEWORK OF DFIs AND BANKS

23. 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.**

24. **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 ***(Sec VI.1.4)***.

25. 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 *(Sec VI.1.5)***.

26. 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)** ***(Sec VI.2.2- VI.2.5).***

27. **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** ***(Sec VI.2.6)***.

28. **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 ***(Sec VI.2.7)***.

29. **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** ***(Sec VI.2.8)***.

30. **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 *(Sec VI.2.9)*.**

31. 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 ***(Sec VI.2.10)***.

ORGANISATION REDESIGN

32. 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.

33. **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** *(Sec VII.2.2)*.

34. **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 *(Sec VII.2.2)*.

RISK MANAGEMENT

35. 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** ***(Sec VIII.1.5)*** :

(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

36. 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 *(Sec IX.2.5)*** :

(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.**

37. **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 *(Sec IX.2.6).***

38. In particular, the Group is of the view that financial sector participants would need to implement computerised decision-support systems ***(Sec IX.2.6)***.

HUMAN RESOURCES DEVELOPMENT

39. 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 *(Sec X.1.2)*** :

(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

(iv) **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

(v) **Skill-building and skill-upgradation**, including moving staff across functions selectively to develop Top Management talent

(vi) **Market-related compensation packages**, with financial rewards for strong performance and superior skills

(vii) **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.

(viii) 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.

III. ROLE AND OPERATIONS OF BANKS AND DFIs IN INDIA: A HISTORICAL PERSPECTIVE

III. ROLE AND OPERATIONS OF BANKS AND DFIs IN INDIA: A HISTORICAL PERSPECTIVE

III.1 The Conceptual Framework

III.1.1 **The primary functions performed by intermediaries operating within any financial system are that of clearing and settling payments, pooling resources and transferring them across time and space.** Multilateral pooling mechanisms that link enterprises and households can be structured in two generic ways, through intermediaries and through financial markets.

III.1.2 **One of the key factors that determines which institutional mechanism is best suited to perform the pooling function is the extent of informational asymmetries in the system.** With the presence of information asymmetries in the financial markets, it would be costly for each individual investor to evaluate the quality and performance of the borrowers. However, financial intermediaries, with their diversified portfolios and high degree of familiarity with a borrower's operations and financial conditions, are in a better position to undertake screening and monitoring operations. **Since the problems of imperfect information are more acute in developing economies (due to their segmented markets, firms with a short history of operations, etc.) the functions of financial intermediaries are even more relevant in these countries.**

III.1.3 Banks and FIs can also exploit economies of scale in information provision. Therefore, it is optimal for the investors to delegate the responsibility of screening and monitoring of prospective borrowers to the financial intermediaries. By acting as a delegated monitor and by producing better and more timely information, Banks and FIs reduce the degree of information imperfection between the ultimate sources and users of funds in the economy.

III.1.4 Also, as Banks and FIs have a diversified portfolio and tend to be more risk-neutral, they are better equipped for risk taking activities than their investors who can achieve only limited degrees of diversification on their own and tend to be highly risk-averse. These differences in the levels of risk aversion make it beneficial for these institutions and investors to enter into implicit risk-sharing contracts rather than

contracts where risks are borne entirely by the investors. The historical role of DFIs/Banks in developing economies needs to be seen in this context.

III.2 Commercial Banks

III.2.1 Commercial Banks in India have played a very important role as mobiliser of household savings through demand and term deposits. The deposits mobilised have been on-lent to primarily meet short-term financial needs of various borrowers in industry, trade and agriculture. In addition, commercial banks provide a range of banking services to individuals as well as business entities by way of savings and current accounts with checking facilities, issue of demand-drafts, transfer of funds, export import business through LCs, foreign exchange related transaction etc. The year 1969 was a major turning point in the Indian banking system when 14 large commercial banks were nationalised. The main objectives of nationalisation were greater mobilisation of savings through bank deposits, widening of branch network, particularly in the rural and semi-urban areas and reorientation of credit flows to benefit priority sectors like agriculture, small borrowers etc. all of which were satisfactorily fulfilled. However, the banking system operated in an environment of administered interest rates and mandatory stipulations on credit distribution; moreover, there were statutory pre-emptions under cash reserve ratio and statutory liquidity ratio. All these factors, besides severely restricting the freedom of intermediation by banks, raised their costs, affected the quality of their assets and strained their profitability.

III.3 Banking Sector Reforms

III.3.1 A series of reforms pertaining to the banking sector were announced in a phased manner from 1991. These reforms addressed four key issues:

a. Modification of the policy framework;

b. Improvement of the financial soundness and credibility of banks;

c. Creation of a competitive environment;

d. Strengthening of the institutional framework.

III.3.2 **The improvements in the policy framework were aimed at removing and/or reducing the external constraints bearing on the profitability and functioning of commercial banks**. Pre-emptions in the form of CRR and SLR were progressively brought down to 10% and 31.5 % (base; incremental SLR of 25 %) by end-April 1998, from 15 per cent and 38.5 per cent respectively in 1991-92. Inter-bank liabilities were exempted from reserve requirements in April 1997. There has been a progressive relaxation in deposit rates, and complete deregulation (barring savings and FCNR(B) rates) was effected in October 1997. This was preceded by a brief period between April-October 1997 when the Bank Rate provided the ceiling for return on deposits of one-year maturity. Lending rates were also deregulated; the present lending rate structure prescribes that rates for loans upto Rs.2 lakh should not exceed PLR while rates on loans above Rs.2 lakh stand completely deregulated. Banks are now allowed to provide term loans; further, there has been relaxation in project financing norms for infrastructure lending by banks, wherein they can exceed the prudential exposure norm of 50 % by an additional 10%.

III.3.3 With an aim to **improving the financial health and credibility of Banks**, the recommendations of the Committee on the Financial System (1991) on prudential accounting norms relating to income recognition, asset classification, provisioning and capital adequacy were introduced in a phased manner from 1992-93 and banks have, since then, been required to adhere to these norms in accordance with guidelines prescribed by RBI. In view of the necessity for banks to progressively move towards the international practice of valuing all investments on fully '*marked to market*' basis, they were advised to 'mark to market' a prescribed proportion of their investments in the permanent category. The prescribed ratio for 1998-99 is 70:30. New private sector banks were advised to 'mark to market' their entire investment in approved securities by March 1997. This measure was also expected to facilitate the development of an active and healthy secondary market in Government securities. Private banks were asked to achieve a capital to risk-weighted-asset norm of 8 per cent by March 31, 1993 and other banks by March 31, 1996.

III.3.4 To **make the banking system more competitive**, new private sector banks were allowed entry, while nationalised banks were allowed access to capital

markets and thereby reduce share of the government (subject to a minimum of 51%) in the total equity.

III.3.5 Policy initiatives towards **strengthening the institutional framework** comprised (1) re-capitalisation of weaker public sector banks to enable them to meet required capital adequacy norms; (2) strengthening the supervisory process; and (3) creating institutions such as Banking Ombudsman and Debt Recovery Tribunals. Besides these measures, emphasis is also on more effective functioning of the Board, better risk management systems and improving transparency and disclosure in the published accounts of Banks, and enhancement in the role of external auditors.

III.3.6 The beneficial impact of the liberalised policy environment is adequately reflected in the performance parameters of Banks. **Net non-performing assets (NPAs)** of PSBs as a proportion of their net advances declined from 14.5% in March 1994 to 9.2% in March 1997, 47% of which was accounted for by priority sector lending. Private and foreign banks reflected a healthier balance sheet, with the NPAs of the former forming 2.07 % of net advances in 1996-97 (for old private sector banks, the figure stood at 5.99% in March 1997).

III.3.7 Further, out of 27 PSBs, 25 had attained the stipulated 8% **CAR** by end-March 1997, with 16 among them exceeding 10%; 9 others had CAR between 8-10%. This is vis-a-vis the position in March 1993 when as many as 26 PSBs had not attained the minimum stipulated CAR of 8%. Among Private and Foreign Banks, 46 had CAR above 10 % and 22 between 8-10%, while 4 old Private Sector Banks had CAR below 8%.

III.4 Development Financial Institutions

(I) All-India Development Financial Institutions (DFIs)

III.4.1 The creation of Development Finance Institutions (DFIs) in India was a considered response to the emergence of broad-based industrial development as an imperative of national policy. It was felt that the extant institutional framework was inadequate to efficiently address the long-term resource requirements of industrial

projects. Indian DFIs thus gradually evolved since 1948, as largely Government owned specialised financial institutions with the principal objective of providing term finance for fixed asset formation in industry alongwith extension services in the field of provision of entrepreneurship and consultancy for small and medium sectors. Given the geographic expanse of the country and the proliferating needs of small and medium enterprises, development banking in India has assumed a tiered approach with State level DFIs (SFCs, SIDCs etc.) providing financial accommodation to the former, albeit with the benefit of refinance and other support from All-India FIs like IDBI/SIDBI. IDBI, by virtue of its Charter, was entrusted with the additional responsibility of acting as principal financial institution for co-ordinating the activities of institutions engaged in the financing, promotion or development of industry. In observance of this role, IDBI co-ordinates the operations of All-India DFIs and supervises the functioning of SFCs and SIDCs, provides resource support to these state-level financial institutions by way of subscription to their share capital (in case of SFCs only) and refinance assistance on concessional terms. The All-India DFIs have played an important role in the diversified and balanced industrial growth of the country. As at the end of March 1997, cumulative assistance sanctioned and disbursed by AIDFIs stood at Rs.2,89,588.3 crore and Rs.1,89,785.8 crore respectively.

III.4.2 Development banking in the pre-reform era transcended the narrow confines of long-term project lending in pursuit of broader development goals aligned to Government's varied socio-economic objectives including, among others, balanced industrial growth through development of identified backward areas, employment creation, identification and encouragement to new entrepreneurs, modernisation of specific industries and support services for creating a vibrant domestic capital market. In order to help discharge these developmental obligations, DFIs were extended access to captive sources of long-term funds (at concessional rates) through loans/equity contribution from Government of India (GoI), funds from multilateral / bilateral agencies guaranteed by GoI, Government guaranteed Bonds which qualified for SLR investment and allocation by RBI out of NIC (LTO) funds. IDBI was also given tax free status in recognition of its various promotional and developmental role.

III.4.3 However, with the introduction of the financial sector reforms in 1991, DFIs' access to assured sources of long-term and low cost funds were

completely phased out and they have had to primarily access the market for resource mobilisation. *Pari passu*, the 'tax free status' available to IDBI was withdrawn in the interests of a level-playing field. This has limited the DFIs' ability to provide long-term finance, more so, at relatively low costs.

III.4.4 With a view to provide some flexibility to DFIs in resource raising, in October 1993, select DFIs (IDBI, ICICI, IFCI, SIDBI, Exim Bank and NABARD) were permitted to access short-term funds by way of CDs/FDs and term money borrowings for 3 to 6 months within the stipulated institution-wise limits. In May 1997, the RBI replaced instrument-wise limits with umbrella limits for resource mobilisation by way of term deposits, term money borrowings, CDs and inter-corporate deposits equal to one time of their net worth. These have, however, been made subject to certain restrictive conditions. (This aspect has been discussed in detail in **Chapter VI**).

III.4.5 In line with the prudential guidelines relating to Banks, DFIs were advised by the RBI in March 1994 to implement prudential guidelines on capital adequacy and income recognition, asset classification, provisioning and other related matters in a phased manner from the accounting year 1993-94. The three major DFIs - IDBI, ICICI and IFCI - as on March 31, 1997, had achieved CAR of 14.7%, 13.2% and 10.1% respectively, while on the same dates, their NPAs stood at 10.3%, 7.8% and 8.27% of their respective assets portfolio. The profits after tax posted by the three institutions for the year 1996-97, stood at Rs. 1144 crore (IDBI), Rs. 770 crore (ICICI) and Rs. 379 crore (IFCI).

III.4.6 Effective June 28, 1997, term lending institutions and three refinancing institutions have been subjected to mandatory credit exposure norms, earlier applicable only to commercial banks. The exposure limit should not exceed 25 per cent of the institution's capital fund in case of individual borrowers and 50 per cent in respect of group borrowers.

III.4.7 Effective March 26, 1998, RBI has stipulated that bond issues by DFIs (which were hitherto free from prior RBI approval) with either a maturity of less than 5 years or maturity of 5 years and above but having special features like options etc. or bearing interest rate exceeding 200 basis points over the yield on Government of India securities of equal residual maturity would require its prior approval.

III.4.8 Further, financial sector liberalisation led to a change in ownership pattern. Pursuant to the amendment of the IDBI Act in 1994, IDBI made its initial public offering of equity shares in July 1995. Simultaneously, the Government also offered for sale a part of its equity holding in IDBI; resultantly the Government's shareholding in IDBI today stands reduced to 72.14%. The constitution of IFCI was changed in 1993 from a statutory corporation to a company under the Companies Act; thereafter, IFCI too accessed the capital market with an initial public offering of equity shares. On April 1, 1996, SCICI Limited merged with ICICI to create a strong capital base and optimise operational efficiency. IRBI was transformed into a full-fledged DFI and incorporated as IIBI Ltd.(a Government Company) in March 1997, thereby providing it with adequate operational flexibility and functional autonomy.

III.4.9 DFIs made concrete efforts to diversify their range of activities and enter into new areas. For example, both IDBI and ICICI have set up banking and broking subsidiaries. While IDBI (in association with UTI & NSE) has set up NSDL with the objective of maintaining record of securities' ownership in electronic book entry form, ICICI set up a ICICI Credit Corporation Ltd. (a NBFC) to create a retail network. To catalyse private capital flows for infrastructure finance, Government, alongwith RBI, major FIs, SBI, and foreign institutions set up IDFC. DFIs, in a bid to reorient their business strategies to align them with term-profile of resource mobilisation, also entered into new areas of short-term and working capital financing. At the same time, reflecting national priorities, DFIs adopted capital-intensive and long-gestative infrastructure financing as a thrust area.

III. 5 (II) State-Level Financial Institutions(SLIs): State Financial Corporations (SFCs) and State Industrial Development Corporations (SIDCs)

III.5.1 The SFCs Act was passed in 1951 to set up the institutional framework to cater to the needs of medium/small-scale industries and SFCs were set-up in various states over a period of time. At present, there are 18 SFCs in the country (including TIIC which was set up in 1949 under the Companies Act, 1948) operating as Regional Development Banks. The SFCs Act provides a special role for the State Government in the management of the affairs of SFCs and also enjoins upon IDBI the responsibility to supervise and monitor the operations of these corporations. The SIDCs were

established in the 1960s and 1970s under the Companies Act, 1956 as wholly-owned State Government undertakings to act as catalysts for promotion and development of medium and large industries in their respective states. There are 28 SIDCs in the country of which 11 also discharge the functions of SFCs. The State Small Industries Development Corporation (SSIDC), established as State Government undertakings under the Companies Act 1956, cater to the needs of the small, tiny and cottage industries in the State/Union Territories under their jurisdiction.

III.5.2 Over the last 3 decades and more, the SLIs have contributed substantially to investment activity in the industrial sector at the state-level, especially to medium and small-scale sectors. The success of their efforts at dispersal of ownership of means of production is reflected in the escalation in the number of units assisted by them. As at the end of March 1997, the cumulative assistance sanctioned and disbursed by SFCs and SIDCs aggregated to Rs.39,657.8 crore and Rs.30,598.4 crore respectively. While the performance of SFCs and SIDCs has been impressive in terms of growth in sanctions and disbursements, their performance in terms of recoveries and collection of dues remain unsatisfactory, particularly in case of SFCs, resulting in high NPA levels and poor profitability.

III.5.3 For the year ended March 31,1997, 10 SFCs and 11 SIDCs posted Profit after Tax vis-a-vis 5 SFCs and 7 SIDCs which ended up with losses (information for remaining SFCs/SIDCs is not available). An analysis of available data for the past 5 financial years(upto FY97) reveals that 8 SFCs and 10 SIDCs have consistently earned PAT while in the case of 3 SFCs and 8 SIDCs, the losses have been mounting every year. IDBI advised SFCs/SIDCs to implement prudential guidelines related to capital adequacy, income-recognition, provisioning and asset classification in a phased manner from FY 1993-94 on the same lines as those issued by RBI to commercial banks and thereafter to term-lending institutions. Mandatory adherence to the required accounting norms laid down by RBI has brought out the deterioration in the financial position of some of these SLIs.

III.5.4 As at March 31,1997 4 SFCs and 12 SIDCs had achieved CAR above the mandated 8%; in respect of 5 SFCs, the CAR ranged between 2.06% and 6.25%

while 7 SFCs and 1 SIDC had negative capital adequacy ratio. Data in respect of remaining SFCs (numbering 2) and SIDCs (14) is not available.

III.5.5 The **recovery performance** of SLIs remains unsatisfactory, adversely affecting the level of NPAs. The recovery position in case of SFCs during FY 97 ranged between 3% and 66% of total demand, while in case of SIDCs, it ranged between 6% and 67%. NPA levels were high, varying from 95% to 9% for SFCs and from 86% to 16% for SIDCs as per latest available data.

III.5.6 Traditionally SFCs / SIDCs have been concentrating on term lending activities; resultantly loans/advances constitute 93-94% of their total assets. However, in tandem with the changing environment, they are also focussing on providing working capital facilities, leasing/hire purchase, investment activities and capital market related operations.

III.5.7 The reforms in the financial sector have necessitated market orientation in the operations of state-level institutions. Refinance support from IDBI/SIDBI has been reduced. Some of these institutions have accessed the market for raising resources. A few strong SFCs/SIDCs have also raised equity capital from the market.

III.5.8 There is thus a pressing need for reforms in SFCs/SIDCs particularly in view of the emerging changes in the operating environment. To enable SFCs to adapt to the emerging challenges, it is necessary to restructure their organisation and management, broaden their resource base and carry out financial restructuring after a review of the financial health of individual SFCs.

III.5.9 To consider the problems of the State-level financial institutions in the changed context, a meeting of the heads of SFCs/SIDCs and Chief Secretaries of State Government was held in August 1993 at New Delhi under the Chairmanship of Finance Secretary, Government of India wherein a Committee was constituted (under the Chairmanship of Shri S.H. Khan, CMD, IDBI) to undertake a comprehensive review of the SFCs Act, 1951. The Committee recognised that, in the changed context, SFCs would have to diversify their operations and get into newer areas; their resource base would need to be broadened and their over-dependence on State Government and IDBI would need to be gradually reduced; their organisation would need to be

strengthened, supported by continuity of top management. and operational autonomy and flexibility. Keeping the above factors in view, the Committee submitted its recommendations to the Government of India on May 31, 1994. While some of the recommendations for providing greater flexibility in operations have already been operationalised, those involving statutory changes are yet to be adopted.

III.5.10 The issue of reorganisation of SLIs have been discussed in detail, in this report in a subsequent Chapter. (**Chapter V, Sec. 2.16 - 2.24**).

III.6 Continued Relevance of DFIs

III.6.1 The accent on resource mobilisation from the market (which currently lacks providers of long-term funds) as a sequel to financial sector reforms in the '90s has led to a shortening in the maturity profile of DFIs' sources of funds. Consequently. the twin dictates of a reasonable asset-liability matching and growing competition from banks in term-financing have led DFIs to enter into working capital and short-term financing of industrial units leading to further blurring of the distinction between Banks and DFIs. At the same time, the need for substantial greenfield investment in long-gestative but thrust areas like infrastructure and the absence of steady source of long-term funds due to an underdeveloped long-term debt market dictate that the traditional specialist role of DFIs as purveyors of long-term funds must continue for sometime. However, for DFIs to assume this responsibility and yet remain viable, there is a need to evolve ways and means of restoring to DFIs the assured access to long-term funds. This aspect has been discussed at length in a subsequent chapter. (**Chapter V, Sec. 2.15**)

IV. INTERNATIONAL EXPERIENCE: BEST PRACTICES

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The likely environmental changes in the Indian financial sector, although daunting, are not unique to it. The financial system in a number of countries, both in Asia and elsewhere, has been subject to a similar confluence of circumstances at different times in the past. Each of them has suitably responded to the consequential opportunities and challenges by putting in place an apposite financial structure with efficient and competitive financial intermediaries alongwith an enabling regulatory and supervisory framework. The Group felt that a scan of such cross-country experiences would be particularly useful to draw upon the best available international practices in these areas for suitable adaptation in the Indian context.

IV.1 Changing Profile of Development Financial Institutions (DFIs)

IV.1.1 An important element underlying the emergence of DFIs in the post-war period, particularly in developing economies, was the need for an institutional framework which would act as a catalyst for industrial development. DFIs were set up as public or quasi-public financial intermediaries with the principal objective of providing medium/ long term finance and technical/ managerial expertise to new projects as well as for expansion/ modernisation of existing projects.

IV.1.2 DFIs have found it difficult to sustain the success and optimism of the early years (50s and 60s) and exist as commercially viable entities in their traditional role. This is due to major structural changes in the economic environment which have given rise to certain operational weaknesses in these institutions. As a result, DFIs - both in the First World countries as well as in Asia- have begun reforming their corporate mission and charter of operations to fashion new services/products and tap new funding sources. The foresight displayed by individual countries in putting together an enabling regulatory and legal framework has exerted a deterministic influence on the pace of such transformation by the respective DFIs in these countries.

IV.1.3 **As part of an overall paradigm shift, financing of pure developmental activities is also being re-examined by DFIs in many countries, including Asian**

DFIs. In the Indian context, with the privileged access to such resources having been progressively withdrawn since the early '90s, the ability of DFIs to perform this function, has been considerably reduced. International case studies clearly bring out that development financing activity has largely been dependent on Government support. For example,

- **Japan Development Bank (JDB)** continues to provide long-term, low interest loans (in conjunction with other Japanese and foreign banks) as supplemental lending to projects which are unable to obtain financing from other sources because of factors such as high risk, long maturity periods, low profitability or heavy initial investment. JDB's lending policy is not dictated by primary considerations of profit. But this has been possible because its entire funding requirements are sourced to government (apart from recycling of repaid loans).
- **The Industrial Finance Corporation of Thailand (IFCT)**, in its present form, appears to be closest in profile and operations to Indian DFIs. It offers concessional loans, primarily for exports, small-scale industries and environmental protection. However, these are sustained through concessional funds from Bank of Thailand (BoT) which are tailored to meet these commitments. The debt instruments issued by the Corporation enjoy privileged status. They are treated as liquidity assets required to be held by banks, FIs and insurance companies under BoT regulations. The government also guarantees borrowings of IFCT subject to a cap of 12 times the capital base. Besides, the Corporation enjoys exemption from income tax, certain withholding taxes and stamp duties.
- For the **Korean Development Bank (KDB),** long-term equipment financing has secularly been the main lending activity, with increasing emphasis on thrust sectors like infrastructure, technology development, environmental protection and telecommunications. The KDB undertakes such directed lending out of Government funds which are allocated by the Budget in accordance with the prevailing stance of fiscal policy. The KDB also has access to special purpose funds such as the Petroleum Business Fund, Tourism Promotion Fund, Special Industry Supporting Fund directed toward specific industries designated by the government. According to the KDB Act, the government has an obligation to

replenish any deficit if KDB's legal reserves are insufficient to meet its accumulated losses.

IV.1.4 The sustainability of development financing by Indian DFIs is thus crucially dependent on some form of dedicated long-term fund support from the Government or the Central Bank until the domestic debt market assumes critical mass.

IV.2 Broad-basing of Products/Services

IV.2.1 Driven by considerations of risk diversification, access to newer sources of funding and opportunities and challenges flowing from increased globalisation, most DFIs in developed and developing countries have transformed themselves in one way or the other into full-service universal banking entities.

III.2.2 Definitionally speaking (following George Benston, 1994), **Universal Banks** are *"Financial Institutions that may offer the entire range of financial services (apart from Commercial Banking). They may sell insurance, underwrite securities and carry out securities transaction on behalf of others. They may own equity interests in firm, including non-financial firms."* .... The rationale seems to be the ability to provide integrated financial services to the client. reduction in the risks of business as also the promotion of efficiency and professionalism within the organisation because of the inter-se competition among unibanks.

IV.2.3 The key to success in universal banking, according to its adherents, lies in: (a) a wide network of branches accessible to depositors and retail borrowers; (b) a decentralised decision making apparatus; (c) more advanced computer technology for on-line information access and high quality customer service.

IV.2.4 **German banks** like Dresdner Bank and Deutsche Bank alongwith banks in Switzerland present classic examples of Universal Banking. However, the term 'Universal Banking' does not mean that every institution in Germany conducts every type of business with every type of customer. This is merely an option; a pronounced business emphasis in terms of products, customer groups and regional activity can, in fact, be observed in most cases. The benefits of Universal Banking System in Germany have been demonstrated particularly in difficult phases of its economic development

under especially adverse conditions, i.e. (a) in the early stages of industrialisation; (b) during the Great Depression, when banks converted many bad loans into shareholdings; (c) after World War II, when they went beyond their customary role of lender to carry a share of the business risks; and (d) in the recent past through the swift construction of an efficient, market-oriented banking system, which did not exist in the former socialist GDR.

IV.2.5 It is also expected that since European Unification permits banks to operate in all EC countries on the same lines as in their home country, all countries in EC will be served by Universal Banks (as well as by specialised banks). Most other countries like Canada allow any financial service through bank-owned subsidiaries.

IV.2.6 The transformation of the Indonesian DFI, BAPINDO was a strategic response to the deregulation of the Indonesian financial system alongwith promulgation of a New Banking Act 1992 that, among other things, permits only two types of banks: universal banks and people's credit banks. Its diversified menu of services include working capital loans, export finance services, forex services to exporters and importers, leasing, venture capital, merchant banks, capital market activities (stock-underwriting, trusteeship) and full service commercial banking (since 1991).

IV.2.7 The DFIs in other Newly Industrialised Countries (NICs) have also redrawn their agenda on similar lines. **IFCT, the private DFI in Thailand**, now provides the entire gamut of financial services, including corporate financing (both working capital and term loans) and investment banking through a group structure of affiliated companies.

IV.2.8 **Development Bank of the Philippines (DBP)** has, since 1989, similarly transformed itself from an institution primarily tasked with the rehabilitation of a war-ravaged economy, when it was established in 1947, into a predominantly wholesale bank (until recently) with a significant retail lending presence to meet the medium and long-term financing needs of industry and other sectors. With the Philippines' Central Bank approving DBP's application for an expanded banking licence in December 1995, it became the first universal bank in the country with thrift banking privileges. This has vested DBP with greater capability to pursue its development thrusts. Its secular role in

project finance and capital market development besides its developmental role of gearing up the engines of Philippine economic development would avowedly continue and strengthen.

IV.2.9 **Industrial Bank of Japan (IBJ),** Japan's largest private development bank (since 1952) is already firmly established as a transnational FI with a global network that provides comprehensive financial services to a cross-border clientele. IBJ's charter has witnessed periodic revisions in response to domestic macro-economic compulsions and enabling changes in the complementary structure of regulations. In response to stagnating domestic conditions and comfortable current account position obtaining from the early 70s, IBJ entered into several areas of financial activity in foreign countries such as commercial banking, investment banking and securities-related services besides project financing, derivative-based operations and advisory services.

IV.2.10 The **Korea Long-Term Credit Bank (KLB),** the private sector development Bank established in 1967, similarly became a full-fledged bank in early 1980s with the enactment of Korea's Long Term Banking Act. It has been progressively expanding its coverage of services as the provider of integrated financial services to clients. This has also been the case with **Korea Development Bank (KDB),** the oldest and biggest DFI in South Korea, set up as a state-owned bank in 1954. Although KDB's assistance to industries have been more or less in step with the priorities laid down by Government policy, its charter of operations have undergone periodic revisions: focus on industrial restructuring and growth in the initial phase, followed by diversification of activities domestically before venturing outward by setting up offices abroad to undertake a broad array of activities. The KDB domestically expanded into leasing, guaranteeing, merchant banking, trust activities, foreign exchange services, credit rating, investment banking, securities business and venture capital financing. Today, KDB's international banking activities are undertaken by its large network of subsidiaries, branches and representative offices in the world's major financial centres. In the Asia-Pacific region, it undertakes a wide range of investment banking, securities and leasing business. In Europe, the Bank engages in both commercial banking and investment banking activities utilising the "Universal Banking" provision there.

IV.2.11 **While examining the varied country experiences with regard to portfolio diversification, two features thus stand out : (a) even with a diversified portfolio, most DFIs prefer to emphasise their basic specialisation in term lending; (b) specialised banks co-exist and have survived in direct competition with universal banking.**

IV. 3. Changing Profile of Banks

IV.3.1 The traditional role of even commercial banks has been undergoing changes. **Historically, the development of commercial banks around the world, combining payments functions and financial intermediation, stemmed from four main types of institutions - payment processors, merchant banks, securities firms and intermediaries, and chartered banks**. Payments processors began by providing local payments services and expanded into lending. (A recent example of a payments processor becoming a bank is the American Express). Merchant banks began with trade and expanded into remittance, the securities business, local payments and lending. Securities firms began with lending and, through economies of scope, expanded into payments. Chartered banks were set up from the very beginning as full-fledged fractional reserve banks. The Bank of England was the first and it served as the model for chartered banks in USA.

IV.3.2. Banks abroad have evolved in three respects: the type of lending they do (their assets), the type of borrowing they undertake (their liabilities) and the additional activities in which they engage. This evolution has been stimulated by the search for profits and has been constrained by Government regulation.

IV.3.3. **As intermediaries**, bank lending, which began with discounting of commercial bills and purchase of Government securities, expanded and indeed moved away in the post-World War Two period to the 1980s towards inter-bank lending, lending to industrial firms (mostly through "loans") and to customers (through consumer credit and mortgages) owing to the increased profitability of these activities. In USA, where commercial banks remain the single-most important intermediary, business lending peaked as a proportion of total assets in the early 1980s but has since

declined. This is due to the increasing competition for business from foreign banks and from non-bank lenders. New capital standards introduced in 1989 also made lending less attractive relative to holding Government securities. A comparison of assets of U.S. commercial banks in 1991 with those of banks in several other countries (e.g., Canada, France, Germany, Italy, Switzerland and U.K.) showed that the former had relatively the highest proportion of securities and also, because of relatively high reserve requirements, the highest proportion of cash assets. But they had the smallest proportion of inter-bank deposits.

IV.3.4. Banks have also steadily expanded their activities in **payments-related services**, in delegation and trust services, in credit substitution and guarantees, and in forward transactions. They have been led here by economies of scope, largely unhindered by regulation. In many countries, banks have been constrained in their expansion into the securities business and into insurance by various regulations. However, in these areas too, there has been selective expansions.

IV.3.5. Dramatic changes are taking place in **retail banking** since the mid-80s, rendering the banks' traditional business of accepting deposits and making loans as the only providers of short-term funds to borrowers such as lines of credit or over-draft facilities less profitable. Although the pace of change varies from country to country, by and large, new delivery mechanisms and aggressive competitors are poised to eat into the easy profits previously enjoyed by retail banks. **In developed economies, the information technology revolution (from sophisticated data storage to internet banking and smart cards) have deprived banks of their monopoly in transmitting money. At the same time, as customers get better access to information on financial services through the media, they are becoming more sophisticated and demanding in their search for better value and more attractive banking products.**

IV.3.6 This has had three major consequences. First, **the focus of banking is shifting from transactions towards sales of financial products.** This is because, as banks merge, they are increasingly centralising and streamlining their processes. A measure of this shift is the secular rise in the proportion of non-interest income in

banks' total gross income since 1981. the highest ratios have been chalked up by banks from Germany, Switzerland and U.K. which have the fewest restrictions on the range of activities allowed to commercial banks. U.S. banks rank in the middle on this count. Second, **barriers around banking are being lowered allowing competitors from other industries to come in and try innovative approaches. Third, the growing variety of delivery channels for banking enables new entrants to survive.**

IV.3.7 The first wave of new entrants- in U.K. in the late '80s- were building societies which started to offer current accounts. The newest competitors in this area are generally from outside the financial sector: in countries like USA, they come from technology companies (such as telephone banks, internet banks) while it is retailers (such as supermarkets) that are entering the business in Europe. The threat posed by the non-banking companies to existing entities stems from the fact that they bring consumer-focused ideas and often strong brand equity without the high-cost burden of a traditional bank infrastructure.

IV.3.8. In fine, **the basic business of banking - a combination of payments and financial intermediation- has changed and continues to change along three dimensions: (a) the entry of new types of institutions into banking, (b) the evolution of the intermediation function as banks develop new types of lending and new types of borrowing, and (c) the addition of other related functions to their basic business.**

IV.3.9 Nevertheless, banks have a continuing role to perform by moving from high quality credit to more information sensitive medium-sized borrowers. With their large balance sheets and capital bases, they have been able to act as a bridge between the borrower and the market through the provision of guarantees rather than funds and short-term funds rather than long-term funds. In addition, even in wholesale markets, with higher quality credits, despite the relatively easy availability of credit information, banks add value through the knowledge of preferences of client managers and mutual trust, by offering customised innovative solutions and the implicit assurance that when markets turn bad, the bank will monitor and suggest appropriate remedial measures to the client. On the retail side, they have a continuing role in the lives of investors because currently the number of people willing to try electronic media for their

financial transactions is small and most people do not know how to manage their financial affairs and look for a trusted source of financial advice.

IV. 4. Best Practices in Structure

IV.4.1 **There are pluralistic options on the organisational structures through which the operations and activities of DFIs/Banks can be carried out**. For example, in USA, a holding company structure is the dominant one. J.P. Morgan (JPM) and Citibank are both organised on the holding company model. While CitiCorp is the holding company equivalent of J.P. Morgan & Co. Inc., Citibank is the commercial bank subsidiary equivalent of Morgan Guaranty Trust of New York. Again, while Citibank's focus has been more retail, JPM's focus has been pronouncedly wholesale. Citibank has attempted to commoditise financial services and is known the world over in every retail segment as the choice bank and focussed credit card player. Similarly, Development Bank of Singapore (DBS) and BAPINDO, Indonesia- originally term-lending DFIs- have moved into full-service commercial banking in response to changes arising in their operating environment. JPM, on the other hand, has chosen to focus on the changing requirements of their core clients, developed their capital and treasury market capabilities and services required to maintain their traditional "Fortune 500" relationships. In the process, they have succeeded in becoming a competitive global investment bank. IBJ and IFCT have followed the wholesale banking route in their domestic arena.

IV.4.2 Even the organisational structure attending universal banking has varied across nations. In the UK, e.g., securities and other such activities are conducted in separately capitalised subsidiaries of banks. German commercial banks, on the other hand, conduct only securities and merchant banking operations within the Bank. Insurance, mortgage banking, portfolio management and investment funds are provided in affiliates, organised under an "*Allfinanz*" financial holding company. Variants of these structures (including joint ventures or public private partnerships) under a holding group configuration are present in Asian DFIs.

IV.4.3 There thus exists a number of corporate structures under which participants in financial systems the world over carry out their activities; there does not appear to be any one ideal structure applicable across different situations.

IV.4.4 **Finally, the type of *convergence* envisaged in Asia is likely to be non-uniform.** Under Japan's proposed "Big Bang" deregulation of financial markets by 2001, banks can move into equity underwriting and investment management. Non-life insurance premiums will be deregulated and life and non-life companies will be encouraged to enter each other's business.

IV.4.5 Generally, in Asia-Pacific, there is far more overlap across the range of financing businesses than cross-fertilisation with insurance. Australia has only just announced changes enabling insurers to acquire banking assets. **The future cross-over between insurers and banking on a larger scale, as envisaged in Japan or as found elsewhere internationally, will largely depend on local Government's will and initiatives.**

IV.4.6 **Despite these caveats, the fact remains that worldwide, with the opening up of the financial sector, the charter of financial players has changed from specialisation to integration.** The perceived advantages from product specialisation are now known to be outweighed by the need to have synergy of operation, which not only reduces the cost of funds. but also helps in providing quality services under one roof. These advantages accrue through integrated treasury operations, information technology support, library and information database services, market and legal research departments, brand identities, and shared representative offices and sales offices. Integrated operation also allows a client to have a seamless relationship with the same Bank across his financing needs. Enhanced quality of credit information about its customers also allows the universal bank to give finer pricing in its credit delivery. Larger size gives access to both domestic and international funds at cheaper rates. Yet another significant source of competitive advantage to an integrated player over the segmented player is that diversification of asset base allows for significant reduction in both risk as well as the possibility of financial distress.

IV.4.7 However, an integrated operation raises the issue of use of privileged information available to one part of the business to help another part of the business. This can be mitigated by the use of appropriate internal checks as well as the use of Chinese walls/ firewalls between different functions. (This is effectively practiced at JP Morgan and other universal banks). It might be argued that the operation of a Chinese wall reduces the cost advantages which arise out of integrated operations. However, advantages which arise out of a uniform brand identity, treasury operations, technology and systems do not depend on the presence of a Chinese wall.

IV.4.8 Broad-basing in products and services portfolio must be complemented by an apposite framework for regulation of structures. The regulatory regime should be such that it allows financial service providers to make choices regarding their structures based on internal business considerations. This can be facilitated if there is function-specific regulation.

IV.5 Consolidation in Global Financial Industry

IV.5.1 Another major trend, apart from "convergence", sweeping across all segments of the financial industry worldwide - be it banking, insurance, investment or finance, in recent times is " consolidation" among financial entities. Both trends are reshaping financial industry internationally, forcing institutions across the financial spectrum to re-examine their business strategy and direction besides adding new dimensions to regulatory oversight.

IV.5.2 **However, *consolidation* and *convergence* are not identical trends although they may run concurrently in the financial landscape**. At a fundamental level, consolidation is a core response to financial pressures that run right across the global marketplace. **Cost cutting or reduction of overheads to more controllable levels is an important element driving consolidation** although empirical evidence does not always support this anticipation. In the substantially open financial markets of the West, a growing and aggressive band of new non-bank entrants from industries such as supermarkets, clothing retailers and even newsagents are eating into market shares of existing financial players. With a lower cost base and more efficient delivery

systems, these new players have fuelled cost pressures on established players further. Provided cost-cutting can be achieved, consolidation would enable banks to refocus resources on revenue enhancement. **Merging to increase market share is another driver of consolidation.** But the issue of whether pruning the number of existing players provides greater opportunities to the balance entities would depend on the degree of market openness.

IV.5.3 Since 1987, globally, mergers involving assets worth nearly $1.4 trillion have been undertaken in the finance industry. This trend witnessed a growth in momentum in 1997. In Europe alone, total value of deals (according to figures from AMDATA) was $107.4 billion, compared with $48.6 billion in 1996 and $46.9 billion in 1995. In the final year before Euro, bank mergers are expected to continue apace throughout 1998. **The motivations and compulsions underlying consolidation have varied somewhat across nations**. In developed countries like USA and **Europe**, as banks became more conscious of shareholder value and technological benefits of scale, **many middle-sized banks have merged, driven by this search for scale and supported by the desire for cost-cutting. The other factors driving consolidation in European banking are overcapacity, deregulation, loss of national protection, disintermediation in wholesale banking and increased competition**. The big banks too in these countries have become convinced of the virtues of being still bigger on the basis of the growing importance (in their chosen markets) and improved financial performance of banks such as ABN Amro and ING in the Netherlands- both products of large mergers- and BBV (a 1988 merger) in Spain. **Some observers attribute a key role to high market capitalisation in the merger-mania; it is supposedly a more important consideration to senior executives than whether a merger creates a better business mix for the new group.** All these factors plausibly account for Chase Manhattan's link-up with Chemical Bank (and a raft of other banking mergers in USA), the recent SBC Warburg - UBS merger in Europe as also the marriage of Bank of Tokyo and Mitsubishi in Japan. Banks in smaller, more consolidated countries of Europe, after cementing a strong domestic market share, have chosen to move cross-border.

IV.5.4 **The merger momentum, notably in USA, has been particularly dominant in the investment banking arena.** The trend in USA is for big investment banks to merge with retail brokers : three of the world's four biggest investment banks now own, or are owned, by retail brokers. **The prevailing belief is that size, expertise and global reach are crucial to viability and future survival; there may be room still for niche players but little space for the middle-sized.**

IV.5.5 Another recent development in Europe has been the acquisition of insurance companies by banks, evidenced by the slew of M&A deals: e.g., Credit Suisse with Winterthur in Swizerland, Bank of Ireland and New Ireland (both in 1997) while Halifax bought Clerical & Medical in U.K. in 1996. **The attractiveness of insurance to banks flows from the fact that in mature markets like the U.K., long-term savings, including life insurance, is a faster growing and more profitable business than traditional banking**. Banks, in turn, score over insurers through their stronger distribution and greater market penetration through branch networks, greater size and financial strength. Nevertheless, the insurance industry itself is consolidating in Europe with plenty of in-market mergers of its own.

IV.5.6 **An interesting empirical trend in the *retail banking sector*, in contrast, is that consolidations have by and large remained national in character.** Some observers prophesise that this may change in the future with the increase in intensity of IT use in banking- in particular, telephone/internet banking - besides the establishment of European Monetary Union in 1999. But most bankers doubt that cross-border retail banking will take off since there continues to be sizeable advantages for a Bank operating in its domestic market.

IV.5.7 A consolidation wave has also got underway in developing economies of Latin America, Eastern Europe and is slowly emerging in Asia. **The forces propelling it in these countries are different from those in the First World countries. In many parts of the developing world and particularly in the Asia-Pacific, bank mergers and acquisitions are a considered response to a crisis.** The severely inadequate capitalisation of many banks in these countries would, over time, lead to their

inexorable elimination through a mixture of liberalisation, banking crises, economic stabilisation and pressure to free trade in financial services.

IV.5.8 Indonesia is the latest entrant in this category. In response to the recent financial turmoil, Bank International Indonesia, one of the country's largest private banks, announced merger plans with Bank Dagang Nasional, Bank Tiara Asia and two unlisted banks in January 1998 to improve efficiency. Indonesia's banking sector is reportedly bloated with as many as 225 banks, many of which are inefficient and a drag on the economy.

IV.5.9 **In other parts of Asia, however, consolidation has not come about voluntarily or spontaneously, dictated by market realities. Instead, banks had to be coaxed into mergers by the Government and Central Banks of these countries through a mixture of policy initiatives and deterrents with a view to create banking champions who can hold their own on the international stage.** One of the prevalent (and to some, preferred) modes to expedite consolidation is the enhancement of statutory minimum capital requirements. This approach had galvanised a series of mergers in Estonia following the collapse of its banking system in 1992. In Asia, banks in the Philippines began merger talks after the Central Bank raised capital requirements in December 1996. In March 1998, these were upped further alongwith higher loan loss provisions. Indonesia too has recently followed suit, enhancing capital requirements for its banks from 50 million rupiah to 3 trillion rupiah. These measures are seen as a part of the general thrust to strengthen the banking system and make it more resistant to adverse shocks. However, as mentioned above, cross-fertilisation of banks with insurance companies have yet to take hold in Asia. ***[Detailed cross-country experiences on recent consolidation and convergence trends are captured in Appendix 1].***

IV. 6. Developments in Regulatory Oversight

IV.6.1 As the functional domain of banks and financial institutions become progressively broad-based in line with emerging requirements, the focus of regulatory oversight would progressively move towards ensuring that each function can be performed by an individual intermediary in an optimal manner and that no particular

institutional arrangement is given a preference over others in discharging a particular function.

IV.6.2 **At a fundamental level, the case for regulation of banks and other financial intermediaries arises from large negative externalities affecting firms and households when something goes wrong with respect to these institutions.** Regulation attempts to enhance social welfare benefits and reduce social costs attached to the provision of financial services. However, while regulation may be socially beneficial, it also imposes private costs, or a regulatory burden, on a financial intermediary. The difference between the private costs of regulation (e.g., costs involved in provision of information to authorities, and costs of frequent monitoring and surveillance by authorities, costs involved in maintaining prudential norms) and the private benefits for the producers of financial services is called the *net regulatory burden*.

IV.6.3 Financial intermediaries are subject to a given net regulatory burden at any point in time. As the demand for different financial services changes due to change in preferences and technology, certain areas of financial services may become less profitable while others more profitable. **Financial intermediaries need to have the flexibility to move to growing areas and away from areas of contraction in order to survive and prosper. Here regulation plays an important role. If regulation constrains the flexibility with which intermediaries can shift between products, it will adversely affect the competitive efficiency of various players.** The existence of barriers within financial services sector preventing the ability to diversify will add to the net regulatory burden on financial intermediaries. In addition, if differences in the net regulatory burden between various classes of intermediaries results in business moving to intermediaries with lower levels of capital requirements (for example from banks and financial institutions to insurance companies and mutual funds), it will result in overall lowering of the efficiency with which the financial system is able to perform the pooling function.

IV.6.4 Going by the experience of developed country markets, the demand for traditional products like bank deposits tends to shrink while the demand for mutual fund and pension fund products will expand. While this trend reflects the changed

preferences of investors, it also reflects a decline in the relative costs of direct securities investment vis-a-vis investment through financial intermediaries. This points to the fact that the net regulatory burden faced by traditional financial intermediaries has been high. They are left with specialising in declining markets as diversification into expanding areas is restricted. In the United States, recent regulatory changes are partially alleviating the net regulatory burden placed on banks and financial institutions by allowing them to move across traditional product boundaries and lines.

IV.6.5 Scanning the international horizon, one comes across varied strands of regulation. Some countries like U.K. and Germany allowed their banks much greater freedom in the range of permissible activities. Many other countries, like USA and Japan, are undergoing a process of financial deregulation. For example,

- In the USA, while the basic regulatory framework has remained unchanged since the Great Depression, there have been gradual relaxations in three areas, viz. (a) price controls, (b) prohibition on inter-state banking, and (c)sequestration of banks from other financial activities.
- **For a variety of historical reasons, intermediaries in the United States are subject to a *multiplicity of regulators* at both the state and federal levels.** The Office of the Controller of Currency, an agency within the US Treasury Department, supervises national banks and federally licenced branches of foreign banks. The Federal Reserve Board and State Governments supervise state chartered banks which are members of the Federal reserve System. State-chartered, non-member banks are supervised by the State Governments. The Federal Reserve Board has the authority to supervise all bank-holding companies and their subsidiaries. In addition, the autonomous Federal Deposit Insurance Corporation also undertakes some supervisory responsibilities. Regulators, banking officials, and analysts alike assert that the multiplicity of regulators has resulted in inconsistent treatment of banking institutions in examinations, enforcement actions, and regulatory decisions, despite inter-agency efforts at coordination.
- To address some of these problems, the federal agencies in USA have operated under a joint policy statement since June 1993, designed to improve

coordination and minimize duplication in bank examination and bank holding company inspections.

- **It has been suggested that regulation which restricts competition (rather than encouraging it) and focuses on failure prevention (rather than on containment of systemic impact of failure) has been at the heart of all these crises.** An effort is currently underway in the United States to completely re-examine its regulatory framework and put in place a comprehensive set of new regulations for the next century.
- In the U.K. , the financial system developed along fairly specialised lines until the 1980s, despite being free of formal regulatory constraints since the 1870s. Thereafter, the segmentation has broken down with commercial banks expanding into securities business, insurance brokerage and other activities, mainly through acquisitions. **U.K. is moving towards a *single-regulator* framework.** The supervisory responsibility of the banking sector was traditionally vested in the Bank of England. However, according to announcements made by the Government in May 1997, the Securities and Investment Board(SIB)- the regulatory body for investment-related business- would assume the responsibility for banking supervision from the Bank of England. The Government also envisaged that the SIB would eventually incorporate the responsibilities of the existing self-regulatory organisations. **Thus, SIB, to be renamed as Financial Services Authority, would become the sole statutory authority for regulating the entire financial services sector in the U.K.**
- In Europe , as stated earlier, the EC plans to create a fully integrated European Financial Area. The Second Banking Directive, effective since January 1, 1993, allows banks from any member country to expand into any other country and perform any activity allowed to it in the home country, irrespective of its permissibility or otherwise to domestic institutions in the host country. The activity should not, however. be specifically excluded by the Second Banking Directive as is, for example. linkage of universal banks with insurance firms. Similarly, a proposed Investment Services directive would allow the same freedom to securities firms, which may or may not be banks.

- The Second Banking Directive is largely modelled on the lines of Germany. Germany, **a classic universal banking country, has an enabling regulatory framework which allows banks to engage in all types of deposit, lending and securities business - plus the acquisition of holdings in non-banks - under one roof.** Further, German universal banks can do business with all types of customers as well as conduct business, other than that defined by law, as banking business without requiring a licence from the regulatory authorities. In such non-banking business, e.g., in the insurance field, they may, however, be subject to special supervision. [The combination of banking and insurance is called *"Allfinanz" in Germany and "bancassurance" in France, where it is also allowed*]. **The Federal Banking Supervisory Office(FBSO), an independent institution responsible to Ministry of Finance(MOF), undertakes overall supervision of banks (including licensing and issuing regulations).** The Banking Act provides for co-operation between FBSO and Deutsche Bundesbank (the Central Bank) and the former has to consult Bundesbank on new regulations. Under the proposed Sixth Amendment to the German Banking Act (to be effective between January and August 1998) the definition of banking business has been extended to include underwriting and securities business (the latter re-named as Financial Commission Business and includes transactions relating to money market instruments, forex and derivatives). Further, as part of the Sixth Amendment, "Financial Services Institutions" will come under the regulatory ambit of FBSO. The Federal Supervisory Office for Securities Trading, the other regulator, deals with investment service providers.
- The **Japanese** economy has relied primarily on failure prevention and restrictions on competition to govern its financial system. However, the Financial System Reform Law (which came into effect in April 1993) now permits financial institutions to compete in each other's spheres through subsidiaries. Banks and other depository institutions are now allowed to set up securities subsidiaries and, within limits, compete in the securities industry. At present, bank-owned securities subsidiaries are excluded by law from buying and selling shares. They are, however, allowed to compete in the primary issuance and secondary markets for straight bonds, and the issuance markets for convertible bonds and

bonds with warrants. **Japan, like U.K., observes a single-regulator approach.** Pursuant to the Banking Law, the Ministry of Finance (in particular, the Banking Bureau) has been given the authority to licence, regulate and supervise banks in Japan.

IV.6.6 **The Bank for International Settlements (BIS) has consistently been working to create a more contemporaneously relevant framework for bank supervision**. Its current efforts in the direction of regulatory-cum-supervisory arrangements are directed at suitably addressing an evolving environment marked by increasing concentration and globalisation of financial markets. As recently as September 1997, the Basle Committee on Banking Supervision released a set of 25 guidelines under the Basle Core Principles for Effective Banking Supervision ***[All the Core Principles have been reproduced in Appendix 2]***. Some of the key principles are set out below:

- Banking supervisors must set prudent and appropriate minimum capital adequacy requirements for all banks. Such requirements should reflect the risks that the banks undertake, and must define the components of capital, bearing in mind their ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the Basle Capital Accord and its amendments **(Principle 6).**
- In order to prevent abuses from connected lending, banking supervisors must have in place requirements that banks lend to related companies and individuals on an arm's-length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks **(Principle 10).**
- Banking supervisors must have regular contact with bank management and thorough understanding of the institution's operations **(Principle 17).**
- An essential element of banking supervision is the ability of the supervisors to supervise the banking group on a consolidated basis **(Principle 20)**.
- Banking supervisors must practise global consolidated supervision over their internationally-active banking organisations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organisations worldwide, primarily at their foreign branches, joint

ventures and subsidiaries. A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, primarily host country supervisory authorities (**Principles 23 and 24**).

IV.6.7 As India's financial system consciously attempts greater global integration and domestic financial players contemplate a move towards Universal Banking like their international counterparts, the regulatory framework too must embrace new charters that are in broad consonance with the best international practices to enable intermediaries to successfully address the new challenges and opportunities.

V. ROLE, STRUCTURE AND OPERATIONS OF BANKS AND FINANCIAL INSTITUTIONS IN INDIA

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V.1 Environmental Changes and Impact on operations of Banks / DFIs

V.1.1 The global trends chronicled in the preceding chapter- in particular, the recent experience in East and South-East Asia - heighten the imperatives of establishing a robust financial system in India with strong and resilient financial participants together with a vigilant but supportive regulatory/ supervisory framework. It is, of course, a truism that the optimal structure, role and operations of Banks and DFIs in India will be largely conditioned by (a) their reading of the current and prospective opportunities and challenges afforded by movements in their operating environment and (b) availability of a compatible policy and regulatory framework. In case of India's DFIs/Banks, the major signposts in this regard are (a) internal liberalisation in the financial sector, (b) a gradual move towards CAC and (c) commitments under WTO.

(a) Internal liberalisation in the financial sector

V.1.2 The chronology of domestic financial sector reforms, operationalised in a phased manner since 1991, is a well-traversed document. This has been dwelt at some length in an earlier chapter. Nevertheless, it merits reiteration as it has brought about a sea-change in the operating environment of financial sector participants, particularly DFIs. The deregulation-cum-liberalisation has assumed varied hues. Its key features have been the deepening of the financial markets, the easing of controls on interest rates and their realignment with market rates alongwith the emergence of new institutions. Relaxation of stipulations on concessional lending to priority sectors, removal of concessional resource window for DFIs and permission to commercial banks to undertake term lending have been the other noteworthy signposts. This has inexorably led to increasing competition within the various financial sub-sectors and between various financial intermediaries within the same sector. Consequently, there has been a blurring of distinction between institutions hitherto specialising in the provision of short term or long term capital.

V.1.3 The banking and financial institutions have responded to these changes by resorting to competitive bundling of financial services covering long-term project financing and short-term working capital loans, alongwith asset-based financing, equipment leasing, fee-based services. On the resources side, innovative resource garnering measures have been on display. The competitive forces, naturally, have led to a sustained pressure on the operating margins of Banks and DFIs. As the agenda of internal deregulation in the financial marketplace unfolds further, there is thus likely to be a greater congruence in the functions of DFIs and banks, both on the asset and liability side.

(b) Gradual move towards CAC

V.1.4 Alongwith the progressive liberalisation of the domestic financial regime, the new development paradigm in 1991 also targeted a more meaningful integration of the Indian economy with the global economy. The eventual transition towards fuller Capital Account Convertibility (CAC) and commitments under WTO in respect of financial services are a logical extension of India's secular reforms agenda on the external sector side.

V.1.5 The Finance Minister, in his Budget Speech on February 27, 1997, had formally indicated achievement of CAC of the rupee as a "cherished goal" and exhorted RBI to institute a task-force to undertake the necessary preparatory work in this regard. A five-member Expert Group, with Shri S.S. Tarapore (ex-Deputy Governor, RBI) as Chairman, was accordingly set up. The Group submitted a comprehensive report (Report of the Committee on CAC, popularly called Tarapore Committee Report [TCR]) on May 30, 1997, wherein they drew up a detailed navigational map towards *de jure* CAC, recommending a cluster of measures aligned to the achievement of a set of pre-conditions culled mainly from cross-country experiences. A crucial mandate preparatory to CAC is the reduction in quantum of gross NPAs within a time-bound programme to 5% by the turn of the century. The Report also provided a detailed time-frame (spanning the period 1997-98 to 1999-2000) and sequence of other measures to be undertaken alongwith supportive changes in domestic policy and institutional framework corresponding to the specified sequencing.

V.1.6 The timing and pace of implementation of these recommendations are currently being examined in the light of the achievement of the signposts indicated therein as well as the lessons provided by the South-East Asian crisis. These events, principally the latter, could arguably compromise the fruition lag of the recommended measures for achieving meaningful CAC as itinerarised in the Committee's Report.

(c) *Commitments under WTO Financial Services Pact*

V.1.7 In contrast, there is an element of committed finality with regard to the early opening up of some segments of India's financial services sector, following the recently concluded WTO Pact. India is among the 102 countries which are a signatory to the Agreement.

V.1.8 The developed and developing member nations of the WTO finalised a ground-breaking accord to lessen or remove international barriers to the expansion of banking, insurance and securities industry at the recently concluded Geneva summit on December 12, 1997. The pact is to be ratified by all the signatory countries by January 30, 1999 and would come into effect at the start of March 1999. This paves the way for the opening up of nearly 95% of the world's multi-trillion dollar financial services market- the fastest growing sector in the world- involving $ 18K billion in global securities, $38 K Billion in international bank lending and around $2.5 billion in worldwide insurance premiums.

V.1.9 However, the extent of liberalisation of the financial services sector, as postulated in the Agreement, would differ across countries. There was pressure on Asian economies by the developed countries to open up their financial sectors and their participation was viewed as a crucial factor in finalising the pact. This is because developed countries have little to offer to developing countries in terms of market access as most developed countries are essentially open and the developing countries, in fact, lack competitive advantage in these areas.

V.1.10 The core of the Indian offer to liberalise the financial services sector was made in 1995. The new offer retained the essence of the 1995 offer with some refinements. Therefore, India permitted only small openings in its banking and

insurance sectors. Nevertheless, the commitments undertaken by India are within the existing policy; in fact, the existing policy in some ways is more liberal than what has been committed.

V.1.11 **India's new commitments on the liberalisation of the financial services sector include:**

- **Most Favoured Nation (MFN) status to all foreign banks**, which in essence means a level-playing field for all foreign banks.
- **Foreign banks, encompassing both new entrants and existing entities, will be able to open upto 12 branches a year in India** against the present 8 branches per year. The important point here is that foreign banks will be allowed to open branches on a rational and non-discriminatory basis, consistent with MFN principle. Off-site ATMs are not included in the number of licences. Entry for foreign banks may be restricted if the market share of foreign banks exceeds 15% of assets in the banking system.
- **In the insurance-related services area, no concessions have been given to foreign insurance companies** as India did not make any commitments to open up the insurance sector. But re-insurance with foreign reinsurers has been permitted to the extent of the uncovered risk after obligatory or statutory placements domestically with Indian insurance companies. Overseas brokers are allowed to have resident representatives and offices to procure re-insurance business from Indian insurance companies.
- **In the non-banking financial services area, India has committed upto 51% foreign equity participation in a host of financial consultancy services** (including advisory services, investment and portfolio research and consultancy, advice on acquisitions and corporate restructuring), factoring, leasing, venture capital and merchant banking constituents **while in the case of stock-broking, foreign equity participation upto 49% only has been bound**. There are no limitations on national treatment.
- **India has not undertaken any commitments in cross-border supply of services. This implies that India can clearly take its own policy decisions on the timing and phasing in of Capital Account Convertibility.**

V.1.12 On its part, India has gained the Most Favoured Nation (MFN) obligations for the markets of 57 of the 70 countries which participated in the negotiations. Despite the small openings offered by India in its new offer made at the Geneva negotiations, the developed countries expressed satisfaction and hoped that the present offer was just a beginning for further substantial reforms in the financial sector.

V.1.13 India's commitments on financial services to WTO testifies to its resolve to irreversibly continue the policy improvements in the areas in which specific obligations have been undertaken. Even in areas where no commitments have been undertaken and only equity participation has been allowed, foreign service providers are assured of MFN treatment and transparency in application of rules.

Overall Implications for India's financial sector participants

V.1.14 **Although, on current reckoning, the transition towards CAC may not happen in the immediate future, it would be prudent to take an early inventory of its implications for India's financial order and plan accordingly.** For, in John F. Kennedy's words, "*the best time to fix the roof is when the sun is shining.*" As we see it, the post-CAC scenario presages the following: increased competition both within and between domestic and foreign players and consequential pressure to retain market shares, greater funding options for corporates, increased volatility in interest and exchange rates, an accent on volumes (with declining margins) to protect profitability, enhanced scope for fee-based activities although fee level per assignment would decline and a spurt in value-added services and customised products.

V.1.15 **The WTO Pact and, in particular, India's offer document also has important ramifications for the prospective shape of India's financial sector and the opportunities and challenges for the service providers who currently inhabit it.** A key challenge will obviously be to redefine the role of what was a somewhat protected and well-defined banking sector which acted as a support to priority industries rather than as independent economic players. This will require a high level of management attention, strategic financial investment and the right regulatory framework.

V.1.16 For consumers - both firms and individuals - of course, the liberalisation would be beneficial insofaras it would lead to an efficient supply of reasonably priced financial services. Foreign service providers also stand to benefit from the greater security and predictability of policy.

V.1.17 The primary impact of the WTO Agreement on the domestic financial service providers is likely to be a palpable intensification of competitive pressures in general from (entry of) more foreign banks, and, in particular, in areas where specific commitments have been made. Indian Banks and DFIs of today, however, are no strangers to competition - albeit predominantly local - due in large measure to the progressive deregulation and liberalisation of the domestic financial sector since 1991.

V.1.18 With the WTO Pact in place, these trends will accentuate as competition becomes more broad-based and frenetic. Cross-country experiences show that institutions (and these are typically domiciled in First-World countries, who have accumulated specialist skills through a process of "learning-by-doing" and have achieved scale economies) would enjoy a decided competitive advantage from the liberalisation of trade in financial services. The time required in establishing oneself in the international market in financial services is observed to be quite lengthy. This, it is viewed, would make it difficult for the Banks and DFIs of developing economies to emerge as leaders in the international market in the near future.

V.1.19 Thus, the removal of barriers to opening up of India's financial services sector would benefit existing market leaders. The strengthening of India's financial sector and its participants has to be viewed in this background. **One of the ways in which domestic players can exploit the opportunities is to sharpen and leverage the benefits flowing from local market access and distribution and imbibe the full financial, technical and structural armoury of the developed world's financial might. This would require the legislative, bureaucratic and regulatory structures to also align with the market so that the required changes can be carried through the system with effective controls, risk management and market rigour.**

V.1.20 **In fine, the currently tentative, expectedly gradual but eventual transition towards CAC awakens the need to undertake a relook at and subsequent**

rehaul of institution-level strategies, structures, policies and processes. India's current commitments to WTO in the financial (services) sector, together with the distinct likelihood of renewed pressures on India to liberalise the sector further when the Pact comes up for review in 2000 A.D., however, invests the required state of preparedness with a decided urgency. There is clearly a need to have robust structures in place ahead of the inevitable strengthening of cross-border competition.

V.2 Requisite changes recommended in their Role, Structure and Operations

V.2.1 In the light of the cross-country experiences outlined in Chapter III, it is possible to draw certain broad inferences regarding the operations of Banks and DFIs and the apposite direction in which regulation of the financial system should proceed. On this basis, the Group has certain broad/specific suggestions to offer in the context of the Indian Banks and DFIs.

V.2.2 If these recommendations are found to be acceptable, the time-frame and manner in which these are implemented would have to be carefully calibrated. The pace of change must not be so slow that, in a rapidly changing international environment, inefficiencies of the domestic financial system constrain progress in the real economy or the local institutions remain at a relative disadvantage compared to international participants in the domestic financial system. Nor should the pace of change be so rapid that participants are not able to adapt to the changes and significant disruptions occur or that one class of participants becomes significantly disadvantaged relative to others. Ideally, there should be a series of discrete policy changes operationalised under the aegis of a new organisational framework that differs fundamentally from the current one.

V.2.3 **Overall, the imperatives for successfully competing in the envisaged CAC and WTO operating environment call for a paradigm shift in the extant mind-set underlying how a Bank/ DFI currently conducts its business.** These would encompass the areas of business strategy, organisation and human resources, corporate culture, risk and treasury management, product pricing, operating processes and MIS. In order to compete both domestically as well as internationally, domestic

financial players should immediately start putting in place (if they have not already done so) systems, procedures, knowledge inputs and responses which are of international standards. Such a sweeping attitudinal change at the operating level has to be dovetailed by enabling policy regime as well as an apposite legal and regulatory framework that is alive to the complexities of a globally-integrated environment. All of these are crucial to the establishment of a robust financial system with players who would have the ability to take on heightened competition, both from within and abroad.

Move towards Universal banking

V.2.4 The varied country experiences- in particular, those emanating from Asian and South-East Asian countries- provide compelling evidence for a progressive elimination of product-market restrictions on all financial market intermediaries (banks, financial institutions, mutual funds, insurance companies and investment banks). **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.** Developments all over the world suggest that continuance of this differentiation, in fact, reduces the efficacy of both kinds of institutions and reduces the efficiency with which the financial system performs the pooling function. **The Group therefore recommends a progressive move towards universal banking, and the development of an enabling regulatory framework for the purpose. 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.**

V.2.5 A universal banking model would allow participants the flexibility to respond rapidly to changes in the environment by developing value-propositions that span traditional product-market boundaries. The advances in financial innovation worldwide alluded to earlier suggest that there are multiple ways of offering even relatively simple products, bridging several traditional product-market boundaries, but with each variation tailored to the need of a particular client segment.

V.2.6 **However, as the German experience and that of other DFIs indicates, it does not automatically follow that only pure universal banks will emerge merely because regulation permits it. On the contrary, international experiences indicate that both types of entities, universal banks as well as specialised institutions, emerge and compete effectively with each other in the market place**. Again, following international trends, DFIs. in practice, might continue to emphasise their core competence area of term-lending even while offering a variegated menu of products and services. This would, in turn, get reflected in the nature of financial instruments conceived by them as well as in the substantive content of their resource mobilisation programme.

V.2.7 Further, in view of the developments in telecommunication technologies, paradigm shifts are taking place in the manner in which financial services are traditionally delivered. **These new methods have the potential to deliver a whole spectrum of financial services at sharply reduced costs but require the elimination of traditional boundaries before they can be effectively employed.** The economies of scale and scope that can be brought to bear with these new technologies will dramatically reduce the costs of intermediation and greatly increase the efficiency with which the pooling function is performed in the economy.

V.2.8 A universal bank can have any of these forms: a single company, a holding company with individually capitalized but fully-owned subsidiaries, a group of entities with cross-holdings, or a flagship company with subsidiaries which may or may not have independent shareholders. **Internationally, there exists, as we have seen in Chapter III, an array of corporate structures under which financial sector players undertake their activities, including activities of the universal banking type. The appropriate choice of structure should be decided internally by the management/ shareholders (and should not be imposed by the regulator) to ensure maximum efficiency in its operations**

V.2.9 It is also important to be aware that, **with the development of derivatives, even under existing regulations, it is, in any case, going to be increasingly difficult to ensure that traditional boundaries are not breached in**

practice. Partly also for this reason, decisions regarding corporate structure are best left to the discretion of management and that regulation focus instead on the development of a risk-based supervisory framework.

Consolidation and Convergence- related Issues

V.2.10 As chronicled in the preceding chapter, a striking global trend in today's financial industry - be it banking, insurance, investment or other financial services - is the accent on *consolidation* and *convergence.* Each variant, we have seen, has been a structured response to distinct pressures although they often run together in the financial marketplace: while consolidation follows a crisis, cost pressures, market saturation and growing threat of new players, global convergence initiatives have been dictated by other pressures, including demographic and political shifts. Again, the primary driver behind consolidation, for instance, has varied across countries. Nevertheless, it is fairly obvious that Indian DFIs and Banks are now faced with dilemmas that have visited some of these countries, particularly in view of the likely eventual transition to CAC and India's commitments to WTO in the financial services sector, apart from continuing reforms in the domestic financial sector. New market entrants in the shape of foreign financial institutions, with more streamlined and focused operational styles, are likely to put pressure on the current market shares of existing domestic entities in India just as market shares in the more open financial markets abroad is being usurped by new entrants from non-financial industries. Some degree of attrition in the domestic financial sector appears inevitable. There are also overbanked pockets in India, whose numbers are likely to grow with increasing disintermediation and technological advances.

V.2.11 **The prevailing view worldwide is that size, expertise and global reach are crucial to viability and future survival in the financial sector.** We have far too many banks and financial institutions of varying size and health in the economy. In **this scenario, the Group recommends that management and shareholders of Banks and DFIs should be permitted to explore and enter into gainful mergers. Such mergers - not only between Banks but also between Banks and DFIs and not only between strong and weak but viable entities but even between two (or more) strong Banks and DFIs - should be pro-actively considered.** There is an urgent

need for consolidation of the financial intermediaries in a well-planned manner so as **to achieve an improved banking structure, whose core would consist of a few strong Universal Banks at the All-India level which would gradually become international in character.**

V.2.12 The merger of DFIs and Banks in India, of course, would initially be a narrower type of convergence than we are seeing in other markets until the domestic regulatory framework acquiesces to permit insurers to cross-over into banking arena to provide "*bancassurance*" offerings. This would, in turn, depend on the Government's appetite to deregulate the insurance sector. Consolidation and convergence would serve to improve the resilience and strength of Indian DFIs and Banks to successfully face the competitive challenges ahead for India's financial industry, particularly those originating from outside her borders.

V.2.13 **However, it merits mention that any strategic initiatives towards 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.** Besides, there should be some enabling mechanism for the total clean-up of the relatively disadvantaged bank's balance-sheet preparatory to the merger process. The emphasis should preferably be on the voluntary character of the merger exercise which would preclude problems usually associated with a top-down approach.

DFIs' Development Financing role

V.2.14 The discussions in the previous chapter (**Chapter III, Sec III.1.3-III.1.4**) clearly bring out that with the withdrawal of the SLR status historically given to DFI bonds and in the absence of any other compensatory support, DFIs in India cannot unilaterally continue to assume their historically specialised role of funding long-gestative projects in capital-intensive thrust sectors like infrastructure and remain healthy, particularly given the relatively underdeveloped state of the domestic long-term

debt market. International experiences bear out that development financing activity elsewhere have largely been sustained on the strength of explicit Government support in the form of concessional finance and other support.

V.2.15 In fact, an important rationale for the observed broad-basing in DFIs' product portfolio to areas like working capital and short-term loans, apart from improved client servicing, has been the need to have a reasonable asset-liability matching. With the DFIs having to depend almost entirely on the market for resources, there has been a progressive increase in the share of short-term resources in total liabilities. **In a scenario where DFIs are leaning towards universal banking on commercial considerations, if they are expected to assume any specific developmental obligation, RBI/Govt. should provide an appropriate level of financial support to enable them to fulfil these obligations.** The support could assume the form of a line of credit/refinance. Alternatively, enabling policy and regulatory measures should be put in place to increase the supply of long-term funds to DFIs for meeting the financing requirements of infrastructure projects and other macro-economic thrust sectors. In the Group's view, these could variously assume the form of pre-emptions from the banking system (like SLR bonds in the pre-reform era), permitting a fraction of the annual corpus of long-term contractual savings institutions like Insurance, Provident and Pension Funds (both in the public and private sector) to be invested in securities (with minimum specified credit rating) floated by DFIs and providing a fillip to asset securitisation by, among other things, rationalising stamp duty incidence and modifying investment norms to permit long-term institutional investors to participate in the securitisation area. These initiatives would additionally help to impart depth and breadth to the fledgling debt market.

Re-organisation of State-level Institutions

V.2.16 The focus of all the three types of state-level institutions (SFCs, SIDCs, SSIDCs), as detailed in Chapter II, has been on financing and promotion of small and medium-scale industries in the respective states as part of a broad socio-economic agenda. **Mirroring attempts at All-India levels, there is attractive logic in eventually merging SFCs, SIDCs and SSIDCs in each state into a single entity.**

V.2.17 **While the consolidation of state-level institutions 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.** Currently, SIDCs and SSIDCs only are governed by the Companies Act while SFCs operate under the aegis of the SFCs Act. The latter has to be suitably modified to enable SFCs to metamorphose as corporate entities within a given time-frame.

V.2.18 Following restructuring/ reorganisation, 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%, thereby moving them out of the purview of State Government control. In due course, a strategic alliance/merger of some state level institutions with a strong bank having a dominant presence in the state can be contemplated.

V.2.19 The overall restructuring-cum-consolidation exercise should include, as an essential ingredient, an arms length relationship between All-India Banks and Financial Institutions and the merged state-level entities. **Consequently, it would be necessary to modify the ownership pattern of SFCs.** The major contribution towards the share capital in SFCs accrues from the State Government (63%), followed by IDBI (34%). 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 State level institutions to SIDBI.** Over time, SIDBI's equity holding in these entities should be allowed to dwindle to around 25% through divestment/IPOs. Further, SIDBI should be vested with the overall responsibility for enacting policy and procedural guidelines with regard to the operations of SFCs.

V.2.20 As a logical corollary, 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. SIDBI would thus need to be converted into an autonomous entity assigned primarily with promotional and developmental work with regard to SSIs/SMEs. **Ownership in SIDBI**

should, as a logical corollary, stand transferred to RBI /Govt. on the same lines as NABARD.

V.2.21 **SIDBI's support to 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**, primarily through NIC(LTO) funds. These have come down substantially over time and require to be restored to their original levels. Alternatively, or *pari passu,* Government of India should enable SIDBI to access low cost foreign currency borrowings from institutions like KfW, OECF, etc. by extending sovereign guarantees and assuming exchange rate fluctuations involved in such transactions.

V.2.22 **On the products side, State level FIs should be given more operational freedom**. They should be allowed to provide an array of products and services, including short term loans, equipment finance, equipment leasing etc. Similarly, with the drying up of concessional and assured funding from the Government and IDBI (including automatic refinance support), the state-level FIs would have to turn to other sources of resource mobilisation to sustain their operations. **They should therefore be allowed to raise funds from public by way of Fixed Deposits and/or bonds on the lines of All-India FIs. The leveraging capacity of State-level institutions may be defined in terms of a model debt-equity ratio.** Besides, these SLIs should target an appropriate resource mix that will ensure a reasonable asset-liability matching.

V.2.23 **A thorough revamp of the management structure and an infusion of professionalism into the operations of the SLIs is imperative for their sustainable turnaround.** These should ideally precede the reforms outlined above. The chief executives of all these institutions, who are usually serving IAS officials, are appointed by the State Government. It has been the practice with most of the State Governments to change the chief executives frequently resulting in lack of continuity at the Top Management level. **With a view to fostering professionalism and efficiency, the CEOs of the SLIs should ideally be a professional / technocrat and be appointed**

by the Board and shareholders for a fixed term to whom he should be accountable for his performance.

V.2.24 **The CEO should have the benefit of operational autonomy and should be allowed to carry on the day-to-day affairs of the corporation with the support and expert advice of a strong and capable Board of Directors elected by shareholders.** This calls for enunciation of some qualificatory guidelines with regard to nomination on their boards so that only members of stature and integrity, who also have a thorough grasp of industrial development-related issues of the State, are represented therein.

V.3 Regulatory Framework

V.3.1 The changing stance of regulatory oversight worldwide clearly brings out the need to revisit the extant regulatory framework in the domestic financial sector. For, a responsive regulatory structure is absolutely crucial to ensure that each function is performed in an optimal manner and that no particular institutional arrangement is favoured for the fulfilment of a specific function. An early sprucing up of the domestic financial system with the aid of an appropriate regulatory framework has assumed considerable urgency to avoid the pitfalls of institutions in South-East Asian countries. **The regulatory authorities, in the Group's view, would need to address the following issues**:

- **Overall Accent of Regulation:** Earlier discussions suggest that **in order to ensure that the domestic financial system becomes more robust, it may be necessary to move towards regulation that encourages free competition across traditional boundaries and focuses on *containing* the impact of failure on the financial system rather than on failure *prevention*.** These changes in the regulation of the financial system in India have become necessary despite the fact that this sector is not yet fully open to international competition because the rest of the economy is getting more and more integrated with the global economy.

⇨ **Function-specific Regulation: 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 is particularly relevant in the context of the proposed move towards universal banking. When two players in the financial market-place (say, a Bank and a FI) offer identical services, they must be subject to identical regulatory treatment in much the same way as a company operating in diverse fields is subject in each of these to the regulations applicable to that particular industry. **Again, regulations for different intermediaries in the same business - local or foreign - must be identical**. This would necessitate a shift in mind-set from a "silo" approach to industry regulation to one that recognises the impact of industry convergence and consolidation.

⇨ **Equalisation of 'net' Regulatory Burden**: In general, when formulating regulation, attention should be paid not only to the benefits of regulation but also to the cost of regulation, the difference between the costs and benefits being termed as the *net regulatory burden*. **It must be ensured that no intermediary (such as a bank, financial institution, mutual fund or insurance company) is 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 debilitating consequences of an asymmetric approach on US banking system is a pointer in this regard. **The net regulatory burden on each intermediary must be determined solely by systemic efficiency and risk management concerns and, where necessary, the equalisation of the net regulatory burden must be through a reduction of the burden on the over-regulated entity, and not through an increase in burden on an adequately regulated entity.** An attempt to equalise net regulatory burden through any other means will seriously impair system efficiency. Comparison of net regulatory burden must be carried out not only between domestic institutions but also with all the potential international participants in the domestic financial system. **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.

- **Adopting International Best Practices on Banking Regulation:** The increasing sophistication of users and suppliers of capital in India as well as the need to protect market reputation in a tightly competitive marketplace are likely to impact the domestic regulatory charter. **It might be useful to refer to the guidelines issued by BIS and its various Working Committees towards creating more consistency and transparency in international bank supervision.** Some references have been made in this connection, among others, to Basle Core Principles for Effective Banking Supervision released in September 1997, in Chapter III.
- **Multiple Regulators for Financial Conglomerates:** In view of the increasing overlap in functions being performed by various participants in the financial system, it would be desirable in the Indian context to have a measure of coordination among regulators. This would mitigate the potential downside risks arising from inadequate co-ordination between the multiple regulators. As the discussion on the concept of net regulatory burden suggests, where regulators are different or multiple entities, unless there is a compatibility in regulation (for example between mutual funds, insurance companies and banks and financial institutions), there is a possibility that business may move from an entity subject, for example, to stringent capital adequacy requirements (such as banks and financial institutions) to one subject to limited or no capital adequacy requirements (such as an insurance company or mutual fund) even though both sets of entities may be lending to the same company or project. Convergence in regulation assumes importance also insofaras it is very likely that the future competitors to Indian entities will be international banks and financial institutions. If the latter are able to benefit from economies of scale and scope, they could very well begin to substitute Indian entities in the provision of even domestic financial services. The federal agencies in USA- a country which, as we have seen, also possesses a multiple-regulatory structure- have sought to improve co-ordination *inter se* by operating under a joint policy statement since

June 1993. As a variant of this approach, **the Group recommends the establishment of a *super-regulator* (or regulator of regulators) to supervise and co-ordinate the activities of the multiple regulators in order to ensure uniformity in regulatory treatment.**

⇨ **Deposit Insurance:** Faced with a diversity of corporate structures, particularly in a scenario of universal banking, regulator concerns could possibly arise about excessive risk taking behaviour of these intermediaries. One argument proffered is that these universal banks, being too big to be allowed to fail, officers in these banks might succumb to the temptations of taking excessive risks. Regulators, recognising this threat, may either attempt to regulate the universal bank very tightly, thus hindering economic efficiency, or be faced with the possibility of a taxpayer bailout. One possible adverse fallout apprehended is *'technical insolvency'* which occurs whenever the internal capital or equity of the intermediary's owners are found inadequate to meet incurred losses. **The Group is of the view that such concerns could be more effectively dealt with, not by restricting the size or scope of the intermediaries, but by allowing greater diversification across product lines, imposition of higher capital adequacy stipulations (measured by market-value accounting and reporting rather than book value) to provide a wider margin of safety against instability, discretionary intervention by regulators should capital decrease below a declared floor level and explicit rules forcing universal banks to replace lost capital (through liquidation, sale or merger) before their market (rather than book) capital falls below zero.** Such a proposal has been largely incorporated into the Federal Deposit Insurance Corporation Improvement Act of 1991 in the United States. This would reduce the required level of Government monitoring of banks and eliminate legal and regulatory constraints on other banking activities.

⇨ Indeed, **given the all-or-nothing payoff features of the deposit contract in the banking system, deposit insurance is used as a major liquidity risk insulation device in many countries to ease the liquidity problems of banks and to deter bank panic and overruns.** This device guarantees the nominal

value and liquidity of deposits up to a certain size and thus helps to establish confidence in the safety of savings with financial intermediaries. The insurer is an institution, generally government-owned, established for that purpose and funded with premia paid by the institutions whose deposits are insured. Most industrialised countries have some form of deposit insurance, with a few exceptions. While participation in deposit insurance arrangements is generally voluntary, competitive forces make it difficult not to participate. For example, in the USA, federally backed insurance programmes include the Federal Deposit Insurance Corporation (or FDIC) for banks and thrifts, the Securities Investors Protection Corporation (or SIPC) - for securities firms and the Pension Benefit Guarantee Corporation (or PBGC) for private pension funds. It has been pointed out by some academic researchers that deposit insurance can lead to a major moral hazard problem as it encourages banks to borrow at rates close to the risk-free rate and on-lend an increasing proportion of credit to risky borrowers. In the case of universal banks, their diversified portfolios of activities exposes them to more risk than mere credit disbursement, which is further enhanced with the moral hazard brought about by deposit insurance. This possibly explains why in Australia, the Central Bank has the authority to take over a troubled institution, and there is no formal deposit insurance scheme. The government of New Zealand too has expressly prohibited deposit insurance on the grounds that it would interfere with the existing high standards of performance and safety. One option to minimise the moral hazard in universal banks is to limit deposit insurance to deposits of universal banks that accrue by way of traditional banking activities, and restrict the use of insured deposits to short-term credit disbursement and investment in Government and other highly rated securities. However, it is possible that such fine separation between bank and non-bank activities of universal banks might not be practicable. In this case, there is need for more vigilant regulatory oversight to ensure that the "fire-walls" remain effective. Overall, regulators should ideally design deposit insurance contracts with the trade-off between moral hazard risk and bank panic/run risk in mind.

V.4 Legal Framework

V.4.1 There is a broad cross-section of informed opinion which insists that, **for the success of the suggested/adopted mix of systems, structures, policies and practices to achieve the desired objectives, a supportive legal framework early into the restructuring process is a *sine qua non*.** There is a need to review the entire legislative framework for this purpose. **The Group feels 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 DFIs should be given top priority.**

V.4.2 **The adverse impact of the poor legal framework is most acutely felt in the matter of debt recovery of Indian banks and financial institutions. In fact, one of the major contributory factors towards a build-up in NPAs is considerable difficulties in recoveries of loans and enforcement of security charged to them.** This has resulted in a significant portion of funds of Banks and DFIs remain blocked in unproductive assets, the value of which deteriorates over time. The existing legal system is stacked against banks and in favour of distressed clients. The load of such a high level of NPAs cannot be borne by Banks when the financial system is opened up to forces of international competition. The setting up of an 'Asset Reconstruction Fund' to take bad and doubtful assets off balance sheets of Banks and FIs and subsequently following up on the recovery of dues owed to them by primary borrowers can provide, at best, a partial solution. **But, at a fundamental level, the only lasting solution to the problem of NPAs is an early implementation of legal reforms that expedite loan recoveries and provide legal backing for enforcement of bank securities/mortgages charged thereon. Suitable modifications in Bankruptcy Laws would play a facilitatory role in this regard.**

V.4.3 The Committee on the Financial System (1991) endorsed the 1981 findings of the Tiwari Committee for setting up special tribunals for expediting the recovery of debts from Banks and FIs. The Govt. of India accordingly promulgated an ordinance for the purpose on June 24, 1993 which was replaced by an Act of Parliament, namely ***Recovery of Debts from Banks and Financial Institutions Act,***

1993 (hereinafter ***"RDBFI Act" or "the Act")*** on August 27, 1993. A beginning has thus been made with the enactment of the Act. For example, the Act has, by suggesting a six-month time limit for disposal of every application for recovery of debt, at least recognised the time value of money.

V.4.4 However It took 8 months for the establishment of the first Debt Recovery Tribunal at Calcutta on April 27, 1994 followed by 7 others at Delhi, Jaipur, Bangalore, Ahmedabad, Chennai, Guwahati and Patna respectively. The Debt Recovery Appellate Tribunal at Mumbai was established on July 12, 1994.

V.4.5 It is over four years since the aforesaid Act came into force and there is widespread concern that the Debt Recovery Tribunals (DRT) set up under the Act is not an effective forum in its present form. In view of its perceived shortcomings, **the following reforms in the 1993 Act and associated areas could be considered for an early implementation.**

- The attainment of the principal objective of the Act, namely, the expeditious adjudication and recovery of debts of Banks and DFIs, has been hampered by the extremely inadequate number of DRTs established for the purpose. **There is an urgent need to establish at least one Tribunal in each state capital to ease the pressure on DRTs catering to the needs of more than one state.** The DRTs should also be located in the Central Business Districts of the city where they are established.
- It has been difficult for the DRTs to dispose of each application within the suggested six months due to their poor location, lack of appropriate staffing, the virtual absence of a modem office infrastructure that would have endowed them with the benefits of information technology, and stays obtained by some of the defendants from courts under one pretext or the other. **The Tribunals have to become fully functional at the earliest, with sufficient infrastructure and adequate legislative powers for effective and speedy implementation of its orders.**
- **The Act has to be amended to provide for the establishment of a Fund, independently administered, with subscriptions from the Government for**

the purpose of meeting the capital and operating expenditures of DRTs. The initial corpus would be used for funding the capital expenditure of DRTs such as the purchase of land and creation of the modern office infrastructure that would substantially contribute towards improving the efficiency of their operations. There is a need to explore ways and means of sourcing funds on a regular basis for meeting operating expenses while the Court Fees could cater to the salaries of the DRT personnel. Interest on unused funds of the corpus established as aforesaid could also be gainfully used for meeting day-to-day expenses of DRTs. Currently, such funds are not available for the setting up and running of the DRTs and this shortcoming has to be expeditiously redressed.

- The scope of the Act should be enhanced to cover all loans.
- Further, the law of limitations should be suitably amended enabling banks in the recovery process to do away with the need to periodically renew documents.
- A major objection from the lawyers' lobby opposing the DRT is the fact that the **Presiding Officer** of a DRT need only have the eligibility criteria of a District Judge. This is considered inadequate, considering the volume and complexity of cases that DRTs are required to handle. **It would therefore be desirable to draft High Court judges as Presiding Officers or at least appoint those who fulfil the eligibility criteria of High Court judges. For Recovery Officers, the recruitment of successful candidates in the All India Judicial Services could be considered.** The administrative machinery needs to be strengthened so that powers vested in the Recovery Officer are efficiently discharged.
- The 1993 Act **(under Section 25)** provides for, amongst other options, the appointment of a Receiver by the Recovery Officer for the management of the moveable and immovable properties. It appears that the right to appoint such Receiver is available to the Recovery Officer ***only after issue of the recovery certificate*** by the Presiding Officer. **Since the need for a Receiver could well be felt even immediately after filing of the application, it is necessary to remove the ambiguity contained in Section 19 (6) by adding a new sentence at the end of Clause 19 (6) : " Such interim orders may also include the appointment of a Receiver and directions to the Defendant for**

payment of royalty on such terms and conditions as the Presiding Officer may deem fit." It would also be desirable to specify in the DRT Rules the scope and functions of the Receiver appointed under the suggested amendment in Section 19 (6) and under Section 25 (c) of the Act.

- Given the unpredictable outcome of cases which have been the subject of the conflicting stands taken by certain High Courts, it would be worthwhile to consider the introduction of an amendment to the Act which specifically states that it would not be necessary for the Company Courts under any of the provisions of the Companies Act to issue any orders to Banks or FIs regarding leave under Section 446 or under any other analogous provisions or to decide any matter in relation to Banks or FIs that is properly within the purview of DRT by virtue of the operation of Section 17 and 18 of the Act.
- Industrial Development Corporations (IDCs), Multilateral Agencies and Foreign Banks not having business establishments in India have not been covered under the Act. **As the above institutions/banks grant financial assistance to borrower concerns in consortium finance or otherwise, it is suggested that the same may be notified as Financial Institutions under Section 2(h) of the Act.**
- Creditors other than the Banks and Financial Institutions covered by the Act are not entitled to recover their dues through the Tribunals. This results in multiplicity of legal proceedings to which Banks and FIs are also made parties. **It is, therefore, desirable that a Tribunal may be empowered to (a) have all such pending suits/proceedings transferred to itself and (b) entertain the claims of such creditors against the borrower.**

V.4.6 **In addition, there is a need to redraft other codified laws impacting operations of DFIs/Banks, enacted earlier, which have either become redundant or are somewhat incompatible with the emerging requirements. This is essential to ensure that legal environment moves in tandem with the emerging needs of the financial sector.** Some of the enabling improvements suggested pertain to the following areas:

- **General Insurance:** Although the *'indemnity business'*, as mentioned in Sec 6(e) of the Banking Regulation Act Sub-Section (2) *may* cover the business of general insurance, **a notification would nevertheless be helpful to remove any ambiguity with regard to undertaking the business of insurance covering life and general insurance by Banks in future.**
- **Publishing the defaulter's name**: With a view to regulate multiple financing, DFIs/Banks may be permitted to publish the names of the defaulters. This will also motivate the borrowers to adjust their dues to avoid adverse publicity.
- **Acquisition of hypothecated goods**: Banks/DFIs' powers to acquire and dispose of hypothecated goods have been disputed by the decision of various High Courts. Suitable amendments may be made in the Contract Act to enable them to overcome the above difficulty.
- **Disproving the claim of Banks/DFIs**: In spite of acknowledging balances outstanding as on various dates, at times, some borrowers contest the genuineness of the documents, calculation of interest, etc. and prolong litigation. In these cases, Banks/DFIs may be supported by the necessary legislative backing (as is available to Income-Tax Department under I-T Act) to make borrowers pay 50% or more of the disputed amount as penalty. Besides, the onus of disproving the genuineness of the Bank's claim must lie with the borrower.
- **RR Act provision**: The Revenue Recovery Act, which is now available to all co-operative banks, may be made available to all Banks/DFIs to fall back upon in the case of default.
- **Stamp Duty Laws of Various States and Creation of Securities**: Multiple Stamp duties by various State Governments and very high rates of stamp duties are creating many impediments in obtaining securities for Bank/DFI loans. Simple stipulations of second charge on fixed assets involve complicated procedures which take a long time to comply with and, in most cases, remain uncomplied. When it comes to enforcement of securities, there are multiple claims of revenue on the properties and secured debts having priority are difficult to realise fora number of years. A comprehensive law to take care of all such difficulties in creating and enforcing securities has assumed urgency.

⇒ **Securitisation of debt,** which would impart the required stability to the debt market, has not taken off so far in a meaningful measure. The choice of instruments too has been limited with most of it being in auto and truck receivable. **A major impediment both to the development of asset securitisation as well as an active secondary market in corporate debt is the heavy stamp duty incidence at both ownership and turnover stages.** These in turn vary widely across states. This requires an urgent corrective in the form of a unified (across states) stamp duty imposition at reasonable levels on primary issuance of debt instruments and its complete elimination on secondary trading. This would reduce transaction costs considerably and give a fillip to both corporate debt and securitised volumes. Some states have already made a beginning: in Maharashtra, stamp duty rates have come down from a range of 3-8%, depending on the asset, to a uniform 0.1%. Both Karnataka and Tamil Nadu have followed suit.

The removal of stamp duty is feasible on two counts: first, the revenue collection from these instruments has been quite modest so far; thus revenue loss from its abolition would be minimal. More importantly, trading in the secondary market is dominated by Government securities and PSU bonds, both of which are exempt from stamp duty at the time of transfer.

Besides, there is a need to effect legislative changes in investment norms of long-term institutional investors that currently prohibit participation in the securitisation area.

Further, as suggested by the Rakesh Mohan Committee, the legal framework for securitisation of loans would have to be simplified to make it cheaper and easier. In particular, the creation of Debenture Redemption Reserve(DRR) in long-gestative infrastructure projects over and above the usual depreciation provisions would cut into the company's dividend payouts. **Thus, if equity and debt are to be attracted to infrastructure projects, the current provisions relating to DRR would need to be discontinued.**

V.4.7 **Computerisation of branches have become a necessity for providing effective banking services to customers and to be globally competitive. In order to provide legal sanction to such activities, a proper enactment on the lines of**

Electronic Fund Transfer Act in U.S.A is warranted. In this context, necessary amendments in the Banking Companies (period of Preservation of Records) Rules, 1985 may be examined for implementation.

V.4.8 An amendment has already been proposed by Government in the Bankers Books of Evidence Act to the effect that **the printout of any entry in the books of a bank on microfilm, magnetic tape or any other form of mechanical or electronic data retrieval mechanism obtained by a mechanical or other processes be included in the definition of the 'Bankers Books'.** The Working Group also avers on this score and argues in favour of its inclusion as evidence in a Court of Law.

V.4.9 Besides, as of today, Banks are entering into some sort of agreements with their recognised trade unions for going in for computerisation in specific branches. This has already caused avoidable problems to the Banks in continuing/expanding the work of computerisation to the branches other than what has been agreed to. There is need for educating employees on the crucial importance of IT and computers in the new globalised Banking era so that unions/associations can play a constructive role in charting the computerisation agenda in Banks.

V.5 Supervisory Practices

V.5.1 An essential concomitant of a successful adaptation to a globally integrated financial system and apposite market regulation with reporting transparency is the evolution of compatible supervisory practices. In the Group's view, the latter should include the following:

- **Off-site Supervision: 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. Bank of England, among others, advocates this blend of supervision. **The emphasis of the supervisory system should be more on the**

macro-management of the supervised entity than on micro-level regulation at the individual transaction/account level.

- **Consolidated Supervision: 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.
- **Global Consolidated Supervision**: Further, keeping in view the likely movement towards Universal Banking and globalisation of operations, **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.
- 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 provides a preliminary private sector perspective on financial supervision in a global market. The Report addresses growing concerns among international financial regulators in the banking, insurance and securities markets as well as international financial policy-makers that financial market globalisation and conglomerate corporate structure may increase systemic risk. **It essentially 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 risks being assumed by the firms rather than their corporate structures and functions being performed**. [*A commentary on the risk-based supervisory*

framework is provided in Appendix 3]. The Basle Core Principles too touches upon global consolidated supervision aspects.

- In India, while access to these technologies exists even today, for a variety of reasons, the implementation of a purely risk based supervisory framework may take some time. Therefore, in the first phase, boundaries only between very similar intermediaries (such as banks and financial institutions) could be removed. A full integration across the entire financial services industry may have to await the full adoption of these technologies by all the key participants.

Regulatory-cum-supervisory framework for State-level Institutions

V.5.2 The overall restructuring-cum-consolidation exercise of State-level institutions on the organisational, operational and ownership side has been touched upon earlier in this chapter (**Sections V.2.16 - V.2.21**). These have some important implications for their supervisory framework.

V.5.3 **Supervision and monitoring of State level institutions (SLIs) should be brought under the supervisory ambit of RBI, which at present monitors Banks, Financial Institutions as well as NBFCs.** RBI's supervisory role with regard to these SLIs would be similar to that of other Financial Institutions and include, among other things, prudential guidelines with regard to capital adequacy, income recognition etc.

V.6 Statutory Obligations

V.6.1 The eventual transformation of DFIs into full-service universal banking entities would require, from a regulatory perspective, grant of a full commercial banking licence to the DFIs. The reformed regulatory framework should be flexible enough to enable DFIs to undertake the commercial banking activities, either through specialised subsidiaries or as divisions within the parent organisation. **Under current regulation, each financial institution would therefore be automatically subject to all the obligations under the Banking Regulation Act and, in particular, to: (a) the Cash Reserve Ratio, (b) the Statutory Liquidity Ratio (c) obligations relating to priority sector lending and other pre-emptions of resources (e.g. food advances) and (d) Rural Branches.**

V.6.2 However, preparatory to any concerted move towards full-service universal banking, it may be useful to examine the relevance of these obligations, from a systemic efficiency point of view, even for existing entities. In the context of DFIs, this re-examination becomes even more important because, as the German experience indicates, merely the granting of a full banking license does not automatically imply that all the institutions will immediately (or even eventually) begin to offer the full range of products and services currently offered by commercial banks in India. Imposition of the burden of these three requirements, before a full re-examination, will therefore serve to reduce the efficiency with which even the existing functions of DFIs are being performed. Nevertheless, care needs to be taken to ensure that the group of entities on which the additional burden continues to be imposed are not disadvantaged in an overall sense relative to other entities in the system. In the following paragraphs, each of these obligations is briefly discussed and some conclusions have been arrived at regarding their applicability and relevance.

(a) Cash Reserve Ratio (CRR)

V.6.3 Despite serial reduction in the initial phase of reforms, CRR/SLR in India is still very high. Besides, there will be intense pressure on margins with increased competition, both domestic and global. **CRR/ SLR should therefore be progressively brought down within a declared time-frame to international levels.**

V.6.4 In any case, the slant of monetary policy in recent times has been towards a gradual de-emphasis of reserve requirements as an active instrument of policy. There has been a growing reliance on Open Market Operations and interest rate signals (through resurrection of Bank Rate) for liquidity management in the system. Such a rationalisation would be in the interests of the banking system and would in no way inhibit the Banks' capacity to finance preferred sectors.

V.6.5 **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 a CRR should be confined to cash and cash-like instruments (such as demand deposits and deposits with no minimum lock-in periods). This is also consistent with the international experience in this regard.** Specifically, it would be necessary to change the definition of the base on which CRR is applicable to

include only such instruments. The Group favours a measure of compatibility between this definition and the one being adopted for M3 by a RBI Working Group set up recently. It would also be necessary to ensure that Banks and Financial Institutions are given equal opportunity to raise resources through instruments which are exempt from CRR so that there is no discrimination between the two on this account.

(b) Statutory Liquidity Ratio (SLR)

V.6.6 **Similarly, the shift in accent of monetary policy also dictates that it may be advisable to phase out SLR requirements.** The assertion by the Committee on Financial System (1991) that "the SLR instrument ... should not be viewed as a major instrument for financing the public sector" also merits consideration. This is particularly relevant in the context of market-determined interest rates and zero risk-weights now applicable to Government Securities that make them good investment avenues for Banks/DFIs. In fact, the existence of SLR may also inadvertently inhibit the degree of trading in these securities and consequently impedes the development of a liquid yield curve. Besides, the era in which SLR was initiated has given way to a regulatory environment characterised by stringent asset classification guidelines, capital adequacy and provisioning norms. These guidelines more than adequately ensure that the financial intermediary will have adequate liquidity to service its fixed-time liabilities. The prudential need for SLR would have, to that extent, declined.

V.6.7 **Cross-country experiences in this regard are mixed**. Currently, industrial countries have, for the most part, eliminated the use of liquid asset requirements for monetary and debt-management purposes and only Austria and Iceland use it mainly for prudential purposes. In some countries, such as Ireland and the Netherlands, supervisors enjoy a certain discretion to modulate liquidity requirements according to circumstances and the risks experienced by individual banks. **However, other industrial countries, (Canada, Italy, New Zealand, Spain, and United States) do not use liquid asset requirements at all for prudential purposes.** On the other hand, developing countries and economies in transition are still using them.

V.6.8 Nevertheless, the general trend has been to reform this instrument with a view to improving banks' liquidity management. This reform has included lowering liquid asset ratios to the minimum level required to manage cash flows and facilitate interbank settlements, allowing for leveraging of liquid asset balances and including among the list of eligible assets those that can be realized in a relatively short time without significant loss of principal. The reforms announced recently by Reserve Bank Of Australia(RBA) is a case in point. Effective April 24,1998, it has eliminated the use of Prime Asset Requirement (PAR) and replaced it with new prudential guidelines. Under the new framework, the RBA would put in place bank-specific liquidity policies to formalise how a particular Bank plans to manage its liquidity under different circumstances. For this purpose, each Bank has a range of strategies for liquidity management to choose from, including setting limits on maturity mismatches, holding liquid assets, diversifying liability sources and developing asset sales strategies. The RBA, by doing away with a formal PAR, has sought to convey that it is no longer appropriate (in Australia) to mandate a *common ratio* or *minimum holdings* of liquid assets for all banks. **However, the extinguishing of SLR should be a gradual affair in line with international trends to avoid the disruptive effects of a Big-Bang approach.**

(c) Priority sector Lending

V.6.9 At a fundamental level, there is attractive logic for a gradual but complete phaseout of priority sector lending, preferably through a declared time-table. In fact, in 1991, the Committee on the Financial System had expressed similar sentiments. The possible redistributive objective underlying directed credit to particular sectors, it stressed, should be addressed through fiscal measures such as tax incentives rather than through the credit system. This process of phasing out however recognises the need for a measure of special directed credit support in the interim.

V.6.10 At a fundamental level, 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.

V.6.11 **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) The Committee on the Financial System in 1991 itself had suggested a redefined priority sector to which directed lending (at non-concessional rates) should be given. There is a need to broad-base the definitional ambit of this sector further to reflect newer macro-concerns. **In particular, 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.

VI. HARMONISING THE ROLE, OPERATIONS AND REGULATORY FRAMEWORK FOR BANKS AND DFIs

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VI.1 Rationale

VI.1.1 Both Banks and DFIs have carved out niche areas for themselves in financing industrial development. While Banks have acquired expertise in working capital financing, DFIs have built up skills for appraising projects for meeting long-term funding requirements. With the ongoing deregulation of the financial system, several new players, including banks, have entered the project financing business which involves a greater degree of risk as compared to short term working capital finance. DFIs have also been increasingly entering working capital financing to widen product range, lower overall risk profile and also act as a conduit for Asset-Liability Management (ALM). Banks, on the other hand, by entering long-term financing, would broaden their product range, reduce risk concentration at the shorter end of the maturity spectrum as well as supplement DFIs in meeting the large funding needs for long-term capital. Thus, there is a measure of complementarity in the role envisaged for DFIs and Banks in funding working capital and project finance, with each supplementing the others' efforts. This synergising of efforts is of particular importance in an economy like India with large development funding needs, particularly in the infrastructure sector.

VI.1.2 The profile of asset creation of Banks and DFIs should be motivated by prudential requirements and ALM considerations. On the funding side, Banks, with their large branch network, have the means to mobilise retail savings. These funds are, however, of short term nature necessitating maintenance of high liquidity. DFIs, on the other hand, are at the cross-roads with conventional sources of long term finance (from Government/RBI) having dried up and with market borrowings now becoming the only source of funding. Since the long term debt market is yet to develop, the maturity profile of DFI borrowings is reducing. With a view to manage maturity and interest rate risks, DFIs have started providing working capital finance which also helps in diversifying risks. Having regard to the need for large amount of funding, both Banks and Institutions (and/or their subsidiaries) could play a role in working capital finance and

long term funding with different levels of emphasis on each segment. The degree of their involvement in the two broad financing segments would depend upon:

a) the need for prudent asset-liability management and, more specifically, liquidity and interest rate risk management;
b) exploiting key strengths built up over the years;
c) gearing up for increased competition, and more specifically from international players, with step-up in deregulation measures; and
d) diversification of business risk through widening of range of products and services.

VI.1.3 Since introduction of universal banking is likely to take some time, the entire aspect of harmonisation of roles of Banks and DFIs is being revisited on the premise that the basic functional differences would remain, at least for the present. Consequently, **the recommendations in this chapter are of an interim nature and must be viewed as such.**

VI.1.4 Considerable amount of overlap between the current businesses of Banks and DFIs necessitates close co-ordination and harmonisation of their lending policies as well as procedural aspects. The objective of harmonisation is not to impede competition but to ensure that appropriate quantum of credit is made available to industry at 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 credit administration. This will help better monitoring of the jointly assisted units leading to improvement of the overall health of portfolio of Banks and DFIs.

VI.1.5 At present, there is no formal forum for interaction between DFIs and Banks despite the emerging overlap in their functional areas. **In order to achieve close co-ordination and harmonisation between them on various issues of mutual interest, it would be useful to set up a Standing (Co-ordination) Committee at the level of Chiefs of Banks and DFIs.** It may set up such other sub-committees as may be considered necessary by it to address specific areas of concern.

VI.2 Regulatory and Funding-related aspects

VI.2.1 RBI has stipulated an uniform SLR of 25% (which is the minimum stipulated under Section 24 of the Banking Regulation Act, 1949) on the entire net demand and time liabilities of banks. These reserve requirements are intended for prudential reasons in view of the liability profile of banks under which about 16% of aggregate deposits are in the form of demand deposits eligible for withdrawal without any notice from the depositor (Source : RBI's Report on Trend and Progress of Banking in India, 1996-97). In practice, depositors can also resort to premature withdrawal of term deposits by payment of pre-announced penalty. DFIs funding sources have in the past been predominantly long term in nature with predetermined maturity dates. Further, DFIs do not have access to demand like deposits. Having regard to this funding profile, DFIs are not subject to SLR requirements.

VI.2.2 DFIs have, during the past few years, been given limited access to short term sources like Fixed Deposits (FDs), Certificates of Deposits (CDs) and Term Money Bonds (TMBs). Various restrictions have been placed on such borrowings. The overall ceiling for DFIs mobilisation of resources by FDs (maturities of 1 - 5 years), CDs (maturities of 1 - 3 years) and TMBs (maturities of 3 - 6 months) has been fixed at 100% of Net Owned Funds (NOF) of DFIs. Some DFIs have also been permitted to raise inter-corporate deposits within the above ceiling. DFIs are not permitted to raise deposits from the public with maturity less than one year. Further, interest rate on deposits of DFIs is capped at interest rates offered by SBI for similar maturities. There is also a restriction relating to minimum size of deposit (currently Rs. 10,000) and lock-in period of 2 years has been stipulated. All the above restrictions on DFI borrowings in terms of choice of instruments, maturity, interest rate and ceiling on short term funding have introduced significant financial repression and have eventually contributed towards increased cost of loans to clients.

VI.2.3 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 bps over the yield on Government of India securities of equal residual maturity would require its prior approval. The Group feels that such restrictions are counter to the spirit of financial sector liberalisation and should therefore be withdrawn.

VI.2.4 The equating of net regulatory burden on various players in the financial system needs to be brought about through a reduction of the burden on the over-regulated entity and not through an increase of the burden on an adequately regulated entity. In the present context, however, with banks being required to maintain an SLR level of 25% (which is the minimum level to be maintained under the BR Act), DFIs would, for the present, need to be subject to SLR requirements on short term funds raised by them. The Group felt that the following factors would need to be taken into account while addressing the issue of imposition of SLR on DFIs :

i) DFIs do not have access to cheap funds through savings and current accounts. The level of SLR to be stipulated would need to be viewed on the basis of impact of imposition of SLR on increase in cost of DFIs' funding. The increased cost would translate into higher pricing on loans to clients.
ii) Currently, DFIs neither have extensive branch network for mobilisation of retail deposits nor offer normal banking services to clients. The retail deposits which they could possibly mobilise are likely to be a small fraction of total incremental deposits.
iii) While SLR of 25% has been levied on banks, the other major players in the financial system, viz., NBFCs are required to maintain an SLR of 15%.
iv) DFIs existing deposits have been raised under extant restrictions and hence SLR should be levied on incremental outstanding deposits.
v) Banks would continue to have sole access to deposits of less than one year.

VI.2.5 Considering the above, 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) subject to removal of :

i) extant overall ceiling on DFIs mobilisation of resources by way of FDs, CDs, TMBs and inter-corporate deposits;
ii) maturity ceiling of five years on deposits from the public;
iii) cap on interest rates on deposits of DFIs; and
iv) minimum size of deposits which may be accepted by DFIs.

Further the current restrictions with regard to premature withdrawal of FDs not being permitted for two years may be reduced to one year. (In line with

suggested policy directions with regard to SLR as stated in **Chapter V Sec.6.6** the Group recommends that SLR for banks should be gradually phased out).

VI.2.6 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. Further, as detailed in **Chapter V (Sec V. 6.3)**, CRR should be progressively reduced to international standards.

VI.2.7 The Group felt that there was 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**.

VI.2.8 Investment made by Banks in bonds of DFIs has been given risk weightage of 100%. **In line with Inter-Bank deposits, a uniform risk weightage of 20% may be assigned for investments made by commercial banks in bonds of 'AAA' rated DFIs**.

VI.2.9 While calculating exposure to a DFI, investments made in SLR securities (where repayment is guaranteed by Government) issued by that DFI is also included. **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.**

VI.2.10 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. The licence would enable DFIs to borrow, lend and guarantee foreign currency funds freely in the international and domestic markets on par with banks, offer risk management products to eligible corporate entities including public sector undertakings (PSUs) and FIIs (interest rate swaps, cross currency swaps, credit derivatives, FRAs, options, etc.), trading in currencies and forwards, FC payments/receipts to/from other FIs, FIIs, PSUs and corporates which have not**

been assisted, and invest foreign currency funds in markets abroad. This would help DFIs to manage their FC funds efficiently, offer better rates to clients and add liquidity and depth to foreign exchange markets.

VII. ORGANISATIONAL REDESIGN

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VII.1 Introduction

VII.1.1 The imperatives flowing from continuing internal liberalisation and further external openness under CAC charter and WTO commitments for an essentially service-driven financial sector go 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 systems, human resource policies, risk management practices, application of Information Technology and MIS.

VII.1.2 **The second phase of financial sector reforms would therefore need to, among other things, address issues connected with improving the organisational effectiveness of Banks and DFIs through imaginative corporate planning and organisational restructuring.** Although the initiatives for organisational redesign would have to come from individual financial entities, based on their specific requirements and targeted positioning in the marketplace, either generated in-house or through external experts, some of the important aspects need to be highlighted.

VII.1.3 The imperatives for Banks/ DFIs successfully competing in the post - CAC/ WTO operating as indicated in an earlier Chapter, environment call for a complete overhaul of the extant mindset underlying how they do business. These would translate into a complete redesign of the business system, encompassing the areas of **business strategy** (more products, different customers, new geographies, focus on returns with volumes), **organisation** (human resources development, active asset-liability and risk management, new functions), **corporate culture** (from reactive to pro-active, emphasis on relationship rather than transaction-based approach, service orientation) and **operating processes** (active tracking of key performance indicators, operating manuals, credit delegation supported by strong monitoring, enabling Information Technology and MIS).

VII.2 Key Components of Organisational Reforms

VII.2.1 The detailed design of the organisation structure in the deregulated, commercial environment should target increased market competitiveness and organisational effectiveness by developing a specialist, skill-intensive organisation, shifting to a customer focus through enhanced marketing and selling skills and establishing a professional, service oriented culture.

VII.2.2 **These objectives lead to a series of recommendations on the key components of such organisational reforms as listed hereunder**:

- If an organisation seeks to bring about a drastic change in the way it functions and has a large staff to deal with, spread over a wide geographical area, **spelling out a new Corporate Mission and Vision Statement, encompassing the strategic intent, becomes extremely useful**. This, in turn, would be a function of *individual institutional capabilities that they can leverage* (e.g., product skills, customer management expertise, transaction processing), *the degree of market competitiveness* (based on strategic extent of competition and likely new entrants) and the *complementary regulatory framework* (current barriers, the ability to respond fast and to predict regulatory change as well as the capability to drive such changes).
- **Strategic objectives for principal stakeholders (clients, employees, shareholders etc.) would typically include both financial and non-financial parameters**. In fixing the financial parameters, some sort of benchmarking would be necessary as a sort of reference base as also for outlining some other measures relating to systems, structure etc. Strategic objectives for *clients* could be parameters like client satisfaction index, client prioritisation and profitability. With regard to *employees*, productivity (as measured by business/profit per employee), encouraging staff involvement and enhancing staff skills across the organisation would be desirable objectives. For *shareholders,* these would essentially be enhancement in shareholder value as captured through parameters such as return on net worth and EPS. These strategic objectives would need to be translated into performance plans, both long-term and short-term.

- Once the strategic objectives have been formulated and accepted by the Boards and Top Management and communicated to principal stakeholders, suitable structures would need to be put in place within the organisation for achieving these corporate goals. While there are no standard solutions, some general principles can be cited. The structure would normally have to provide for **a lean corporate office**, focussing more on broad policy and objectives, relating to key constituencies and engaging itself in broad monitoring function. The line offices/functions should be properly integrated with proper support systems and clear reporting/control mechanisms.

- **For operating units to function effectively in deregulated and competitive markets, decentralised decision-making with meaningful delegation of powers has to be encouraged**, albeit within broad policy parameters. The organisational structure of Banks/DFIs will have to provide for units within themselves (such as Strategic Business Units or SBUs) which are given specific tasks of assessing competition and ensuring that competitive strategies and other appropriate mechanisms to compete effectively in the marketplace are put in place.
- The delegation of powers should go hand-in-hand with accountability. These SBUs (e.g., a Branch or Zonal Office) would operate as a Bank within a Bank, enjoying the benefits of the organisation's total capital and yet having the operational flexibility required in the market place. **This is akin to the concept of profit centres within the organisation,** with capital allocated to the profit centres. Each profit centre should earn profits over the cost of the capital allocated through a transfer pricing mechanism. This will also aid performance evaluation and make it more meaningful and objective. The SBU will have its own delivery system and other selling arrangements. There would, of course, have to be appropriate linkages between various SBUs in the organisation so as to drive synergies and avoid operating at cross-purposes. Further, the SBU will have to provide feed-back to the corporate office for policy formulation. A more participative management than a hierarchy conscious one would be preferable.

- **Quick decision making, for which decentralisation and delegation are enabling modes, can be facilitated by moving rapidly towards technology-driven operating systems**. There have been mind-boggling advances in banking technology worldwide with Information Technologists looking to the financial sector for inspiration to develop new products and packages. This will have to be assimilated in the Indian financial sector as an essential pre-condition for successful positioning in the globally integrated scenario. One such key area is electronic banking, where it is estimated that the level of banks worldwide offering this facility would swell from the current 40% to 85% by the turn of the century. Thus, the traditional "brick-and-mortar" branch model of a Bank would be substantially complemented, and in most cases replaced, by the new distribution/delivery mechanism of ATMs, PC banking, apart from franchises. The latter would inevitably contribute to a sizeable chunk of business transactions. **Plans for Electronic Banking thus needs to be included in the organisation's strategic planning process and must enjoy unequivocal Top Management support**. Further, data across branches should be on-line and use of e-mail / Intranet should be encouraged.
- While windows of technology, mainly IT, can activate efficient *responsive banking* that enhances service with faster and more convenient delivery mechanisms, perspective plans of Banks and DFIs should target *proactive (including predictive)* banking. Proactive banking improves service with innovative and customised product development. This is aided by predictive banking, or having total customer information ahead of customer arrival. Thus, a product can be customised while he is transacting in real-time, thereby pre-empting competition. Responsive banking can cut costs while proactive banking can spur sales and margins. Both are needed to enhance overall service quality. To accommodate the new service philosophy, pro-active banking requires people with pro-active thinking wherein employees will become consultants and sales people as they are expected to provide advice and promote the Bank/DFI's other products and services. **Thus, the new service orientation calls for a decided shift from reactive to a mix of proactive and responsive banking; this has important implications for organisational redesign.**

- As a logical corollary, **corporate culture must undergo an attitudinal change in favour of a proactive relationship-based approach**. Relationship Managers (RM), serving as single customer contact points, would help promote the Bank/DFI's range of financial products and services in concert with product specialists. They would contribute towards the deepening of existing relationships and developing new ones. The RM should be a specialist in his area while at the same time have an overall perspective of the Bank/DFI's business operation and general trends in the market. It would be necessary to intensively train selected officers in the art of Relationship Management.
- **A consensus-driven Committee-based approach should be introduced for loan sanctions to get the benefit of pluralistic views and at the same time eliminate individual biases**. This is the prevalent international practice.
- **Banks/DFIs will need to put in place strong project appraisal systems with global perspective of assessing credit risk**. The project/loan viability assessment needs to be on an objective basis and based on international demand and supply as well as international prices/trends, keeping in view WTO obligations and economic appraisal in case of large projects.
- **Creation of Specialised Branches will be one of the imperatives which the CAC environment would force, particularly on Banks**. General banking alone will not be adequate; specialised outfits like `Overseas Branches' for cross-border transactions, Commercial Branches, Industrial Finance Branches, NRI branches, Small Scale Industry Branches, High-Tech Agri Business Branches etc. would have to be created to render specialised services.
- **Large Banks/DFIs should also consider expanding/opening of International branches which, to start with, will operate as liaison offices,** collecting and disseminating information on investment climate, business opportunities, market movements, foreign investment proposals, market research reports and promote their Banks/Institutions among investors and businessmen. These offices should be considered as a future investment as initially they will be cost incurring offices but would emerge as profit centres in due course.
- **A radical paradigm shift in the objective function of research activities undertaken by Banks/DFIs has assumed considerable urgency**. Currently,

these assignments cover a rather broad canvas. In the progressively competitive, deregulated and globally-oriented post-CAC environment, Bank/DFI's research activities should focus on areas which have direct and demonstrable externalities for their chosen business activities (e.g. tracking and projecting movements in interest rates/exchange rates, business expectations, investment climate- both domestic and global, policy tracking etc.). Further, the research personnel should be geared to generate quick and crisp analyses of actual and envisaged environmental/policy changes on their business prospects. These research outputs should ideally be available on-line to enable more informed decision-making by the Top Management as well as all users. All these would necessitate a sea change in research focus, culture and orientation.

- **In order to compete and raise resources in the international market, Banks/Institutions should recast their accounting statements to comply with the internationally accepted accounting standards.**

- **On the business processes side, the accent would be on redesigned customer contact and internal processes to improve customer service and the ability to manage increased business volumes.** An upgraded IT and MIS, developed either in-house or through third party banking packages (outsourcing), is mandatory to support new organisational structure and redesigned processes.
- A pronounced short coming of the existing organisational structure and response is the existence of "silos" or firewalls between different parts of the organisation, leading to uncoordinated and sometimes contradictory signals emanating in the marketplace. An example is the disconnect between borrowing and lending entities within the institution. **All business units in the organisation would do well to synchronise their strategies and focus on the business level bottomline.**
- In fact, International Banks, who have successfully transited to new modes, drive home the fact that the **all components of an organisational restructuring should run concurrently as part of an overall change**

management program; piecemeal efforts would fail. They lay particular emphasis on 'communication' as the key propeller for successful change management. Nevertheless, the fact remains that the response of each entity abroad has been unique and there are thus no standard solutions.

- **An essential component of organisational restructuring, particularly in an emerging scenario of global competition, is an early implementation of appropriate corporate practices which would contribute towards the evolution of corporate governance on par with the best available worldwide.** *Corporate governance* means much more than mere compliance with the letter of law or maximisation of profit. It encompasses performance accountability not only to shareholders, but to other stakeholders as well, like employees, clients, investors and to the society at large. The term also implies professionalism in the conduct of the Board, business ethics, conformity with law and regulations and sensitivity to social concerns. **Appropriate constitution of the Board together with a meaningful measure of operational autonomy and flexibility to managements and Boards of Banks and DFIs is the *sine qua non* of good corporate governance.** Adequate notice for meetings, circulation of informative agenda papers in advance, transparent and objective discussions on affairs of the DFI/Bank are all necessary to render the expression *"Board Governed"* more meaningful. Further, predominance of independent and professional non-executive directors on the Board would ensure the required objectivity. A logical corollary of the above is that **the ownership pattern of Banks/DFIs is likely to exert a deterministic influence on the broad contours of any organisational transformation.**
- **Last, but not the least, the spirit of the above recommendations rests clearly on the assumption that the Top Management of the Banks/DFIs would be allowed to operate freely in the increasingly complex and globally competitive environment and decisions on organisation and staffing are allowed to be made on merit, based on commercial judgement.**

VIII. RISK MANAGEMENT

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VIII.1.1 A major challenge in improving organisational effectiveness of financial entities lies in **strengthening their capabilities of risk management, backed by proper Management Information System (MIS) and sound treasury management network**. The progressive liberalisation of domestic financial markets, increasing overlap between traditional commercial banking and DFI activities, imminent globalisation of the financial services sector alongwith the eventual opening up on the Capital Account would multiply the menu of risks which would need to be suitably identified, measured, monitored and skilfully handled. Financial intermediaries would now have to manage an entire spectrum of new financial market risks, principally interest rate and exchange rate risks, local and cross-currency funding risks, counterparty risks and systemic risks in addition to credit risk.. The duration risk or asset-liability matching would assume added urgency. In the past, most of these risks arose mainly from regulatory dispensations. Further, as financial markets achieve progressively greater global integration, the volatility of exchange/interest rates in the international market would get transmitted to the domestic market. [***A detailed treatment of the universe of risks that are likely to arise in a globally integrated scenario and its possible management features in Appendix 4***].

VIII.1.2 Existing risk assessment and management systems adopted by Banks, Financial Institutions and even financial market regulators are by and large not fully geared to meet the exacting demands of increasingly complex global markets. Inured to operating in a regulated environment until recently - including on the external side - financial sector participants have largely focused on mitigating only credit risk. In the changed scenario, the business-mix is likely to encompass an increasing proportion of foreign currency as well as enlarged exposures in Government and corporate securities, both domestic and foreign. Financial intermediaries would henceforth need to impart a decidedly scientific temper to the issue of containment of the entire risk matrix. **It is thus imperative for financial sector players to effect a sea-change in their handling of risk-related aspects and assign it a primacy of place in strategic responses**

VIII.1.3 In any case, the business of financial intermediaries is to assume and manage risk. The moot issue is about how much risk to bear and systemic capability to manage risks of this degree. The management should appreciate that "*Not to take a decision is as much a decision by itself*". Every decision is a trade-off between risk and return. Thus, with the increase in the menu of risks to which the Banks/DFIs are exposed, **it is important for these intermediaries to operationalise, either singly or in concert with other institutions, an effective risk management system before starting to operate in the new and volatile environment**. Risk Management systems will enable the intermediaries to have a better understanding of the importance of maintaining the balance between risk and return by adequately assessing and controlling risk exposure.

VIII.1.4 **Definitionally, Risk Management encompasses:**

- A comprehensive framework for defining, measuring, evaluating, making decisions on and communicating about all types of risks;
- The policies, limits and decision making process used in determining the desired level and mix of risks to keep in the portfolio;
- A sophisticated methodology and infrastructure for measuring and evaluating risks and for setting capital requirements to cover the risks taken;
- A philosophy underlying management decisions regarding business strategy, resource allocation, performance targets and capital adequacy that incorporates the risk-return trade-offs of different alternatives; and
- The tools and processes used by top managers in order to manage the risks of the institution.

(Source: *Banker's Trust Publication on Risk Management*)

VIII.1.5 The Top Management of each Bank/DFI would, of course, evolve their own customised standards of risk measurement to gauge an acceptable level of risk for the Bank, guided possibly by the objective function of optimising the risk-return portfolio. The various divisions of the Bank/DFI would then strategise to insulate

business operations from the varied market risks which are above this threshold level. Nevertheless, they would stand to benefit from **the following priorities suggested in the risk management function area, based on international best practices**:

- The evolution of new financial products has altered the way risks are managed. There should be a **clear strategy approved by the Board of Directors as to their risk management policies and procedures,** with the Senior Management ensuring that the structure of Banks/DFIs' business and the level of risk they assume are effectively managed with clear definition of individuals/committees responsible for managing such risks.
- **There should be a well defined system for effectively managing risks and their regular reporting to Management**.. A revised checklist of Risk Management, compiled by Bank of Japan recently, is a good reference point.

- Further, a **pro-active Asset-Liability Management (ALM)** would be central to future prosperity of financial sector participants under the changed scenario. ALM policy should include *inter-alia* objectives, philosophy, limits, roles, responsibilities, risk limits, methodologies, reportings etc., duly approved by the Board of Directors, with provision for periodic review. Besides, the innovations in the risk-management area in general-and ALM in particular - would call for both, external inputs (at least in the initial stages) as well as an agile regulatory oversight with a transparent outlook.
- From a strategic risk-alleviation angle, in a scenario of closer integration between domestic money and forex markets as well as between domestic and international money and securities markets, there is considerable merit in an **Integrated Treasury.**
- **The analysis of a financial player's risk profile should include both on and off-balance sheet items and their sensitivities to future events,** with methods used for forecasting and managing their outcomes. Indeed, in general, the weightage of emerging eventualities into risk assessment is more important than its assessment based on past developments.
- Even in the hitherto dominant **credit risk-containment area**, the current infirmities which accentuate these risks like unsupportive legal system, loan

appraisals being done on the basis of certain unvalidated assumptions, lack of periodical monitoring, inadequate disclosures would need to be addressed through a mix of policy and organisational reforms.

- Although risk management techniques were originally developed for defensive purposes, **risk-based tools can also be applied offensively to improve portfolio performance**. The applicable areas include construction of a basis for asset allocation, as a quantitative tool in finding the envelope of possible choices for the upcoming investment period, and in the evaluation of the performance of individual portfolio managers.
- The likely emergence of deep and liquid long-term debt market in India and the evolution of a Rupee reference rate clearly dictates that Banks/DFIs should actively **encourage development of a rupee derivatives market**. In general, derivatives enable greater control of risks with smaller cash requirements. They also usually have lower transaction costs and credit exposure. This could also be adopted by corporates to facilitate their risk management, thereby resulting in positive fall-out on the Bank/Institution's NPA levels.
- **Tested risk control systems are today virtually available off the shelf to monitor the universe of risks within the limits set by Boards/Top Management and can be made universally applicable with a little bit of judgement and modification**. For example, the identification, quantification, control and management of market risks- which are not mutually exclusive - across the entire business spectrum could be addressed by a possible adoption of *one of several variants of Value at Risk (VAR) models* currently in vogue. This can provide a standard measure for risk exposures, i.e. an estimate of the 'maximum' loss in the value of a portfolio/financial position over a given period with a certain level of confidence. VAR can be specified taking into account both management/supervisory risk limits and can provide a dynamic level of comfort as a speed breaker while taking business decisions. With reasonable level of discretionary loss-limits and an independent risk-management unit, such systems could prove very effective. In addition to VAR models, DFIs and Banks can also adopt *"stress-testing"* to provide them with a richer set of information about the risks in their portfolio of universal events. J.P. Morgan, alongwith a

group of international banks, has developed *CreditMetrics* which allows seemingly diverse set of credit risks to be quantified and consolidated across product-markets. The model can properly quantify portfolio effects (i.e. the benefits of diversification and costs of concentration) as also the likelihood that different types of loans will turn sour simultaneously.

- Banks/DFIs' risk management agenda, in their own interest, should extend beyond their own balance sheets to incorporate risk containment in client portfolios. Banks/ DFIs should look for best practices within the industry to absorb into their own systems. However, at a fundamental level, the risk measurement models do not remove the element of experience and judgement from the risk management process. They do not provide the definitive answer to the question: "*how much risk am I taking?*". They simply provide a statistical framework within which a more rigorous evaluation of risk can take place.
- Overall, an **effective risk management framework would require robust (internal) operational controls as well as strong firm-wide support functions** which would provide assistance to the risk-management group to ensure that risk management policies are being supported, controls are in effect and that complex areas are being appropriately dealt with. The Banks/DFIs should have in place internal controls that are adequate for the nature and scale of their operations. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the organisation, transferring its funds and accounting for its assets and liabilities; reconciliation of these processes; safeguarding its assets; and appropriate independent internal and external audit and compliance functions to test adherence to these controls as well as applicable laws and regulations. Banks/DFIs should have adequate policies, practices and procedures in place that promote high ethical and professional standards in the financial sector and prevent the Banks from being used intentionally or unintentionally for unethical purposes. The crucial importance of these control functions has been driven home by the failure of a few international institutions who were found wanting in this regard.

- These controls must be supplemented by an **effective systems audit function** that independently evaluates the adequacy, operational effectiveness and efficiency of the control systems within an organisation. **In particular, there is a need to introduce concurrent audit on a real-time basis, with particular focus on asset-liability mismatch and compliance with prudential norms.** This would provide a strong buffer against incidence of frauds, irregularities and the element of risk. Consequently, the internal auditor must have an appropriate status within the Bank and adequate reporting lines designed to safeguard its independence. The external audit can provide a cross-check on the effectiveness of this process. Banking supervisors must be satisfied that effective policies and practices are followed and that management takes appropriate corrective action in response to internal control weaknesses identified by internal and external auditors.
- The important impediment DFIs/Banks face in implementing risk management system is the timely availability of data. The **MIS system of these institutions will need to be strengthened** for faster consolidation of data from various sources.
- Good supervision is the key to risk management. **The regulatory/supervisory oversight for the financial sector would have to embrace new charters in consonance with the new paradigm shifts in risk management**. The Report of the Working Group on Conglomerate Supervision, published by the Institute of International Finance in February 1997, suggests development of a **risk-based supervisory framework**. This has been touched upon in an earlier section (**Chapter V, Section V.5.1**). The development of concepts such as VAR and its variants make it possible to move towards the risk-based framework. Among other things, the home country supervisor for each globally active financial group should receive information on common risks in the financial business and use it to assess the financial group's global profile. A key component of such consolidated supervision is establishing contact and information exchange with other supervisors involved. Financial players should also work to increase understanding of their risk management approach among supervisors, analysts, counterparties and investors.

- Finally, in order to ensure that the information submitted by Banks/DFIs is of a comparable nature and its meaning is clear, the regulatory agency will need to provide report instructions that clearly establish the accounting standards to be used in preparing the reports. **These accounting standards should be based on principles and rules that command wide international acceptance and should be aimed specifically at financial sector participants.**

IX. INFORMATION TECHNOLOGY SYSTEMS AND MIS

IX. INFORMATION TECHNOLOGY SYSTEMS AND MIS

IX.1 Introduction

IX.1.1 **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 radical changes in DFI/Banks' competitive and regulatory environment are poised to create **new business needs with considerable implications for IT and MIS**. These include: (i) information needed for effective decision making, managing customer relationships as well as improving profitability and risk management techniques; (ii) the need to eradicate organisational deficiencies flowing from non-integrated systems, including frequent re-keying and data duplication. An integrated system would release skilled human capital for other value-additive activities like relationship management and managerial decision-making; and (iii) the need to impart systemic flexibility to support new products, markets and customers which is necessary for rapid growth; The existing systems of most financial intermediaries were not designed to support such business needs and would need to be modified accordingly.

IX.1.2 There are clear compulsions for an early sizeable investment in the direction of full-scale technology upgradation that supports the business strategy. These flow not only from the broad canvas of such innovations currently available abroad but also from the fact that domestic players will shortly have to compete for business and survival with an array of global players who already have such integrated state-of-the art technology in place. As the Tarapore Committee Report clearly states, without a greater degree of technology absorption, domestic market participants will be ill-equipped to build strong risk-management systems and MIS. Technology upgradation can also pave the way for an efficient payment and settlement mechanism which will strengthen the financial system considerably. The entire aspect of MIS also needs to be studied *de novo* with a view to bringing about an integrated MIS dove-tailed to a compatible technological set-up that is alive to the contemporaneous needs of the business place.

IX.2 Information Technology (IT)

IX.2.1 The global advances in technology and communications **(detailed in Appendix 5)** has opened up a flood of new opportunities that are redefining the very concept of traditional banking. When adopted, these would also help provide a number of benefits to the domestic financial intermediaries. For example, the rapid decrease in the cost of very high powered computing and database sources would make possible the management of risks (on a near real-time basis) of operating in a wide variety of product-markets such as retail/wholesale banking, derivatives, bond and currency trading and insurance. *Pari passu*, the advances in telecommunication technologies (to wit, cellular telephones, VSAT networks, satellite based international as well as domestic communications) have opened up new frontiers in financial intermediation, including the possibility of seamless and interactive communication between geographically remote customers and service providers, shrinking progressively the need for brick-and-mortar branches for providing basic banking services. Modern technology also ushers in better work practices and serves the customers' cause.

IX.2.2 The Group strongly feels that, in the emerging scenario, the choice before Banks/ DFIs between using technology infrastructure as a springboard to derive business advantages or to remain oblivious and insular to the winds of technological innovations sweeping across the globe is really a Hobson's choice. There is no way that a Bank/DFI can remain lukewarm to new technology products and yet hope to stave off extinction.

IX.2.3 This, of course, is not to suggest that the sense of urgency in this area has been lacking among Banks. In fact, the first blue-print for computerisation and mechanisation in the banking industry was drawn up as early as 1983-84 by the Rangarajan Committee, set up by RBI, which drew up a phased plan of mechanisation for the banking industry covering the period 1985-89. In the backdrop of the experience gained in the eighties and keeping the future tasks in view, a second Committee, again under the Chairmanship of Dr. Rangarajan, was set up in September 1988 to draw up a perspective plan of computerisation in the banking industry for the quinquennium 1990-94. This Committee highlighted the fact that computerisation must be looked upon as a

means to improve customer service, house-keeping, decision-making and efficiency, and that the banks' work-force should realise that mechanisation would lead to growth and employment expansion. Towards achieving these objectives, the Committee counselled a move away from the use of dedicated and stand-alone machines towards on-line, real-time, transaction processing environment in relation to branch banking. Subsequently, in 1994, the Saraf Committee was set up which made several concrete recommendations on technology issues relating to payments system, cheque clearing and securities settlement in the banking industry to infuse greater efficiency into the system. It also reviewed telecommunication systems like the use of BANKNET and optimum utilisation of SWIFT by banks in India. The Committee *inter alia* recommended a switchover from voice grade transmission to higher speed transmission facility like VSAT technology and targetting fibre optic radio frequency etc.

IX.2.4 The RBI has thus all along been playing a pro-active role, enabling all Banks to benefit from technology. Currently, it is at an advanced stage of setting up a proprietary VSAT network, based on satellite technology, to help link all branches of a Bank, anywhere in the country, to each other round the clock. The linkage for big Banks would translate to becoming virtually a single banking entity for all business operations.

IX.2.5 It is now upto individual Banks to build reliable, inter-operable, functionally rich and user-friendly IT products and item processing solutions to give the required dimension to automation of service activities and delivery of superior quality customer services. **The Group advocates the following guidelines for facilitating the establishment of IT systems in Banks/DFIs of international standards**:

- Automation in banking has important connotations for the complementary legal framework. Apart from the issues relating to labour laws, there are transactional issues which have legal implications involved in it. These broadly relate to authentication of instructions, countermanding or reversal of instructions, operational security standards and liability for loss in case of a fraud, technical failure and errors. In the latter case, a helpful amendment should be made in the Bankers Book of Evidence Act to include Bank's books maintained through electronic media like floppies/diskettes, etc. Further, the legal status and the regulatory or tax treatment of prospective Internet transactions have to be

resolved. **In the light of these issues and others that might emerge out of introduction of computerisation and technologically advanced communications in banking, the Group concludes that existing laws may not be adequate or have the clarity to deal with them and recommends examination of the appropriate legal framework.**

- **Based on international trends and the intrinsic merits of each, the accent of Banks/DFIs should be on establishing, creating employee/ customer awareness and familiarity with e-mail, Internet and Intranet Banking, Smart Cards and Electronic Data Interchange (EDI) in a strategically sequenced fashion.** There should be a determined move towards linking all the departments and offices through technology and ushering in a paperless environment.
- Technology brings with it specific strategies which needs to be factored in a Bank's overall strategy. **One is the Leader or Follower strategy, which will determine the power equilibrium between various Banks and increase the competition in terms of markets targeted, the reach and need for technology upgradation.** While the cost of introducing new technology and developing and launching associated products would increase, the cost will have to be measured both in market and opportunity cost terms. The other is the **Competitive or Co-operative Strategy** and would be a function of the cost and speed of introduction and the organisation's philosophy in terms of strategy. Generally, Leaders would be competitive with proprietary systems, low lead time for implementation but higher cost of development. Followers would opt for a co-operative strategy, with the benefits of shared cost and lower (individual) risks but longer implementation schedules and low product differentiation levels.
- While the VSAT network has many advantages for banks, such real-time communications will be highly productive only when there is corresponding efficient support at the originating and destination points. The imperatives here are (a) **an overhaul of internal operational procedures and operating manuals which were devised for manual working.** The computerised environment would render many of these procedures and statements

redundant; (b) **rigid standardisation and codification of procedures, compatible hardware and software systems across the organisation.** Human ability (in a manual environment) to make out correct interpretations from documents / formats which are not exactly identical cannot be expected in a computerised environment with programmed instructions. The standardisation requirement would become more critical with EDI types of applications and growing global relationships.

- **A contentious issue in the area of IT would be the choice between 'proprietary systems' (i.e. information systems developed in-house) and third party banking packages, to solve IT issues.** Some experts assert that the latter is the more efficient way to upgrade systems as they variously provide inherently compatible applications, can be automatically upgraded and are more cost-efficient in the long-term. This issue would need to be closely examined by individual entities in view of the strategic importance of IT on business prospects.
- At a fundamental level, involvement in technology development by Banks would manifest itself at two levels: (a) adequate funding of upcoming technology efforts like Research and Development, and (b) adopting the new technology as a work culture. Due consideration would have to be given towards likely impact on skill/knowledge requirements, systems and procedures as well as organisational culture and overall preparedness.

IX.2.6 **In view of the crucial role of IT and automation to business success in the globalised environment of tomorrow and the large agenda for action, the Group considers that it might be worthwhile to go into the requirements in a detailed fashion and draw up a perspective plan or blue-print for a robust automation in the financial sector.** In particular, in an era where quick and informed decision-making is crucial to capitalise on market opportunities, the availability of relevant data to support such a decision making process has considerable premium value. Managements of Banks/DFIs should, therefore, instal computerised decision-support systems for this purpose early into the automation process.

IX.3 Management Information System (MIS)

IX.3.1 MIS systems in Banks/DFIs will have to assume newer dimensions as banking competition becomes more and more global and intense. MIS on IT, in particular, will be a crucial input for IT management and can help the Bank/DFI to integrate its IT strategy with business strategy. The Banks/DFIs of the future will have to fight more creatively and pro-actively for market shares, using "knowledge" as the leverage for survival and excellence.

IX.3.2 A strategic delivery mechanism would be **"data mining" from banking systems** (which is an exploratory process aimed at knowledge discovery). The tremendous increase in the power of IT would help Banks/DFIs to tap existing information systems, or legacy systems, mine useful management information and insights from the data stored in them and regurgitate these into decision-supporting outputs to help manage resources, compete successfully and enhance customer satisfaction. At present, terabytes of transaction data, unmined and unappreciated, are collected, generated, printed and stored, only to be filed and discarded after they have served their immediate purposes as audit and paper trails instead of serving to generate useful management reports.

IX.3.3 However, data mining has to be preceded by data warehousing, which is the process of extracting, cleaning, transforming and standardising incompatible data from the Bank's current systems at periodic rests (as the needs for management reports and decisions dictate) so that it can be analysed for useful patterns, relationships and associations. Indeed, data warehousing and mining can run parallel with banking transaction information systems, without intrusion and interruptions.

IX.3.4 Data mining would provide an important tool for addressing various issues such as prevention of attrition, to cross-sell and do target marketing, to detect and deter fraud and prevent defaults, bad loans and improve screening and to increase customer loyalty and retention. **In view of its manifold advantages, DFIs and Banks could gainfully adopt *data mining* as part of their MIS agenda.**

IX.3.5 Nevertheless, one must not lose sight of the fact that mere introduction of appropriate IT and efficient MIS alone is not sufficient to bring in the necessary

performance improvement and get the competitive edge. It would require skilled human capital (or "intelligent people") to turn the hardware / software and the networking tools into a powerful ingredient to help Banks and DFIs achieve their corporate goals.

X. HUMAN RESOURCES DEVELOPMENT

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X.1.1 As the transformed mandate of DFIs/Banks requires increasing specialisation and diversification within the group, an underlying essential is a dedicated and able core of management and staff, a commitment to high productivity alongwith strong IT support. Clearly, Human Resource initiatives are pivotal to acquiring the flexibility, strength and ability to successfully adapt to the emerging commercial culture and respond to new opportunities. This message clearly emanates from documented evidence from cross-country experiences and the need has been underscored by the Tarapore Committee, among others.

X.1.2 The Working Group recommends that the following should be integral to the strategic responses required to upgrade skills of employees commensurate with the demands of the new operating environment :

- **Prescient management and leadership** has a crucial role to play in the increasingly sophisticated/complex environment. The CEO and his Top Management Team should possess the foresight to anticipate changes in the environment in which they operate and take advantage of emerging opportunities by continuously regenerating competitive strategies and other mechanisms on a periodical basis as new environmental factors emerge and existing mechanisms become obsolete or suffer from diminishing returns. The Top Management would thus need to be glued to changes in the global environment on a continuing basis. They could stand to benefit from short-term refresher modules organised for Senior Executives of Banks and DFIs at reputed centres for this purpose.
- The CEO should have the benefit of the support and expert advice of a **fully professionalised Board of Directors with members of stature, integrity and wide experience. As stated in an earlier chapter, the shareholding pattern of Banks/DFIs will ultimately determine the composition of the board.**
- Product specialisation would be the pivot of the new business strategy. **In addition, a comprehensive risk-management strategy would require the creation of a soft infrastructure in the form of specialist development in the**

areas of risk management in Banks, DFIs and Regulatory Organisation(s). This should start immediately so that a core group of personnel trained in risk containment skills and other related activities is in place before full CAC/ WTO commitments are implemented.

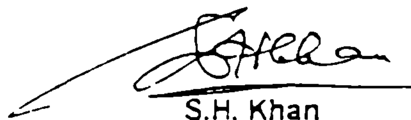
- As a logical corollary, Banks and DFIs should have an adequate number of quality employees in all relevant disciplines. There should be **broad-based recruitments**, both at entry level from top schools as well as lateral entry of professionals at higher levels to fill skill gaps, **systematic training programs** with focus on practical skills and expertise linked to career development, real-time familiarisation of staff with the latest developments, **career path planning**, including moving staff across functions selectively to develop Top Management talent, **rigorous performance appraisals** to sift through performances and link these to promotion and compensation and last, but not the least, **market-related compensation packages**, with financial rewards for strong performance and superior skills. *Pari passu*, it will be necessary to provide a **viable and enforceable exit option to employees** unable to cope with the cultural and technological change. An enabling legal framework thus needs to emerge fairly early in the organised labour market area.
- **Induction of talent**, in the opinion of the Group. is a must in the following specific areas at various levels:
    a) Risk Management
    b) Treasury and Financial Derivatives
    c) Investment Banking
    d) Economic Research & Industry Analysis
    e) Human Resources Management
    f) Information Technology
    g) Relationship Management
- The career progression path of these specialist cadres should be suitably mapped. **In this connection, there is a need to appreciate that market-related compensation package would be a necessary, but not necessarily sufficient, condition for retaining professional staff**. The motivational aspect would need to be provided through the other components of HRD such as

placement, transfer, delegation, career path, conducive work culture, etc. Since the human element is central to a Bank/DFI's success in the changed operating environment, it would be useful to **induct an HRD professional at a relatively senior level**. Such induction has the potential to help provide the requisite focus and impetus to the HRD function in Banks/Institutions.

- **Since specialisation is the *sine qua non* in the emerging operating environment, transfer policy within the organisation would need to be substantially modified to further this objective**. It would be desirable to have a transfer policy which will focus on specialisation upto a certain hierarchical band. At higher hierarchial levels, personnel who display leadership, adaptability and have the desired management perspectives could be laterally moved across departments/ offices where they could rely on the skills of the specialists in those departments/offices. **HRD policy and performance evaluation should thus show a pronounced orientation towards skill-building and skill-upgradation**. The apprehension of possible malpractices flowing from an extended tenure in these specialised activities (which need not necessarily be confined to the same office or branch) can be suitably addressed through well-defined systems and procedures and adequate checks and balances. This should be complemented by an enabling audit set-up.
- There is considerable concern that the current framework for addressing vigilance cases in the financial sector is hampering the decision-making process in Banks and DFIs. The Group feels that it would be preferable to strengthen the internal vigilance wing of each DFI/Bank and they should ordinarily be the deciding authority for all vigilance cases involving permanent employees of the DFI/Bank. This, in the Group's view, would facilitate pro-active decision making and make the vigilance function more meaningful. However, in cases of serious frauds (for example, those exceeding a prescribed limit), a Special Vigilance Machinery exclusively for the financial sector, comprising multi-disciplinary teams with relevant expertise, may be considered. In this context, the key features of the Serious Fraud Office (SFO) of the U.K. could be taken up for examination. ***[A brief write-up on SFOs appears in Appendix 6]***

- There would be considerable externalities in deputing employees from banks to DFIs and *vice versa* on **training programmes** at each other's institutions where state-of-the-art infrastructure exists, to fill skill-gaps in the non-core competence areas. This would also benefit smaller Banks/DFIs whose training facilities are inadequate relative to emerging requirements.
- **A reference needs to be made in this connection, for possible replication, of the "powerful human network" developed by institutions like Industrial Bank of Japan (IBJ).** This network operates through IBJ's programme of executive transfers and industrial finance seminars, creating strong personal bonds between key IBJ personnel and those in Japanese and, more recently, global industry. The bulk of IBJ's Credit Appraisal Team, for example, has experience on secondment with industrial firms. Global networks are fostered through programmes like extended industrial finance seminars for foreigners being organised by IBJ since 1992.
- **There is a need to also highlight teamwork as a key attribute in corporate policy**. Career advancement and rewards should therefore be based as much on individual performance and ability as on teamwork.
- **Central to the above initiatives, as spelt out in Chapter VII, is the need to impart a meaningful measure of operational autonomy and flexibility to the managements of Banks/DFIs.** This is an ineluctable necessity to enable financial sector intermediaries to robustly respond to the opportunities and challenges likely to be posed by the emerging operating environment and successfully compete with their counterparts abroad.
- In particular, **the primacy of the Board should prevail in the areas of recruitment and promotion of personnel, general staff management, drawing up of a market related compensation package** (that is conducive to attracting, motivating and thereby retaining the requisite skilled human capital), and in determining the optimal organisational structure. Autonomy would mean that the Board of Directors will determine all actions within the regulatory framework and be answerable to shareholders in much the same way as the private corporate sector operates. Autonomy will be particularly crucial in the area of manpower planning and deployment wherein there is a sizeable agenda

for reforms. Enabling changes in labour laws which can be rigorously enforced, in particular, would play a key role in this regard.



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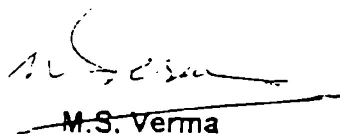

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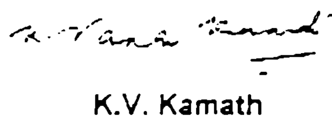

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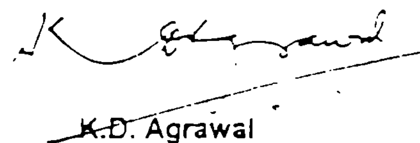
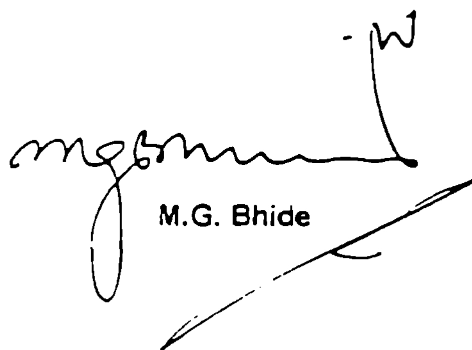


K.D. Agrawal



M.G. Bhide

A.T. Pannir Selvam

V. Subrahmanyam

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ANNEXURES

ANNEXURE-I.

भारतीय रिज़र्व बैंक
केन्द्रीय कार्यालय
शहीद भगतसिंह मार्ग,
मुंबई-400 001.
RESERVE BANK OF INDIA
CENTRAL OFFICE
SHAHEED BHAGAT SINGH ROAD,
BOMBAY-400 023. INDIA.
MUMBAI

उप गवर्नर
DEPUTY GOVERNOR

D.O.DBS.FID.No. 359 /01.02.00/97-98

December15, 1997

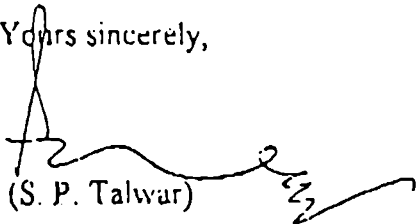
Dear Shri Khan,

Working Group for Harmonising the
Role and Operations of DFIs and Banks

I enclose a copy of the Memorandum relating to the constitution of the above referred Group with yourself as the Chairman. The other members are being advised about constitution of the Group.

With kind regards,

Yours sincerely,



(S. P. Talwar)

Encl: as above

Shri S. H. Khan,
Chairman & Managing Director,
Industrial Development Bank of India,
IDBI Towers, Cuffe Parade,
Mumbai 400 005.

RESERVE BANK OF INDIA
CENTRAL OFFICE
MUMBAI

December 8, 1997
Agrahanya 17, 1919(Saka)

CONSTITUTION OF WORKING GROUP FOR HARMONISING THE ROLE AND OPERATIONS OF DFIs AND BANKS

In the light of recent chnages in the Indian financial system and keeping in view the need for evolving an efficient and competitive financial system, it has been decided to constitute a Working Group for harmonising the role of DFIs and Banks. The terms of reference of the Group will be as follows:

1) To review the role, structure and operations of DFIs and commercial banks in emerging operating environment and suggest changes;

2) To suggest measures for bringing about harmonisation in the lending and working capital finance by banks and DFIs;

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

4) 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;

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

The members of the Working Group will be:

1. Shri S. H. Khan Chairman & Managing Director, Industrial Development Bank of India Mumbai.	Chairman
2. Shri M. S. Verma Chairman, State Bank of India, Mumbai	Member

3. Shri K. V. Kamath — Member
   Chief Executive Officer & Managing Director,
   Industrial Credit and Investment Corporation of India Ltd.,
   Mumbai

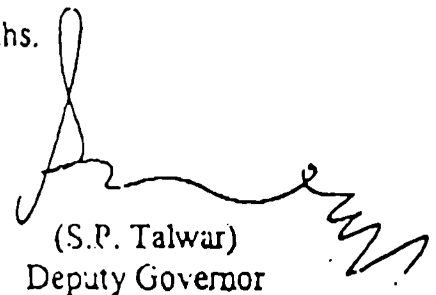
4. Shri K. D. Agrawal — Member
   Chairman & Managing Director,
   Industrial Finance Corporation of India Ltd.
   New Delhi

5. Shri M.G. Bhide — Member
   Chairman & Managing Director,
   Bank of India,
   Mumbai

6. Shri A. T. Pannir Selvam — Member
   Chairman & Managing Director,
   Union Bank of India,
   Mumbai

7. Shri V. Subrahmanyam — Member - Secretary
   Executive Director,
   Reserve Bank of India,
   Mumbai

The Working Group may submit its report within three months.



(S.P. Talwar)
Deputy Governor

ANNEXURE II

WORKING GROUP FOR HARMONISATION OF THE ROLE AND OPERATIONS OF BANKS AND DFIS: COMPOSITION OF THE SUB-GROUPS CONSTITUTED BY THE WORKING GROUP

The Working Group constituted three Sub-Groups; each Sub-Group was asked to prepare a Working Paper related to one(or more) terms of reference.

SUB-GROUP I

TERMS OF REFERENCE (I): *Review the Role, Structure and Operations of DFIs and Commercial Banks in the emerging operating environment and suggest changes.*

(a) Sub-Group Members

Sr. No.	Name	Designation	Institution
1.	Dr. K. Kameswara Rao	CGM, RPD	IDBI
2.	Ms. Kalpana Morparia@	GM	ICICI
3.	Shri M.V. Muthu	CGM, ERP	IFCI
4.	Shri M.M.S. Rekhrao	CGM, DOS (FID)	RBI
5.	Shri N. Sadasivan	GM, Credit Policy	SBI
6.	Shri N.V. Rao	DGM (Planning)	BOI
7.	Shri K.Suresh Rao	GM, Credit	UBI

@ Sub-Group Convenor; since elevated to Senior General Manager

(b) Resource Persons

Sr. No.	Name	Institution
1.	Dr. Nachiket Mor	ICICI
2.	Dr. Mathew Joseph	ICICI
3.	Ms.. Rupa Rege Nitsure	ICICI
4.	Shri S.Umapathy	IDBI
5.	Shri H.C Grover	IDBI
6.	Shri Krishnendu Banerjee	IDBI
7.	Ms. Susan Koshy	IDBI
8.	Shri S.S. Banerjee	IDBI
9.	Ms. Sudipta Datta-Roy	IDBI
10.	Shri Janak Raj	RBI

SUB-GROUP II

TERMS OF REFERENCE (II & III COMBINED): *Measures for harmonisation of lending & working capital finance by Banks and DFIs alongwith examination of whether DFIs could be given increased access to short term funds and the regulatory framework needed for the purpose.*

(a) Sub-Group Members

Sr. No.	Name	Designation	Institution
1.	Shri R.M. Malla@	GM, Domestic Resources	IDBI
2.	Ms. Kalpana Morparia	GM	ICICI
3.	Shri R.G. Sharma	GM, Resource Dept.	IFCI
4.	Shri V.G. Damle	GM, IECD	RBI
5.	Dr. K.V. Rajan	DGM, DBOD	RBI
6.	Shri S.A. Bhagali	GM, Project Finance-SBU	SBI
7.	Shri C. Chandrasekhar	AGM, Treasury Division	BOI
8.	Shri K. Suresh Rao	GM, Credit	UBI

@ Sub-Group Convenor

(b) Resource Persons

Sr. No.	Name	Institution
1.	Shri M.V. Subaraman	IDBI
2.	Shri Melwyn Rego	IDBI
3.	Ms.Sharbari Nag -Fernandes	IDBI
4.	Shri S.J. Balesh	IDBI
5.	Shri Sandeep Jain	IDBI
6.	Shri Akash Sen	IDBI
7.	Ms. Madhavi Kapadia	IDBI
8.	Dr. Nachiket Mor	ICICI

SUB-GROUP III

TERMS OF REFERENCE (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 CAC.*

(a) Sub-Group Members

Sr. No.	Name	Designation	Institution
1.	Shri O.V. Bundellu	CGM, Treasury & Funding	IDBI
2.	Shri Sanjiv Kerkar#	GM, Risk Mgmt.	ICICI
3.	Shri L. Mishra	GM, Plg. & Research	IFCI
4.	Ms. Shyamala Gopinath	Addl. CGM, DBOD	RBI
5.	Shri S. Govindrajan	CGM, Treasury	SBI
6.	Shri Y. Radhakrishnan@	CGM, Personnel and HRD	SBI
7.	Shri A.P. Phadnis	DGM, Reorganisation Dept.	BOI
8.	Shri Michael Bastian	GM, Investment (Domestic & International) and Merchant Banking	UBI

@ Sub-Group Convenor; since elevated to Deputy Managing Director,SBI

Since elevated to Senior General Manager

(b) Resource Persons

Sr. No.	Name	Institution
1.	Shri S. Dinahar	SBI
2.	Shri Krishnendu Banerjee	IDBI
3.	Shri S.J. Balesh	IDBI

ANNEXURE III

List of Organisations and Individuals with whom the Group had discussions or received material pertaining to Terms of Reference

A. INDUSTRY ASSOCIATIONS

1. FICCI, New Delhi
2. Assocham, New Delhi
3. CII, New Delhi
4. Bombay Chamber of Commerce, Mumbai
5. Bengal Chamber of Commerce , Calcutta
6. COSIDICI, New Delhi
7. Indian Banks Association, Mumbai

B. EXPERTS AND REGULATORY ORGANISATIONS

1. Shri M. Narasimham, Chairman, ASCI
2. Shri S.P. Talwar, Deputy Governor, RBI
3. Shri Jagdish Capoor, Deputy Governor, RBI
4. Dr. Y.V. Reddy, Deputy Governor, RBI

APPENDICES

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3.	Financial Supervision in a Global Market *(based on a risk-based supervisory framework)*	3.1 - 3.4
4.	The Universe of Risks in a Globally Integrated Scenario	4.1 - 4.12
5.	Global Advances in Technology and Telecommunications	5.1 - 5.4
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APPENDIX 1

CONSOLIDATION AND CONVERGENCE IN THE FINANCIAL SECTOR: RECENT CROSS-COUNTRY EXPERIENCES

A major trend sweeping across all segments of the financial industry worldwide - be it banking, insurance, investment or finance- in recent times is "**consolidation**" and "**convergence**" among financial entities. Both trends are reshaping financial industry internationally, forcing institutions across the financial spectrum to re-examine their business strategy and direction besides adding new dimensions to the regulatory oversight.

However, *consolidation* and *convergence* are not identical trends although they may run concurrently in the financial landscape. At a fundamental level, **consolidation** is a core response to financial pressures that run right across the global marketplace. **Cost cutting or reduction of overheads to more controllable levels is an important element driving consolidation** although empirical evidence does not always support this anticipation. In the substantially open financial markets of the West, a growing and aggressive band of new non-bank entrants from industries such as supermarkets, clothing retailers and even newsagents are eating into market shares of existing financial players. With lower cost bases and more efficient delivery systems, these new players have fuelled cost pressures on established players further. Provided cost-cutting can be achieved, consolidation would enable banks to refocus resources on revenue enhancement. **Merging to increase market share is another driver of consolidation**. But the issue of whether pruning the number of existing players provides greater opportunities to the balance entities would depend on the degree of market openness. Thus, consolidation or mergers are driven by a search for scale and supported by the desire for cost-cutting.

On the other hand, **convergence (or broad-basing) fundamentally involves a realignment of the global financial system (at both retail and wholesale levels). It brings together, under one institution, a suite of financial services and products (*financial boutiques or full-service Universal Banking*) or includes a diversification into a narrower groove like commercial and/or investment banking business in others depending, among other things, on the complementary regulatory framework.**

Mergers: Empirical Trends

During 1987-97, globally, mergers involving assets worth nearly $ 1.4 trillion have been undertaken in the finance industry. This trend gathered sizeable momentum in 1997. In Europe alone, total value of assets (according to figures from AMDATA) was $107.4 billion, compared with $48.6 billion in 1996 and $ 46.9 billion in 1995. Bank mergers are expected to record an uptrend throughout 1998, particularly in view of the envisaged European Monetary Union (EMU) in 1999 .

Factors driving Consolidation: Cross-Country Experiences

(a) USA

The motivations and compulsions underlying consolidation have varied somewhat across nations. In developed countries like USA as well as in Europe, as banks became more conscious of shareholder value and technological benefits of scale, many middle-sized banks merged to stay competitive and drive down recurrent (operating) costs in their production function. Observers in the **USA** attribute the trend towards bank mergers as a considered response to a combination of disintermediation pressures in banking sector (and consequential overbanking in the sense that a plethora of institutions chased a dwindling universe of clients), globalisation, rapidly advancing technology, derivatives and debt securitisation. Now, big banks too in

developed countries have become convinced of the virtues of being still bigger, evidenced by Chase Manhattan's link-up with Chemical Bank (and a raft of other banking mergers in USA) , the recent SBC Warburg-UBS merger in Europe as also the marriage of Bank of Tokyo and Mitsubishi in Japan. The merged Japanese entity emerged as the world's largest bank *at that time(1997)* with an asset base of $626 billion; India's largest bank-the State Bank of India- with an asset base of $43 billion appears puny in comparison.

The merger momentum, notably in USA, has been particularly frenetic in the investment banking arena. Apart from the SBC-UBS tie-up, other notables include the merger of Morgan Stanley with Dean Witter, Discover in February 1997, takeover of Salmon Brothers by Traveler (and merged with its Smith Barney affiliate), the takeover of Alex Brown (a hitherto rival American house) by Bankers Trust in April 1997. The trend in USA is for big investment banks to merge with retail brokers (e.g., firms such as Dean Witter, Discover and Smith Barney sell shares, bonds and other investments to small brokers). In fact, three of the world's four biggest investment banks now own, or are owned by, retail brokers.

For close to two decades, US banks and securities firms have been edging closer to each other, in culture and product, as the legal barriers crumbled and client demands increased. This gained momentum last year when around a dozen mergers took place between banks and securities firms, enabled by the relaxation of the Glass-Steagall rules which hitherto separated the two businesses. The three largest deals in 1997 were $1.7 billion stock swap by Bankers Trust for Alex Brown, $ 1.2 billion in cash and stock that Nations Bank paid for Montgomery Securities and the $540 million all-cash deal between Bank America and Robertson Stephens. **However, these fade in comparison to the proposed mega-merger, announced in April 1998, of banking giant Citicorp into financial services titan Travelers Group to create the world's largest financial services company called** ***Citigroup.***

Once the merger closes as scheduled in the third quarter of calendar 1998, Citigroup will have assets of nearly $ 700 billion (based on 1997 results of the partners) and equity of more than $ 44 billion.

Many investment bankers believe that merger mania in this area would last until there are around 10-15 dominant financial service providers in the global bulge bracket". Thus, **the prevailing belief is that size, expertise and global reach are crucial to viability and future survival; there may be room still for niche players but little space for the middle-sized.** This might force some of the latter category banks such as Lehman Brothers and Deutsche Morgan Grenfell to come together. Alternatively, they may be forced out of the business altogether, like Barclays and National Westminster Bank, both based in U.K. These two banks have sold most of their equity operations business and now concentrate solely on debt more closely linked to their business.

The theoretical underpinnings of the consolidation drive appear to be convincing: each of the three main bits of the global investment-banking business- underwriting and selling shares and bonds to investors, making markets in these securities for the investors who want to buy and sell them, and selling all manner of advice to big companies and governments- display signs of becoming one of the great growth industries of the new millennium. However, there are certain caveats into this basic premise, primarily access to cheaper and more widely available financial information, more powerful, sophisticated and demanding customers (mainly fund managers) and fiercely intensive competition in an oligopolistic set-up (as in global airline and automobile industries) as factors that are likely to impact margins.

(b) Europe

The factors driving consolidation in **European banking** are overcapacity, deregulation, loss of national protection and increased competition. These factors are likely to be exacerbated by the single currency, weak earnings

growth in many banking business sectors, the need for scale to spread growing Information Technology (IT) and processing costs and the rising demands of shareholders for decent returns. The consolidation trend has been in vogue for some time now among Europe's smaller banks. Following mergers among small savings banks in France, the number of banks declined from 801 in 1990 to 626 in 1994; in Netherlands, they dwindled from 153 to 127. The number of small co-operative banks in Germany fell from 3,221 to 2,591 between 1990-95.

As in USA, larger banks in Europe too have consciously opted for bulge through M&A, enthused by the growing importance (in their chosen markets) and improved financial performance of pioneers such as ABN Amro and ING in the Netherlands - both products of large mergers, BBV (a 1988 merger) and Santander (which took control of Banesto in 1994) in Spain. In the U.K., the two dominant banks are Lloyds TSB and HSBC Midland which have both emerged out of M&A and are now pulling away from others because larger market shares have generated improved profitability.

The prevalent wisdom is for any bank to merge with or acquire a large domestic competitor: banks are most profitable in countries where market share is concentrated in a few entities. As a general rule, the bigger the bank the lower the cost/income ratio. In fact, **observers attribute high market capitalisation as the key driver behind many mergers in Europe and is supposedly a more important consideration to senior executives than whether a merger creates a better business mix for the new group**. A high market capitalisation adds to a bank's strategic flexibility: it allows banks to make hefty investments in technology, add on other desirable acquisitions of banks that have expertise in particular products or countries and even get away from mistakes that might crop up in the process. ING, one of the largest banks in Europe, had a market capitalisation of $ 40 billion at end-December 1997.

Consequently, there were a spate of domestic M&A in Europe last year(1997): Société Généralé and Credit du Nord in France, Bank Austria and

Creditanstalt in Austria, Handelsbanken and Stadshypotek in Sweden, Ambroveneto and Cariplo in Italy besides the celebrated UBS-SBC merger in Switzerland towards the end of 1997. The merger of Bayerische Vereinsbank and Bayerische Hypotheken-und-Wechel-Bank AG in Germany to form BHV is scheduled to be completed by September 1998. BHV has already forecast a double-digit growth in operating profits in 1998 and a medium-term plan of cutting its cost-income ratio from 58.4% in 1997 to 50% by 2003. There is continuing speculation that, at some stage, Barclays and Natwest of U.K. will merge, adding another giant combination to the European banking landscape. According to one estimate, by 2003, the average market capitalisation of a Top-Ten European Bank would be around $80-100 billion, the average for the Top-Twenty perhaps $ 60 billion and likewise, for the Top-Thirty, $45 billion.

The progress of consolidation in European member-states present a mixed trend. Taking percentage of bank-wide assets controlled by top five banks at the beginning of 1997 as the basis, it is obvious that some of the smaller countries like Sweden (86%), the Netherlands (81%) and Finland (74%) have reached the advanced stages of domestic consolidation. In contrast, some of the larger European economies like Germany (17%), Italy (29%), France (47%) and even U.K. (54%) have still some way to go. **For the former group of countries, the next step after cementing a strong domestic market share has been to move cross-border**. For example, ING (Netherlands), with a large domestic share, has moved into Belgium, taking over Banque Bruxelles Lambert (BBL). Similarly, Merita, itself a product of a 1995 merger and with a 40% market share in Finland, has entered into a cross-border merger with Sweden's Nordbanken late last year. In both cases, the participating banks are talking about further cross-border deals. The question of whether banks in the larger European countries will follow suit after becoming national champions remains to be seen. For, there are pluralistic views on the advisability of cross-border mergers, backed by empirical evidence of past mistakes, even with Euro in

place. Even if big banks do start buying or merging with each other across borders, experts believe that it is unlikely that any single bank, Deutsche or ING or Lloyds, would ever quickly become a dominant European bank *under a single brand name*: e.g., it would continue to be BBL in Belgium, NMB in the Netherlands and so on. The advantage would flow essentially from synergies associated with a single "platform": one operating and processing system, one product design group, one treasury.

An interesting empirical trend in the *retail banking* sector, in contrast, is that consolidations have by and large remained national in character. ING's takeover of BBL is a stray example of a cross-border deal and borders are reportedly eroding in Scandinavian countries. It appears that one obstacle to further consolidation is that retail banking has proved stubbornly resistant to economies of scale in the recent past. Complexity in banking activities has in the past tended to offset any benefits accruing from size. But this may change in the future with the increasing intensity of information technology use in banking, in particular telephone/internet banking. EMU will no doubt eliminate most remaining barriers to entry between banking markets in Europe and, at least potentially, heightens the possibility of competition. Even today, Svenska Handelsbanken, the biggest bank in Sweden, has a successful presence in Norway, Denmark and Finland while Germany's Deutsche Bank has 300 branches in both Italy and Spain, and intends to expand into France. But most bankers doubt that cross-border retail banking will take off since there continues to be sizeable advantages for a bank operating in its domestic market.

Another recent development in Europe has been the acquisition of insurance companies by banks, evidenced by the slew of M&A deals: e.g., Credit Suisse with Winterthur in Swizerland, Bank of Ireland and New Ireland (both in 1997) while Halifax bought Clerical & Medical in U.K. in 1996. **The attractiveness of insurance to banks flows from the fact that in mature markets like the U.K., long-term savings, including life insurance, is a**

faster growing and more profitable business than traditional banking. Banks, in turn, score over insurers through their stronger distribution and greater market penetration through branch networks, greater size and financial strength. The latest trend is to simply buy insurance companies, including their assets under management and their different types of sales forces which may include telesales, direct sales and independent financial advisers. But there are considerable cultural differences between a commission-driven insurance salesforce who hard-sell front-loaded policies to customers and bank branches that offer simpler, more transparent accounts to customers who trust them. Thus, even groups like Fortis and ING, which combine banking and insurance, conduct retail banking and insurance under separate committees.

***Pari passu,* the insurance industry itself is consolidating in Europe with plenty of in-market mergers of its own.** For example, Sun Life merged with Equity and Law and Prudential with Scottish Amicable in 1997 as did Axa and UAP in 1996 and Royal and Sun Alliance in 1995.

(c) Developing Economies (including Asia)

A consolidation wave has also got underway in developing economies too in Latin America, Eastern Europe and is slowly emerging in Asia. The forces propelling it in these countries are different from those in the First World countries and may seem ironical considering that the banking system in the former countries is dominated by a few big banks. The fact remains that, barring these major banks, there exist a large number of small, inadequately capitalised banks which, over time, face inexorable elimination through a mixture of liberalisation, banking crises, economic stabilisation and pressure to free trade in financial services in these countries. In Eastern Europe, e.g., many banks are falling victims to the after-effects of unruly liberalisation. Some Governments and Central Banks are using these collapses as an excuse to push consolidation. Thus, **in many parts of the developing**

world, bank mergers and acquisitions are a considered response to a crisis.

Indonesia is the latest entrant in this category. As a conscious response to the recent financial turmoil, Bank International Indonesia, one of the country's largest private banks, announced merger plans with Bank Dagang Nasional, Bank Tiara Asia and two unlisted banks in January 1998 to improve efficiency. This was among the first actions as part of the agreed financial and economic restructuring package between Indonesia and IMF signed in early January 1998 to halt the nation's slide towards economic disaster.

In some countries like Russia, economic stabilisation will help to reduce the number of banks as yields in Government bond markets, the mainstay of many small banks, plummet. Similarly, in Brazil, bankers have been forced to consider tie-ups as new found stability from inflation (since 1995) swept away their old livelihood earned from playing in distorted markets and financing the budget deficit while overlooking credit assessment and efficiency. The merger process started in 1996 and has gained momentum in 1997; experts predict that the number of banks in Brazil will halve to 100 within five years.

In other parts of Asia, however, consolidation has not come about voluntarily or spontaneously, dictated by market realities. Instead, banks had to be coaxed into mergers by the Government and Central Banks of these countries through a mixture of policy initiatives and deterrents with a view to create banking champions who can hold their own on the international stage. South Korea's Central Bank is promoting consolidation by offering carrots to small and sick banks with a view to create banking champions that can hold their own on the international stage. Similarly, Malaysia's regulators have, since 1995, been trying to coax banks into mergers to strengthen them before the Government has to dismantle barriers to foreigners. Bank Negara (Malaysia's Central Bank) hopes to create six large banks in the country out of 37 banks, currently serving a population of 20 million. The

mergers are expected to be approved based on four criteria of compatibility: (i) business compatibility and the merged firm's potential to become a financial supermarket; (ii) asset compatibility and whether the merger will create enough financial strength for investment in technology and infrastructure and (iii) the third and fourth criteria take into account shareholder compatibility and political considerations. In view of the lukewarm response (only one bank -Bank Simpanan Nasional - has big merger plans with three banks to merge its commercial banking arm with after it is corporatised), the Central Bank has introduced a two-tier regulatory system of controls and rewards which give bigger banks regulatory advantages over smaller ones. This includes a 2.5% allowance for overheads, provisions and margins in the base lending rate formula for merged entities. Thailand too is announcing new merger regulations for the financial sector which are expected to give incentives to banks that meet size requirements by merging, including liquidity support. Small banking firms would come under tougher supervision by the Government.

However, a prevalent (and to some preferred) mode to speed up consolidation is the enhancement of minimum capital requirements, forcing the weakest banks to seek new partners or close down. This approach reportedly led to a series of mergers in Estonia after the banking system collapsed in 1992. More recently, this has promoted rationalisation in the banking sector in the Philippines where several banks began merger talks after the Central Bank raised capital requirements in December 1996. In March 1998, these were upped further alongwith higher loan loss provisions. Universal Banks in Philippines will have to raise their minimum capital to 5.5 billion pesos (around $ 138 million) from the present 3.5 billion by 2000 A.D., while for commercial banks, the figure has been revised upwards to 3 billion pesos from 1.6 billion obtaining at present. Indonesia too has recently enhanced the capital requirements for its banks from 50 million rupiah to 3 trillion rupiah which should lead to the development of a healthy financial sector that is more resistant to

adverse shocks. These measures are seen as part of a general thrust to strengthen the banking system and make it more resistant to adverse shocks.

Convergence-related issues

Finally, the type of *convergence* envisaged in Asia is likely to be non-uniform. At least in the initial stages, this would be a narrower type of convergence than seen in other developed markets until the regulatory framework acquiesces to permit insurers to cross-over into the banking arena to provide *bancassurance* offerings. Under Japan's proposed "Big Bang" deregulation of financial markets by 2001, banks can move into equity underwriting and investment management. Non-life insurance premiums will be deregulated and life and non-life companies will be encouraged to enter each other's business.

Generally, in Asia-Pacific, there is far more overlap across the range of financing businesses than cross-fertilization with insurance. Australia has only just announced changes enabling insurers to acquire banking assets. **The future cross-over between insurers and banking on a larger scale, as envisaged in Japan or as found elsewhere internationally, will largely depend on local Government's appetite and initiatives to deregulate the insurance sector.**

Despite these caveats, the fact remains that world-wide, with the opening up of the financial sector, the charter of financial players has changed from specialisation to integration. The perceived advantages from product specialisation are now known to be outweighed by the need to have synergy of operation, which not only reduces the cost of funds, but also helps in providing quality services under one roof. However an integrated operation raises the issue of use of privileged information available to one part of the business to help another part of the business. This can be mitigated by the use

of appropriate internal checks as well as the use of Chinese walls/ firewalls between different functions. It might be argued that the operation of a Chinese wall reduces the cost advantages which arise out of integrated operations. However, advantages which arise out of a uniform brand identity, treasury operations, technology and systems do not depend on the presence of a Chinese wall.

Source :
1. ***Emerging Trends in Banking and Financial Services: A presentation by John I. Tiner, Partner, Arthur Andersen & Associates to IBA (January 15, 1998).***
2. ***Euromoney: February 1998 issue.***
3. ***The Economist (various issues.)***
4. ***Asia Banking Digest (various issues).***

APPENDIX 2

BASLE CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

Preconditions for Effective Banking Supervision

1. An effective system of banking supervision will have clear responsibilities and objective for each agency involved in the supervision of banking organisations. Each such agency should possess operational independence and adequate resources. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking organisation and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

Licensing and Structure

2. The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined, and the use of the word "bank" in names should be controlled as far as possible.

3. The licensing authority must have the right to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the banking organisation's ownership structure, directors and senior management, its operating plan and internal controls, and its projected financial condition, including its capital base; where the proposed owner or parent organisation is a foreign bank, the prior consent of its home country supervisor should be obtained.

4. Banking supervisors must have the authority to review and reject any proposals to transfer significant ownership or controlling interests in existing banks to other parties.

5. Banking supervisors must have the authority to establish criteria for reviewing major acquisitions or investments by a bank and ensuring that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.

Prudential Regulations and Requirements

6. Banking supervisors must set prudent and appropriate minimum capital adequacy requirements for all banks. Such requirements should reflect the risks that the banks undertake and must define the components of capital, bearing in mind their ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the Basle Capital Accord and its amendments.

7. An essential part of any supervisory system is the evaluation of a bank's policies, practices and procedures related to the granting of loans and making of investments and the ongoing management of the loan and investment portfolios.

8. Banking supervisors must be satisfied that banks establish and adhere to adequate policies, practices and procedures for evaluating the quality of assets and the adequacy of loan loss provisions and loan loss reserves.

9. Banking supervisors must be satisfied that banks have management information systems that enable management to identify concentrations within the portfolio and supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers.

10. In order to prevent abuses arising from connected lending, banking supervisors must have in place requirements that banks lend to related companies and individuals on an arm's-length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks.

11. Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring and controlling country risk and transfer risk in

their international lending and investment activities, and for maintaining appropriate reserves against such risks.

12. Banking supervisors must be satisfied that banks have in place systems that accurately measure, monitor and adequately control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.

13. Banking supervisors must be satisfied that banks have in place a comprehensive risk management process (including appropriate board and senior management oversight) to identify, measure, monitor and control all other material risks and, where appropriate, to hold capital against these risks.

14. Banking supervisors must determine that banks have in place internal controls that are adequate for the nature and scale of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding its assets and appropriate independent internal or external audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.

15. Banking supervisors must determine that banks have adequate policies, practices and procedures in place, including strict "know-your-customer" rules, that promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally, by criminal elements.

Methods of Ongoing Banking Supervision

16. An effective banking supervisory system should consist of some form of both on-site and off-site supervision.

17. Banking supervisors must have regular contact with bank management and thorough understanding of the institution's operations.

18. Banking supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on a solo and consolidated basis.

19. Banking supervisors must have a means of independent validation of supervisory information either through on-site examinations or use of external auditors.

20. An essential element of banking supervision is the ability of the supervisors to supervise the banking group on a consolidated basis.

Information Requirements

21. Banking supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisors to obtain a true and fair view of the financial condition of the bank and the profitability of its business, and that the bank publishes on a regular basis financial statements that fairly reflect its condition.

Formal Powers of Supervisors

22. Banking supervisors must have at their disposal adequate supervisory measures to bring about timely corrective action when banks fail to meet prudential requirements (such as minimum capital adequacy ratios), when there are regulatory violations, or where depositors are threatened in any other way. In extreme circumstances, this should include the ability to revoke the banking license or recommend its revocation.

Cross-border Banking

23. Banking supervisors must practise global consolidated supervision over their internationally-active banking organisations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organisations worldwide, primarily at their foreign branches, joint ventures and subsidiaries.

24. A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, primarily host country supervisory authorities.

25. Banking supervisors must require the local operations of foreign banks to be conducted to the same high standards as are required of domestic institutions and must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision.

Source: ***Extract from paper submitted by Basle Committee on Banking Supervision, BIS, Basle (September 1997).***

APPENDIX 3

FINANCIAL SUPERVISION IN A GLOBAL MARKET
(based on a risk-based supervisory framework)

Financial market globalisation, achieved through domestic deregulation and computer technology, has enabled financial firms to develop global business strategies that blur traditional boundaries within the financial services industry. Information and management systems to monitor firms' risk exposure often focus on risk components, enabling globally active financial firms to offset risks and diversify their portfolios to avoid undue risk concentration. In the process, the type of product as well as the location and legal structure of the entity are assuming secondary relevance in assessing risk profiles.

The breakdown of product boundaries and the implementation of global risk management systems pose challenges for both financial firms and the substance of financial oversight within a defined geographic jurisdiction even as firms begin to manage global risk profiles across geographic and product markets. A full understanding of an entity's role within the group and the entity's vulnerability to changes in the group's global risk profile may thus elude the national supervisor. In addition, no one supervisor may have a comprehensive understanding of an individual group's overall risk dynamics.

Financial supervisors and other official bodies are beginning to explore the implications that globalisation holds for supervisory oversight. What systemic risks are created or heightened by firms with global activity? Do financial "conglomerates" with extensive business in more than one industry segment present a particular risk to the system ? Complex corporate structures predominating in some global firms may require closer supervisory scrutiny to determine whether important gaps in oversight exist and, if so, where those gaps occur.

Against the backdrop of these developments, the Institute (IIF) organised the Task Force on Conglomerate Supervision in early 1996. The Task Force is composed of IIF member financial firms active in multiple products and geographic markets. The Task Force believes that **a good opportunity now exists for supervisors to begin considering, in a non-crisis environment, how best to**

supervise the limited number of globally active firms. Improved information-sharing among supervisory agencies internationally and across product sectors may represent a first key step toward adapting the prudential oversight framework to financial market globalisation. The Task Force believes, however, that supervisors should pursue more broad-based revisions in the supervisory framework in order to adapt fully to the globalised financial marketplace.

For example, **supervisors could consider creating an oversight framework for globally active financial institutions that would evaluate management of comparable risk types in a comparable manner in order to form a view of a firm's global risk management**. Such a framework, by definition, would focus on globally active financial institutions rather than so-called "financial conglomerates" because **the Task Force believes that financial market globalisation (not corporate structure) should be the central issue for discussion. The risk-based supervisory framework should focus on explicitly addressing global systemic safety and soundness and should seek to harness market discipline for supervisory purposes.**

Therefore, the Task Force believes that supervisors should begin reviewing fundamental framework issues related to financial market globalisation before proposing changes to supervisory norms. Two key considerations should frame supervisors' choices in this area.

- First, financial supervisors should distinguish between potential systemic risks, which could adversely impact global or sectoral financial markets, and consumer protection concerns, which necessarily are more local in nature. This distinction should facilitate the identification of appropriate policy objectives and instruments to minimise potential systemic risks at the international level. In this manner, domestic consumer protection rules that safeguard specific local markets can remain in place while global or cross-sectoral guidelines can help forge a new relationship between global firms and their regulators.
- Second, as supervisors begin to explore how oversight can be extended effectively to globally active firms, a better approach is required than one that focuses on global corporate structure. **This report suggests that an alternative focus on collecting comparable information on common risk types through regulatory**

reporting and expanded public disclosures may offer a meaningful approach to the supervision of globally active financial firms and financial markets. Specifically, a risk-based approach should enable supervisors to use the communication channels created by expanded information sharing agreements to collect more meaningful information concerning the activities of a financial group.

Focussing on these issues will facilitate creation of a more flexible and modem approach to oversight through risk-based supervision guidelines that would enable superviors to assess each firm's unique set of risks without resorting to globally standardised risk measurement systems. This will require substantial dialogue between supervisors and practitioners, both nationally and internationally.

Implementation of a risk-based approach to supervision for globally active financial institutions also implies that regulatory reporting requirements applicable to these firms could be rationalised significantly. Risk-based regulatory reporting requirements could therefore replace overlapping, redundant, and often contradictory reporting requirements applicable to firms operating under multiple jurisdiction today.

Thus, the regulatory reporting process simultaneously could become both more efficient (because it would be aligned with internal data collection systems at financial firms) and more meaningful (because supervisors would receive more comprehensive and comparable information on a firm's global risk profile). This can be accomplished by exploring whether common data sets of risk types can be collected and shared among supervisors through new and existing information sharing arrangements. At the same time, firms participating in the Task Force agree that public disclosures by financial firms of risk-based information should be expanded.

In sum, the Task Force makes four recommendations for supervisors as they begin to consider adapting the supervisory framework.

- Financial supervisors should consider creating a special supervisory arrangement for globally active financial institutions whose key is to foster the safety and soundness of the global financial system.

- This arrangement should initially focus on collecting information on common risk types present in the financial business (e.g. credit risk, contingent credit risk, market risk, interest rate risk). **A corollary recommendation is that supervisors should avoid collecting information or creating new rules based exclusively on corporate structure. The Task Force calls this new approach a "risk-based supervisory framework".**
- The Home country supervisor for each globally active financial group should receive information on common risk types and should use it to generate an assessment of the financial group's global risk profile. This assessment should be communicated to supervisors for individual entities in the group although the Home Supervisor should not be expected to share the detailed information it receives from other supervisors. **This implies that supervisors will have to upgrade their internal ability to assess risk-based data sets and become more willing to rely on other supervisors' judgements. It also implies that regulatory reporting requirements should be rationalised, at least for globally active financial institutions providing risk-based data sets to their supervisors on a confidential basis.**
- **Financial firms should expand their public disclosures (and confidential regulatory reporting) to increase understanding of their risk management approach** among supervisors, analysts, counterparties, and investors.

<u>Source</u>: ***Excerpts from the Report of the Working Group on Conglomerate Supervision published by The Institute of International Finance, February 1997.***

APPENDIX 4

THE UNIVERSE OF RISKS IN A GLOBALLY INTEGRATED SCENARIO

MARKET RISK

The risk of loss that results from changes in interest rates, foreign exchange rates, equity and commodity prices is usually referred to as Market Risk. The two main components of market risk for Indian financial institutions are:

Interest Rate Risk

Foreign Exchange Rate Risk

INTEREST RATE RISK

Interest Rate Risk is the potential impact on an institution's earnings (net interest income) and market/economic value due to the movement in interest rates. Interest rate risk arises from interest rate mismatches in both the volume and maturity of interest-sensitive assets, liabilities and off-balance sheet items. An unanticipated movement in interest rate can seriously affect the profitability of the institution.

Interest rate movements have two types of impacts – earnings/income impact and/or value/price impact. The earnings impact refers to the impact of interest rate movements on the earnings of an institution. This is usually addressed by monitoring the Net Interest Income (NII) impact on the concern. The value/price impact refers to the changes in price / values of various components of an institution's asset/liability portfolio due to movements in interest rates. This is usually addressed through the concept of benchmarking and computation of market/economic values.

An institution typically lends at either fixed or variable rate and where the variable rate is linked to some reference rate. Thus, there may be an interest rate mismatch, such as a mismatch between fixed and variable rate assets and liabilities. If an institution have excess fixed rate assets, they are vulnerable to rising interest rates and in case of excess fixed rate liabilities, they would be vulnerable to falling rates. Further, Bank/DFI may be either asset sensitive, implying that their interest rate sensitive assets reprice faster than their interest rate sensitive liabilities, or liability sensitive, where the opposite is the case. Typically, if the former is the norm, a fall in interest rates will reduce net interest income by reducing their yield on assets as

compared to its cost of funds. If, however, an institution is liability sensitive, a rise in interest liability will reduce net income.

Repricing Mismatch Risk

This arises when there are mismatches or gaps in the amount of assets, liabilities and off-balance sheet instruments that mature or get repriced in a given period. The following techniques are usually employed to manage this risk:

Gap Analysis

The "gap" is the difference between interest-sensitive assets and liabilities for a given time interval. In gap analysis, each of the institution's asset and liability categories are classified according to the dates on which the asset or liability is repriced as different "time buckets". Normally both incremental gaps and cumulative gaps are computed. An incremental gap could be defined as the gap between earning assets-funding sources in each time bucket; cumulative gaps are the cumulative subtotals of the incremental gaps. A negative gap means sensitive liabilities > sensitive assets: a positive gap means sensitive assets > sensitive liabilities. The gap ratio would be the ratio of sensitive assets to sensitive liabilities. A gap ratio of 1 would indicate a complete matching of both the assets and liabilities. The impact of negative/positive gap position would be contingent upon direction and magnitude of interest rate movements. For instance, in the event of a positive gap, a rise in interest rates will cause the institution to have a return on assets rising faster than the cost of liabilities. If interest rates fall, cost of liabilities will rise faster than return on assets. Gap Analysis provides the platform for an institution to view the overall balance sheet mismatches. Availability of relevant, timely and accurate data is a pre-requisite to facilitate such an analytical approach.

Duration Analysis

Duration is the calculation of the average life cycle involving a process of discounting future cash flows to net present values. The concept of duration captures both the size and timing of the future cash flow. Through duration analysis, it is possible to compute the impact of changes in value of an asset/liability or a portfolio of assets/liabilities for every percentage rise and/or fall in interest rates.

Duration Gap Analysis

This form of analysis is a melange of both gap and duration analysis. The duration of the assets and liabilities are matched, instead of matching them until

repricing, as in standard gap analysis. The on and off balance sheet interest sensitive position of the institution are placed in time bands, based on the maturity of the instrument. The position in each time band is netted and the net position is weighted by an estimate of its duration, where duration measures the price sensitivity of fixed rate instruments with different maturities to changes in interest rates. If the duration of designated deposits and liabilities are matched, then the "duration gap" on that part of the balance sheet is zero. This part of the balance sheet is said to be *immunized* against unexpected changes in interest rates. This tool can be used to measure small changes in interest rates for short-term time horizons due to the limitations of convexity.

Value at Risk

Value at Risk (VAR) is a concept that uses statistical models to calculate, with a given confidence level, the maximum loss in value that the institution would incur from an adverse movement in market rates. VAR takes into account numerous variables that may cause a change in the value of portfolios, including interest rates, foreign exchange rates, equity and commodity prices, volatilities and correlations between these variables. VAR methodology provides a uniform measure for evaluating and communicating relative levels of market risk as well as providing a mechanism for aggregating institution-wide market risk exposure into a single number, which encompasses all major underlying risks. VAR is thus the total value of a potential risk an institution stands to lose while holding a market position. Some of the factors about which assumptions would need to be made while undertaking a VAR computation are:

- The distribution of price changes – for example, do they follow a normal distribution?
- The extent to which today's change in the price of an asset is correlated to past changes in the price – can it be assumed that these price changes are serially uncorrelated?
- The extent to which the characteristics of mean and standard deviation (volatility) are stable over time;
- The interrelationship between two or more different price moves;
- The data series to which these assumptions apply

Normally, while employing VAR, the time horizon is extremely short – normally a day and is usually the time taken to sell or hedge out a position.

Basis Risk

This risk arises due to the change/mismatch between various indices upon which an organisation prices its products. For instance, two internationally accepted interest rate indices are LIBOR and PRIME. Both these indices usually are unidirectional but there is usually a time lag between their movements. The intensity of movements also need not always be the same.

An institution could choose to price its assets based on PRIME while it could source its liabilities based on LIBOR. It would then have taken a basis risk exposure on its books. Such an organisation would need to closely monitor both these indices for appropriate price adjustments.

Options Risk

Options risk arises when a product contains a feature, commonly referred to as an embedded option, which allows modification of cash flows or price of the transaction. Premature encashment of a Time Deposit is a case of embedded option whereby a customer exercises the option to withdraw the relative deposit ahead of its contractual mandate. This is usually witnessed when the yield curve is rising or better yields are available in the market as compared to the return on the relative deposit.

Simple variants of options risk such as premature encashments etc. could possibly be built into the behavioural patterns of various customers/products and factored into the Gap Analysis. However, options risk arising out of off-balance sheet products such as derivatives, swaps etc. is usually captured through the VAR technique.

FOREIGN EXCHANGE RISK

Foreign exchange or currency risk arises from exposure in foreign exchange. Any net short or long open position in a given currency will expose an institution to foreign exchange risk. An institution with global operations experiences multiple currency exposures. Foreign exchange risk arises from adverse exchange rate movements, which affects the institution's foreign exchange positions taken on its own account, or on behalf of its customers. Banks/DFIs usually engage in spot and/or forward dealings. Mismatch both by currency and maturity is an essential feature of foreign exchange business.

Spot Foreign Exchange Risk

Spot Foreign Exchange Risk arises when the total present value of assets in any currency does not equal the total present value of liabilities in that currency. Unless there is a match between the level of assets, liabilities and off-balance sheet items in each currency, there is a risk that exchange rate movements may have a negative financial impact. This risk is usually measured through the VAR methodology. All institutions have various limits in place viz., Intra-day trading limits which fix the size of exposure during the day, Overnight trading limits which fix the maximum spot exchange position allowed overnight and Stopless limits. These limits are usually fixed per currency per dealer.

Forward Foreign Exchange Risk

This risk arises when, for a given currency, the maturity profile of forward purchases differs from the maturity profile of forward sales. Unless there is a match between the level of assets, liabilities and off-balance sheet items in each currency, there is a risk that exchange rate movements may have a negative financial impact. An open forward position is exposed to interest rate risk since the interest differentials of the currencies concerned are subject to fluctuations over time. This risk is usually measured through the VAR methodology. All institutions have various limits in place viz., Intraday trading limits which fix the size of exposure during the day, Overnight trading limits which fix the maximum position allowed overnight and Stopless limits. These limits too are usually fixed per currency per dealer.

The traditional focus of the Asset Liability Management process within a Bank/DFI is the management of market risk.

A Bank/DFI should divide its portfolio into two distinct types – the trading portion and the non-trading portion. The market risks of both these segments should be addressed differently.

The trading book is usually monitored through the Value at Risk methodology arising out of the need for its close monitoring due to the potential impact it could have on the institution's balance sheet and overall operations. The non-trading portion is usually less actively managed through other less rigorous models viz., Gaps, Duration, Simulation etc.

Market Risk needs to be addressed through a comprehensive Asset Liability Management Policy which should include, inter-alia, objectives, philosophy, limits, roles,

responsibilities, risk limits, methodologies, reportings etc., duly approved by the Board of Directors with provision for periodic review.

CREDIT RISK

Credit Risk results from the unwillingness/inability of a client to honour his repayment commitments. It can be further segregated into direct credit risk (e.g. loans) and credit equivalent exposure (e.g. performance guarantees, swaps etc.).

In order to have a well laid out policy framework that results in more effective credit risk management, the following needs to be addressed :

1. The credit administration function and the business promotion function needs to be separated in order to prevent conflict of interest and to have better control on credit quality. This can be done by having a separate department to assess the credit quality of borrowers independently.

2. Concentration of credit risk needs to be avoided by clearly laid limits for individual borrowers, groups and industries.

3. There should be a standard methodology in place for measuring credit risk. This can be done by assessing the quality of the borrower and differentiating between borrowers of varying quality by linking lending rates and credit limits/exposure to the quality of the borrower.

4. Methods and models for measuring credit risk need to be reviewed regularly.

5. Banks/DFIs need to come up with a mechanism for sharing information relating to defaulters.

6. There should be stringent processes in place for monitoring the end-use of funds disbursed to the client. These could be in the form of appointment of nominee directors and concurrent auditors during project implementation and regular site visits by the credit officer himself.

7. The loan covenants, wherever necessary, should be structured so as to provide credit enhancement.

8. Valuation of collateral should be carried out on a regular basis so as to identify shortfalls (if any) and take remedial measures to protect the interest of Banks/DFIs.

9. There should be well defined authorisation procedure for sanctioning assistance and pricing. There should also be a clearly laid out policy for action to be taken in case of any excessions. There should be a system of reporting excessions to the Top Management.

10. Capital allocation needs to vary across borrowers, depending on their exposure and credit quality. This would weed out the possibility of cross subsidisation i.e. if the capital allocated is fixed across all borrowers, it would result in subsidisation of the lower quality borrowers at the expense of better quality borrowers, which would be inconsistent. Therefore, such capital allocation would require the amount of capital allocated to a borrower to be linked to credit quality.

11. The Banks/DFIs need to compile manuals specifying methodology employed for credit evaluation and approval. This would ensure uniform credit approval criteria within the Bank. These manuals need to be reviewed regularly and revised, if necessary.

12. Regular monitoring of large exposures (or credit review) is a must. The monitoring process should cover the payment record of the borrower, status of projects on hand, sensitivity analysis of projected profitability given current and likely prices and interest rates.

13. Independent review of borrower's credibility - industry and business analysis needs to be carried out on a regular basis by an independent research cell within the Bank (a function distinct from that of the credit officer who acquires the business). Credit rating of the borrowers should be done by the Banks/Financial Institutions themselves as they have access to much more information than the external rating agencies.

14. Any new products should be introduced only after getting approval of the risk management department.

LIQUIDITY RISK

Liquidity risk is usually associated with an institution finding itself unable to meet its commitments on time, or being able to do so by emergency borrowings, probably at

high cost. Liquidity management is geared to ensure that the organisation has the ability to obtain sufficient cash or its equivalent in a timely manner at a reasonable price to meet its commitments as they fall due. Liquidity concerns of financial intermediaries stem from its immediate obligations, such as deposit withdrawals or legitimate loan demands that it must meet. One of the most important tasks is measuring and managing the institution's liquidity needs. The liquidity needs requires to be measured dynamically. Long-run profitability may be hurt if an organisation has too much in low-earning liquidity sources in relation to its needs for such liquidity. On the other hand, too little liquidity may lead to severe financial problems and even failure. Liquidity can emerge from either side of the balance sheet of an institution – increase in liabilities and/or reduction of assets. An organisation's approach to liquidity and funding needs to be comprehensively examined and recorded in a Liquidity and Funding Document, which should be approved by the Board.

Dynamic Liquidity Measurement

Appropriate management of the money position usually meets daily liquidity needs (hourly in the case of some institutions). There, however, remain short-term, cyclical and trend needs for liquidity which any well-managed institution will try to estimate as accurately as possible. The best guides in this regard are past experience and knowledge of events that are likely to affect liquidity needs.

Short-term liquidity needs may arise from several sources. Institutions that are heavily dependent on one or a few types of customers may find seasonal liquidity needs particularly important. Estimation of short-term needs usually revolves around knowledge of the needs and intentions of large business interests. With availability of requisite data, it may be possible to predict, with a reasonable sense of accuracy the needs of short-term liquidity by employing various computer-modelling techniques.

Cyclical liquidity needs are much more difficult to estimate as they are often beyond the control of any individual institution. Economic recession or boom and interest rate movements, particularly when institutions may be constrained from changing their own rates because of regulation, can cause significant liquidity pressures. Further, the timing of such cyclical pressures can be very difficult to predict. An institution, which provides for all potential cyclical liquidity needs would probably end up holding primarily low-yielding liquid assets which will result in significantly lower profitability. The lower risk of this high liquidity position would probably not offset the

negative impact of these lower returns. Some of the methods that could be employed to estimate cyclical liquidity needs are: monitoring current loan utilisation patterns vis-à-vis previous trends; correlation patterns between deposit flows and selected indicators such as the level of interest rates, changes in rates etc. that may provide guidelines for deposit inflows and outflows. Computer simulation models would need to be developed to suit individual needs.

Trend Liquidity needs are required for liquidity demands that can be predicted over a longer time span. These longer-term liquidity needs are generally related to the secular trends of the market(s) in which the institution operates. In rapidly expanding markets for instance, loans often grow faster than deposits. In such a situation, sources of liquidity to provide funds for loan expansion need to be established. Attempts at long-range economic forecasting could provide the most dependable basis for a reasonable estimation of loan and deposit levels for the subsequent financial year.

Liquidity Fulfillment

Provision for liquidity needs is as complex as estimating them. Some of the factors that go into this decision making process are:

Purpose - The purpose for which liquidity is needed will often dictate the source of meeting the relative requirement. For instance, seasonal liquidity needs tend to be reasonably repetitive in extent, duration and timing. There would thus be moderate risk in sourcing these needs from purchased liquidity sources.

Market Access – The size, reputation and reach of an organisation would be a crucial determinant of its liquidity sourcing.

Managerial Philosophy – The management philosophy is an important factor. This philosophy usually consists of a set of implicit or explicit liquidity guidelines established by the Top Management. For instance, an institution that makes little or no use of purchased funding sources for liquidity needs usually reflects a "*conservative management philosophy*". On the other hand, an organisation that seeks out purchased funds from any available source, as long as the total cost of such funds is less than the net rate of return it is earning by investing them could be said to have an "*aggressive management philosophy*".

Interest Rate Forecast – The opinions on the future course of interest rates also affect an institution's choice among alternatives for meeting liquidity needs.

Contingent Liquidity

Every institution needs to have adequate resources to fall upon to meet unexpected incidents. Contingency needs are caused by unusual events that are difficult if not impossible to predict – unusually large outflow of deposits pursuant to a rumour about the organisation, larger than expected loan increases etc. Every organisation ought to have a *Liquid Contingency Plan* to remain liquid in case some contingencies occur.

OPERATING RISKS

Operating risk is the potential for loss caused by the breakdown in information, processing, settlement and legal compliance systems. It can also result from systems or procedural failures, human error, the impact of natural disasters and criminal activity.

While operating risk can never be fully eliminated, the institution should endeavor to minimise it by ensuring that the appropriate infrastructure control systems and people are in place throughout its organisation. Key policies and procedures involved in managing operating risk would involve evolution of detailed instructions for all activities, segregation of duties, delegation of authorities and responsibilities, risk monitoring, financial and managerial reporting, on-going inspection and audit processes, provision of proper, safe and adequate storage, updation and retrieval of records, continuous review of existing instructions, procedures and practices. The institution should also have in place extensive back-up capabilities to ensure on-going service delivery under adverse conditions.

The risks of global operations also merit mention. While global diversification of operations often allows improvement in profitability and shareholder value, it calls for a very high degree of sophisticated risk control and management. However, fraud or financial mismanagement is even harder to detect in international operations, thereby increasing operating risk.

PEOPLE RISK

Banks/DFIs are basically service providers and are as such heavily dependent upon its human resource assets. Every organisation needs to address this issue comprehensively and put in place appropriate policies which provide for proper

recruitment, placement, training, career planning, specialisation, motivation, roles and responsibilities, reporting relationships, controls etc. These policies would need constant review in keeping with changing objectives, practices, market and other operating realities.

REPUTATIONAL/COMPETITIVE RISK

Banks/DFIs, by the very nature of their operations, tend to be highly leveraged than other businesses individuals feel safe placing their resources with Banks/DFIs with a reputation for soundness. There are normally no sudden or random changes in the amount people wish to save or borrow; hence the financial system as a whole generally tends to be stable, unless the customers are given reason to believe otherwise. It is here that the reputation of the organisation comes to the fore. The organisation's ability to withstand competitive pressures, maintain/improve market confidence and pro-actively manage/improve upon its returns on an ongoing basis will ultimately have a significant bearing on its bottomline. Competitive pressures are bound to increase and will need to be managed through on-going proactive and innovative strategies. Some of the internal competitive issues that financial institutions would need to increasingly focus their attention on include productivity, efficiency, economies of scale and scope etc. Further, the flexibility and the ability of the institution to adapt itself to the changing operating conditions, regulations, market expectations etc., would dictate its competitive position to a significant extent.

REGULATORY/LEGISLATIVE RISK

Banks/DFIs, like any other commercial enterprise, are subject to regulation and compliance functions. The ability to foresee, plan and take in its stride the consequences arising out of various legislative/regulatory challenges would be an important area of concern for the Top Management of all Banks/DFIs.

SYSTEMIC RISK

Systemic Risk refers to the possibility of a sudden, usually unexpected event that disrupts the financial markets and thus the efficient channelling of resources quickly enough and on a large enough scale to cause a significant loss to the real

economy. These are external risks beyond the control of the organisation. However, the ability to face challenges arising out of such risks would be contingent upon how effectively it has been able to manage the other aforesaid risks.

TECHNOLOGY RISK

Risk control entails extensive investment in technology, which throws open another risk front that needs attention – the risk arising out of technological dependence. Some of the critical issues that needs to be addressed in this connection would include selection of relative capabilities, its customisation and parameterisation to suit specific individual needs, training of manpower, continuous review and updation; putting in place comprehensive operating manuals and instructions, incorporation of stringent safety and security features, disaster management concerns, etc.

SOVEREIGN RISK

Banks/DFIs are operating in a borderless environment and are constrained by the credit rating of the country. Any change in the sovereign rating will have an effect on the individual institutional credit rating. This risk is also outside the control of an individual institution.

Source : *Reference paper submitted by sub-Group III to Working Group.*

APPENDIX 5

GLOBAL ADVANCES IN TECHNOLOGY AND TELECOMMUNICATIONS

Internationally, computing and communications are experiencing rapid and sweeping technological improvements. In conjunction with increasing globalisation and cross-border business, this is metamorphosing the world's financial institutions to a significant degree. Investments in technology have multiplied: US banks, which spent around $ 10 billion on Technology in 1987, expended over $18 billion in 1996. Banks in some developing economies, such as the former Soviet Union and Eastern Europe, have transited directly from technologically-backward state institutions into some of the most leading-edge technological products without any intermediate steps. Such a leap forward is, of course, dependent on the available technical infrastructure and degree of commercial sophistication. The IT products are also becoming more user-friendly and cost-effective to adopt.

A global scan shows up that extant and prospective advances in information and telecommunication technologies in banking are headed in the following direction:

- **There is a pronounced orientation towards electronic banking**. An estimated 40% odd level of banks offer electronic banking facilities today. This number is poised to swell to 85% by 2000A.D. A logical extension of PC/ATM banking is Internet Banking. The latter is the next stage of the distribution revolution, and not just at the retail level. A survey of 220 financial institutions by management consultants Booz Allen and Hamilton reveals that about 42% of their customers plan to avail of corporate banking services based on Internet and Intranet. [*Intranet aids dissemination and sharing of information in a closed user group, permits better and faster flow of communications, eliminates duplication of databases and inconsistencies thereof because of data centralisation. SWIFT in India is a successful Intranet application*]. There will be around 600 to 700 fully functioning corporate **Internet Banks** by the year 2000, led by benefits of round-the-clock access from multiple locations, rapid execution and service, ready availability of transaction and payment histories and low transaction costs for banks. Internet Banking has been a great success in Finland, Sweden,

Norway and Iceland. In Asia, Singapore has been in the forefront of Internet Banking with three of its leading banks (DBS Bank, United Overseas Bank and POS Bank) launching these services recently. Malaysian banks are likely to follow suit once regulatory restrictions are removed. On the other hand, Bacob Bank in Belgium is one of the growing clan of financial institutions reaping the rewards of a corporate-wide Intranet.

- **Today, globally, there is an increasing acceptability of the credit card or the so-called 'electronic purse'**, as exemplified by the volumes and transactions recorded by the two global credit card giants- Mastercard International and Visa International. Charge and debit cards too have a large following. **The micro-chip embedded 'smart cards' are poised to be the next major contributor to electronic commerce**. By the year 2000, smart cards are likely to replace cash for around 3.6 billion people, with a third of these to be domiciled in Asia. In Asia, Singapore has taken the lead with seven Singaporean banks forming a Consortium called Network for Electronic Transfers. The network facilitates use of ATM and smart cash cards. Malaysia is likely to follow suit with a multipurpose electronic purse soon. The smart cards would ease the tedium and cost of handling cash and would additionally provide valuable inputs on consumer behaviour and their purchase trends.
- **The electronic mail (or e-mail) has become commonplace abroad as a low cost, fairly prompt means of communication**. The Electronic Messaging Association expects the year 2000 to throw up a message traffic of about 6 trillion. But the concept is yet to catch on in meaningful measure in India's financial landscape. An e-mail facility through a PC and modem in every branch eliminates the cost of long-distance STD calls, courier charges and fax transmission expenses, thereby shoring up the banks' bottomline.
- Another delivery mechanism, which is being widely exploited abroad, is the Electronic Data Interchange (EDI) . This facilitates exchange of structured and formatted messages conforming to UN/EDIFACT standards between the computer systems of trading partners and their bank. **Originally dedicated to domestic (electronic) commerce, big banks in Europe and the USA are already working on Financial Electronic Data Interchange for the Internet.**

- For traditional financial service providers, electronic commerce will put enormous pressure on profit margins. Both retail and commercial consumers can now garner a wide range of competitive price information and quotes almost instantly. In the forseeable future, retail as well as professional and commercial purchasers of financial products will be able to buy these on a best-price or best-risk basis from providers based anywhere in the world. This underlines the extent of change that technology will bring to the financial services sector worldwide.
- With the advances in information technologies and the rapid decrease in the cost of very high powered computing and database resources, **it is now possible, on a near real-time basis, to manage the risks of operating in a very wide variety of product-markets** such as retail/ wholesale banking, derivatives, bond and currency trading and insurance. Information technology allows, for example, J.P. Morgan to generate, for the benefit of its management, a daily "*four-fifteen Report*" which, on a global basis, provides information on J.P. Morgan's exposure to a wide variety of risks. Historically, one of the rationales for ensuring that entities entered very narrowly defined product-markets was that, on a manual basis, it was impossible to assess the risks of operating in more than one market on a timely basis.
- **The advances in IT has been attended by commensurate strides in telecommunication technologies**. With the advent of cellular telephones, VSAT networks, satellite based international as well as domestic communications, a whole host of possibilities have opened up all over the globe (including India). More specifically, developments such as the introduction of nation-wide toll free numbers (which is imminent in India) now make possible seamless and interactive communication between geographically remote customers and service providers. This would shrink rapidly the need for things like full-service rural branch networks for the provision of basic banking services. Similarly, it is possible to effect a complete geographical separation of back-offices from front-offices, allowing economies of scale to play in the hardware intensive back-offices and shrinking the investment required to create points of physical contact (front-offices) with the eventual customer. This would help to

rapidly bring down the barriers to entry even into traditional retail banking business.

The world has never been more reliant on technology, which is increasing with the growing use of Internet, Intranet, EDI and various other banking innovations. Evolution of technology is taking place at an enormous pace and the approach to automation in Banking must have an element of healthy opportunism. Technology development with a decided strategic focus has the potential to provide a competitive advantage in a global environment.

Source : ***Extracts from "Special Issue on Banking Technology", The Journal of the Indian Institute of Bankers, October-December 1997.***

APPENDIX 6

SERIOUS FRAUD OFFICE IN THE U.K. : KEY FEATURES

Genesis

During the 1970's and early 1980's, there was considerable public dissatisfaction with the system of investigation and prosecution of serious and complex frauds in UK. The general feeling was that major fraudsters were "getting away with it" and that the system could not cope with the prosecution of such complex cases.

When the Fraud Trials Committee published their report (known as Roskill Report) in 1986, their main recommendation was that there was a need for a new unified organisation to assume all the functions of detection, investigation and prosecution of serious fraud cases. This need was subsequently met with the establishment of the Serious Fraud Office (SFOs) in April 1988. The office and its powers were created under the Criminal Justice Act, 1987.

Objectives

The principal aim of SFO is to deter fraud and maintain confidence in the UK's financial system by appropriate and effective investigation and prosecution of serious and complex frauds in England, Wales and Northern Ireland. The key criterion for deciding whether the SFO would accept a case is that the suspected fraud is such that the direction of the investigation should be in the hands of those responsible for the prosecution.

Salient Features

The various criteria governing acceptance of a case by the SFO are:

- frauds in excess of GBP 1 million. This is simply an objective and recognisable signpost of seriousness and likely public concern, rather than the main indicator of suitability;
- cases likely to give rise to national publicity and widespread public concern;
- cases requiring highly specialised knowledge of, for example, stock exchange practises or regulated markets;
- cases in which there is a significant international dimension;

- cases where legal, accountancy, and investigative skills need to be brought together; and
- cases which appear to be complex.

None of these factors, taken individually, should necessarily be regarded as conclusive.

The SFO is an independent government department and the Director exercises her powers under the superintendence of the Attorney General. The Director maintains contact with government departments and regulatory bodies such as the Department of Trade and Industry, Bank of England, Financial Services Authority, International Stock Exchange, Take-over Panel, and others. These and other organisations report to the SFO allegations of serious or complex fraud. Other cases of fraud are mainly dealt with by the police and the Crown Prosecution Service (CPS).

The distinctive feature of the SFO's approach to investigations is the use of multi-disciplinary teams. When a case is accepted, a case team of lawyers, accountants, police officers and support staff is appointed. The confluence of a team of people from varied forms of expertise is necessitated by the vast quantities of documents left in a deliberately obscure and fragmented form in major fraud cases that would need to be shaped into a compact and coherent document which would stand up to the scrutiny of courts. The team is headed by a lawyer who, as case controller, is responsible for ensuring an expeditious and effective investigation and for any ensuing prosecution. Once the case has been investigated, the SFO will consider whether there is a realistic prospect of securing a conviction based on accumulated evidence and whether the public interest requires a prosecution before instituting any criminal proceedings.

The operations of SFO have been reviewed three times, most recently by Rex Davie CB in 1995. Davie recommended that the SFO should remain as a separate focused organisation. In order to minimise the overlap between cases dealt with by the SFO and CPS, a new set of criteria were devised. These ensure that the SFO's powers of investigation, its resources and expertise are devoted to the right cases. Further, effective February 1995, the SFO has been empowered, through enabling legal reforms, to use its investigative Section 2 powers to assist fraud investigators overseas where so referred by the Home Secretary. Institutional co-operation has assumed

priority as most of the core cases investigated by it have a foreign dimension. A greater ability to assist criminal justice authorities in other countries is an important way to combat fraud at an international level. To receive SFO help, an overseas authority would have to write to the Home Office who, if he deems it to be appropriate, would refer the case to the SFO. The latter, in turn, would examine whether the case met the SFO's criteria. With transnational fraud assuming prominence, the SFO would continue to play a vital role in this area and is gearing itself accordingly.

Source: ***(1) " Serious Fraud Office - What it does and how it works": Press and Information Office, Serious Fraud Office.***

(2) 'The Serious Fraud Office Ten Years on'(April 1998) - Robert Wardle, Assistant Director, Serious Fraud Office.