X FINANCIAL REGULATION AND SUPERVISION

10.1 Financial sector reforms during 2001-02 continued to focus on strengthening the financial system and improving the functioning of the various segments. The broad parameters of the reforms undertaken during the year comprised ongoing deregulation of the operation of institutions within the Reserve Bank's regulatory ambit, tightening of the prudential norms and improvement in the supervisory oversight, expanding transparency and market disclosure, all with a view to improving overall efficiency and stability of the financial system.

The Board for Financial Supervision

10.2 The Board for Financial Supervision (BFS), which is entrusted with supervision of commercial banks, select all-India financial institutions (FIs), non-banking financial companies (NBFCs), the Clearing Corporation of India Ltd. (CCIL) and primary dealers (PDs), monitored and reviewed the performance of these institutions and provided guidance on regulatory and supervisory policy decisions. The strategy pursued by the BFS was delineated with a focus on institution-specific supervisory concerns. The BFS also engaged in the monitoring of bank frauds and overseeing issues in house-keeping in public sector banks (PSBs) including reconciliation of entries in inter-branch and inter-bank accounts (including *nostro* accounts) and balancing of the books of accounts.

10.3 During 2001-02 (July 2001 to June 2002), the BFS held 12 meetings. In these meetings, the Board reviewed inspection reports and considered various memoranda on the performance of banks, FIs and subsidiaries of banks for the quarters ending September 30, 2000, December 31, 2000, March 31, 2001, September 30, 2001 and December 31, 2001. During the period under review, the Audit Sub-Committee of BFS held two meetings. The Sub-Committee considered revision of audit fees, *etc.,* payable to the central statutory auditors of PSBs and restoration of audit work to certain firms who were denied such work earlier.

10.4 The Audit Sub-Committee of the BFS recommended various measures to deal with the accounting and regulatory implications of Voluntary Retirement Scheme (VRS) implementation in PSBs. They broadly related to disclosures, allocation of expenditure and providing relief to banks on one-time burden without compromising regulatory standards. The procedure to be adopted for appointment of statutory auditors for State Finance Corporations (SFCs) from 2001-02 and their remuneration was approved. The system of half-yearly review was introduced in September 2001 and the format of review reports approved by the Sub-Committee was finalised in consultation with the Securities and Exchange Board of India (SEBI) and forwarded to all PSBs for introduction from September 2001. All Indian private sector banks were advised about the minimum eligibility norms prescribed for audit firms to be appointed as their statutory auditors effective 2001-02 onwards.

10.5 During 2001-02 (July-June), annual financial inspections in respect of 27 PSBs, 14 local head offices (LHOs) of the State Bank of India, 31 private sector banks and 38 foreign banks, two local area banks and ten all-India FIs were completed. The BFS reviewed 126 Inspection Reports during 2001-02; of these, 77 related to the position as at end-March 2001.

10.6 As banks are under the regulatory and supervisory oversight of the BFS, it was decided that regulation of institutions performing payment and settlement services for systemically important systems such as the Clearing Corporation of India Ltd. be performed by the Reserve Bank and oversight on them by the BFS.

10.7 In the recent period, PDs have become systemically important as they are leveraged entities with mostly short-term funds and relatively high interest rate risk. Their share in the government securities market is substantial and their participation in the money markets is on par with banks. Accordingly, the supervision of PDs has been brought under the regulatory purview of the BFS.

SCHEDULED COMMERCIAL BANKS

10.8 Scheduled commercial banks (SCBs) improved their performance in 2001-02 as reflected in key financial parameters. The ratio of operating

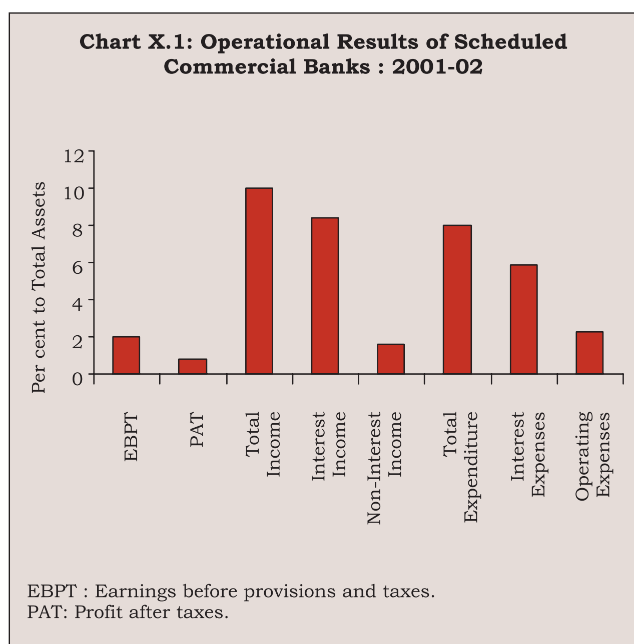
profits to total assets of SCBs increased to 2.0 per cent during 2001-02 from 1.5 per cent during 2000-01 while that of net profits to total assets rose to 0.8 per cent from 0.5 per cent over the same period. Total income and total expenditure of SCBs amounted to 10.0 per cent and 8.1 per cent, respectively, of their total assets during 2001-02 as compared with 10.2 per cent and 9.7 per cent, respectively, during 2000-01 (Chart X.1).

10.9 During 2001-02, 69 banks recorded increase in the ratios of their operating as well as net profits to total assets (Table 10.1).

10.10 As at end-March 2002, all SCBs (except five) recorded capital to risk-weighted asset ratios (CRARs) in excess of the stipulated nine per cent with as many as 53 SCBs posting CRAR between 10 per cent and 15 per cent while for another 30 SCBs, CRARs were in excess of 15 per cent (Table 10.2).

10.11 The ratio of gross non-performing assets (NPAs) to gross advances of SCBs was 10.8 per cent as at end-March 2002, lower than that of 11.4 per cent as at end-March 2001. The ratio of net NPAs to net advances at 5.9 per cent as at end-March 2002 was also lower than that of 6.2 per cent as at end-March 2001. Bank-group wise, the ratio of net NPAs to net advances was the highest for old private sector banks (7.5 per cent) and the lowest for foreign banks (1.8 per cent). The ratios of gross NPAs to total assets and that of net NPAs to total assets for all SCBs were 4.8 per cent and 2.6 per cent, respectively, as at end-March 2002 as compared with 4.9 per cent and 2.5 per cent, respectively, as at end-March 2001 (Chart X.2).

Chart X.1: Operational Results of Scheduled Commercial Banks : 2001-02



EBPT : Earnings before provisions and taxes.
PAT: Profit after taxes.

10.12 The majority of SCBs - 74 out of 97 banks - recorded net NPAs within 10 per cent of their net advances (Table 10.3).

Policy Initiatives in the Banking Sector

10.13 The thrust of the ongoing reforms in the banking sector was on increasing operational

Table 10.1: Operational Results of Scheduled Commercial Banks during 2001-02

(Number of Banks Showing Increase in Ratios during the Year)

Ratio to Total Assets	Public Sector Banks		Private Sector Banks		Foreign Banks	All Banks
	SBI Group	Nationalised Banks	Old	New		
1	2	3	4	5	6	7
Earnings before provisions and taxes (EBPT)	8	18	21	4	18	69
Profits after tax (PAT)	8	17	22	3	19	69
Total income	4	13	15	4	14	50
Interest income	3	5	3	3	11	25
Non-interest income	7	17	21	7	18	70
Total expenditure	–	2	8	3	14	27
Interest expenses	2	5	6	3	15	31
Operating expenses	–	6	11	5	17	39
Provisions and contingencies	8	12	18	7	18	63

Note: 1. Data are provisional.
2. Date relate to domestic operations only.

Table 10.2: Capital to Risk-weighted Asset Ratio (CRAR) of SCBs: end-March 2002

(Frequency Distribution)

CRAR	Public Sector Banks		Private Sector Banks		Foreign Banks	All Banks
	SBI Group	Natio-nalised Banks	Old	New		
1	2	3	4	5	6	7
Negative	–	–	2	–	1	3
Between 0 and 9 per cent	–	2	–	–	–	2
Between 9 and 10 per cent	–	2	2	2	3	9
Between 10 and 15 per cent	8	14	12	6	13	53
15 per cent and above	–	1	7	–	22	30
Total	**8**	**19**	**23**	**8**	**39**	**97**

Note : Data are provisional.

effectiveness, strengthening the prudential and supervisory norms, developing the technological and institutional infrastructure and redefining the regulatory role of the Reserve Bank.

Exposure Norms

10.14 Ceilings on exposure to single/group borrowers serve to limit credit risk in banks' portfolios and have been linked to capital funds of banks as reckoned for capital adequacy purposes. Effective March 2002, the exposure limit for individual borrowers was lowered from 20 per cent to 15 per cent and for group borrowers from 50 per cent to 40 per cent of banks' capital funds. Credit exposure to borrowers belonging to a group may exceed exposure norms of 40 per cent by an additional 10 percentage

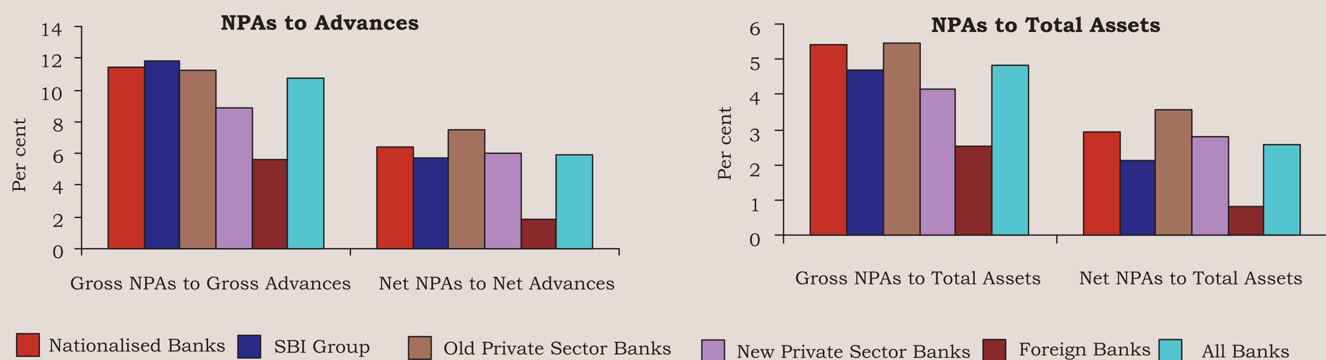
Table 10.3: Net NPAs to Net Advances of SCBs

(Frequency Distribution)

CRAR	Public Sector Banks		Private Sector Banks		Foreign Banks
	SBI Group	Nation-alised Banks	Old	New	
1	2	3	4	5	6
1996-97					
Up to 10%	5	12	22	9	36
Above 10% and up to 20%	3	6	3	–	1
Above 20%	–	1	–	–	2
1997-98					
Up to 10%	4	13	21	9	33
Above 10% and up to 20%	4	5	4	–	6
Above 20%	–	1	–	–	3
1998-99					
Up to 10%	4	14	16	9	27
Above 10% and up to 20%	4	4	4	–	10
Above 20%	–	1	3	–	3
1999-2000					
Up to 10%	7	15	17	8	32
Above 10% and up to 20%	1	4	6	–	6
Above 20%	–	–	1	–	4
2000-01					
Up to 10%	8	14	16	8	31
Above 10% and up to 20%	–	5	4	–	6
Above 20%	–	–	3	–	5
2001-02 P					
Up to 10%	8	16	17	8	25
Above 10% and up to 20%	–	3	3	–	5
Above 20%	–	–	3	–	9

P : Provisional.

Chart X.2 : Non-Performing Assets (NPAs) of Scheduled Commercial Banks



points (*i.e.,* up to 50 per cent), provided the additional credit exposure is on account of extension of credit to infrastructure projects. Banks were advised that infusion of capital either through domestic issue or overseas float after the published balance sheet date would be taken into account for determining the exposure ceiling but other accretions to capital funds, such as by way of quarterly profits, would not be eligible to be reckoned for determining the exposure ceiling. Banks were also advised to ensure that exposures are not taken in excess of the ceiling prescribed in anticipation of infusion of capital on a future date.

10.15 For the purpose of prudential exposure limits, foreign banks were allowed to reckon foreign currency loans deployed in India in their capital funds. Furthermore, effective March 31, 2002, foreign banks were brought at par with Indian banks for the purpose of exposure ceiling based on the capital funds as reckoned for capital adequacy purposes in India. With the revised concept of capital funds, a number of foreign banks exceeded the prudential exposure ceiling. To allow a smooth transition, the Reserve Bank allowed banks, on a case by case basis, to continue with the existing level of exposure in excess of the limit up to March 31, 2003.

Asset Classification and Provisioning Norms

10.16 Consistent with the recommendations of the Committee on Banking Sector Reforms (Narasimham Committee II) and with a view to moving closer to international best practices in regard to asset classification norms, banks were advised that with effect from March 31, 2005 an asset would be classified as doubtful if it remained in the sub-standard category for 12 months. Banks are permitted to phase the consequent additional provisioning over a four-year period, commencing from the year ending March 31, 2005 with a minimum of 20 per cent each year.

10.17 In March 1999, banks were advised to make 100 per cent provision for the net debit position in their inter-branch account, arising out of the unreconciled debit and credit entries outstanding for more than three years as on March 31 every year. This period was reduced to two years from the year ended March 31, 2001 and further to one year from the year ended March 31, 2002.

10.18 Banks are required to make 100 per cent provision each year in respect of unreconciled debit entries in the *nostro* and mirror accounts originating on or after April 1, 1996 and remaining outstanding for more than three years. In respect of credit entries remaining unreconciled for more than three years, banks were advised to transfer the net credit entries appearing in the books of the banks as on September 30, 2001 to distinct blocked accounts and show them under "other liabilities and provisions" in the balance sheet. The balance in the blocked account will be reckoned for the purpose of maintenance of cash reserve ratio (CRR)/statutory liquidity ratio (SLR), pending reconciliation.

Disclosure Norms

10.19 In continuation of ongoing efforts to make the balance-sheet and profit and loss account of banks more reflective of their true financial health, banks are required, from the year ended March 2002, to make additional disclosures in the "notes on account" of their balance sheet relating to: (i) movement of provisions held towards NPAs and (ii) movement of provisions held towards depreciation of investments. Banks are also required to disclose the total investments made in equity shares, convertible bonds and debentures and units of equity-oriented mutual funds and aggregate advances against shares in the 'notes on account'. Banks should also disclose the total amount of loan assets subjected to restructuring under Corporate Debt Restructuring (CDR) and amounts of standard and sub-standard assets subjected to CDR.

Investment by Banks

10.20 Based on the recommendations of the Reserve Bank-SEBI Technical Committee, guidelines for financing of equities and investments by banks were revised and banks were allowed to extend finance to stockbrokers for margin trading within the overall ceiling of 5 per cent prescribed for banks' exposure to capital market. A minimum of 40 per cent margin was required to be maintained on the funds lent for margin trading. The shares purchased through margin trading were to be in dematerialised mode under pledge to the lending bank. The banks' Boards were directed to prescribe necessary safeguards to ensure that no nexus develops between inter-connected stock-broking entities and banks in respect of margin trading.

10.21 To ensure that banks follow a more prudent policy for utilising the gains realised on sale of investment in securities by building up adequate reserves to guard against any possible reversal of the interest rate environment in future, banks were advised

to transfer the gains realised on sale of securities to the Investment Fluctuation Reserve (IFR) Account and to achieve a minimum IFR equivalent to five per cent of the specified investment categories within a period of five years. Banks are free to build up IFR up to 10 per cent of their portfolio depending on the size and composition of their portfolio, with the concurrence of their Board of Directors. The IFR has to be computed with reference to investments for the two categories, *viz.,* "held for trading" and "available for sale". Banks were advised to ensure that the unrealised gains on valuation of investment portfolio are not taken to the income account or to the IFR. In modification of the previous instructions, banks were advised to mark to market the individual scrips held under the "available for sale" category at least at quarterly intervals. The IFR consisting of realised gains from sale of investments would be eligible for inclusion in the Tier II capital.

Compliance by Banks with Accounting Standards

10.22 With a view to identifying the compliance as also gaps in compliance by banks with Accounting Standards (AS) issued by the Institute of Chartered Accountants of India (ICAI) and to recommend steps to eliminate/reduce the gaps, a Working Group has been constituted.

10.23 In view of difficulties expressed by banks in complying with certain AS, especially AS 17 on Segment Reporting, AS 18 on Related Party Disclosure, AS 21 on Consolidated Financial Statements and AS 22 on Taxes on Income due to absence of uniform disclosure formats, appropriate management information systems (MIS) to support comprehensive disclosures and the likely impact of their regulatory compliance, it was decided that compliance with these specified AS be made optional for banks only for the year ending March 31, 2002. Banks would be required to conform to the above AS by March 31, 2003 in accordance with detailed guidelines to be issued on the basis of the recommendations of the above mentioned Working Group.

Consolidated Accounting and Supervision

10.24 A multi-disciplinary Working Group was set up to look into the introduction of consolidated accounting and quantitative techniques for consolidated supervision, in line with international best practices. The Group's report was placed before BFS in January 2002 and also put in the public domain for comments/suggestions.

Deposit Insurance

10.25 Deposit insurance constitutes one of the components of a safety net for the financial sector. The Union Budget, 2002-03 announced that the Deposit Insurance and Credit Guarantee Corporation (DICGC) would be converted into the Bank Deposits Insurance Corporation (BDIC) to make it an effective instrument for dealing with depositors' risks and distressed banks.

Ownership Function of the Reserve Bank

10.26 The Committee on Banking Sector Reforms referred to the potential conflict of interest between the ownership and supervisory roles of the Reserve Bank and suggested that ideally, the Reserve Bank should not own the institutions it regulates. The Reserve Bank accepted the recommendation for transfer of ownership of its shares in the State Bank of India (SBI), National Housing Bank (NHB) and National Bank for Agriculture and Rural Development (NABARD) to the Central Government. During the year, the Reserve Bank divested its entire holdings of the Securities Trading Corporation of India and the Discount and Finance House of India. In the case of transfer of ownership in SBI, NABARD and NHB, an internal Working Group was constituted to recommend the modalities, *viz.,* valuation, payment adjustments, *etc.,* and the legislative measures required consequent to transfer of shareholding. The Working Group submitted its report in November 2001 which was forwarded to the Government.

Entry of New Private Sector Banks

10.27 In January 2001, the Reserve Bank issued revised guidelines for entry of new banks in the private sector and stipulated a period for submission of applications. In all, 10 applications were received within the stipulated period and the same were scrutinised to ensure *prima facie* eligibility and were thereafter referred to a High Level Advisory Committee (Chairman: Dr. I.G. Patel). The Reserve Bank granted "in-principle" approvals for setting up two new banks to Kotak Mahindra Finance Ltd. and to three banking professionals with Rabobank in February 2002. These approvals are valid for one year.

Foreign Direct Investment in Banking Sector

10.28 Guidelines/clarifications relating to foreign direct investment (FDI) in the banking sector were issued. FDI up to 49 per cent from all sources is

permitted in private sector banks under the automatic route, subject to conformity with the guidelines issued from time to time (Box X.1).

Banks' Entry into Insurance Business

10.29 According to guidelines issued for entry of banks into insurance business, those banks which satisfy the vital parameters set therein, *i.e.,* a minimum net worth of Rs.500 crore, CRAR not less than 10 per cent, reasonable level of non-performing advances, net profit for the last three continuous years and satisfactory track record of subsidiaries are allowed to set up insurance joint ventures on risk participation basis. Banks not eligible to be joint venture participants are allowed to take up strategic investment up to a certain limit for providing infrastructure and services support without taking on any contingent liability. Any SCB or its subsidiary is permitted to undertake insurance business as an agent of an insurance company and distribute insurance products without any risk participation. However, as the extant IRDA Regulations do not include PSBs in its definition of "Person" eligible to undertake agency business, necessary amendment to the IRDA (Licensing of Insurance Agents) Regulations is awaited. All banks entering into insurance business will be required to obtain prior approval of the Reserve Bank. Banks are required to maintain an 'arms length' relationship with the insurance entity so that the banking business does not get contaminated by risks arising from insurance activity.

Interest Rates

10.30 In relation to interest rates on advances, banks were required to move over to charging of interest at monthly rests by April 1, 2002 subject to certain conditions relating to applicability and timing. This was meant as a facilitating measure for adoption of the 90 days' norm for recognition of loan impairment from the year ending March 31, 2004.

Box X.1
Foreign Direct Investment in the Banking Sector

The norms relating to foreign direct investment (FDI) in the Indian banking sector are governed by the overall foreign investment policy as well as guidelines laid down by the Reserve Bank under various statutory provisions.

Limit for FDI under Automatic Route in Private Sector Banks

a) FDI up to 49 per cent from all sources is permitted in private sector banks under the automatic route, subject to conformity with the guidelines issued by the Reserve Bank from time to time.

b) Initial Public Offerings (IPOs), private placements, ADRs/GDRs and acquisition of shares from existing shareholders are included for the purpose of determining the above mentioned FDI ceiling under the automatic route.

c) Issue of fresh shares under the automatic route is not available to those foreign investors who have a financial or technical collaboration in the same or allied field. This category of investors requires FIPB approval.

d) The automatic route is not applicable to transfer of existing shares in a banking company from residents to non-residents. This category of investors requires approval of FIPB, followed by "in principle" approval of the Reserve Bank. The "fair price" for transfer of existing shares is determined by the Reserve Bank, broadly on the basis of SEBI guidelines for listed shares and the erstwhile Controller of Capital Issues (CCI) guidelines for unlisted shares. After receipt of "in principle" approval, the resident seller can receive funds and apply to the Reserve Bank for obtaining final permission for transfer of shares.

e) Under the Insurance Act, the maximum foreign investment in an insurance company has been fixed at 26 per cent. Application for foreign investment in banks which have joint venture/subsidiary in insurance sector should be made to the Reserve Bank. Such applications will be considered by the Reserve Bank in consultation with Insurance Regulatory and Development Authority (IRDA).

f) Foreign banks having branch presence in India are eligible for FDI in the private sector banks subject to the overall cap of 49 per cent with the approval of the Reserve Bank.

Limit for FDI in Public Sector Banks

FDI and portfolio investment in nationalised banks is subject to overall statutory limits of 20 per cent. The same ceiling would also apply in respect of investments in the State Bank of India and its associate banks.

The norms also include provisions relating to (i) voting rights of foreign investors, (ii) approval of the Reserve Bank and reporting requirements, (iii) conformity with SEBI Regulations and Companies Act Provisions and (iv) disinvestment by foreign investors.

Risk Management Guidelines

10.31 The Working Groups on Market Risk Management and Credit Risk Management drew up comprehensive guidance notes for banks, which were put on the Reserve Bank's website for wider discussion among banks, FIs and other market participants. The guidance note on Market Risk Management delineates the minimum requirements for the banks including approval levels and requirements for any exceptions, deviations and waivers. The note illustratively encompasses the areas relating to the responsibilities of the risk management committee, the risk taking unit, the risk manager, identification and reporting of risk monitoring, its funding and liquidity, and models of risk analysis. The note on Credit Risk Management covers areas on policy and credit rating framework, credit risk models, portfolio management and risk limits, inter-bank exposure/credit limits, off-balance sheet exposure, country and transfer risk, loan review mechanism/ credit audit, risk pricing, economic profit and the implications of the new capital accord on credit risk.

NPA Management in Banks

10.32 The Central Government and the Reserve Bank have taken several steps to reduce the level of NPAs in the banking sector (Box X.2). Some of the important steps taken recently relate to CDR, one-time settlement of small loan accounts, *Lok Adalats* and Asset Reconstruction Company (ARC). These measures draw from the lessons of cross-country experience (Table 10.4).

Restructuring of Public Sector Banks (PSBs)

10.33 A High-Level Group headed by Shri S.P.Talwar, former Deputy Governor, had suggested in January 2001 infusion of capital for ensuring viable restructuring of the Indian Bank, the UCO Bank and the United Bank of India. Of these three PSBs classified as weak banks on the basis of criteria suggested by the Committee on Banking Sector Reforms in 1997-98, the UCO Bank and the United Bank of India turned around and reported net profits of Rs.165 crore and Rs.119 crore, respectively, during 2001-02. They could also achieve CRAR of nine per cent. Despite considerable progress, the Indian Bank had shown lesser than the prescribed capital adequacy ratio. To enable the bank to improve its CRAR to the prescribed level, the Government of India agreed to recapitalise the Indian Bank and released assistance of Rs.1,300 crore on March 30, 2002 on the basis of a commitment to the Government for implementing monitorable reform measures. The

Box X.2

New Policy Initiatives Relating to NPAs

From the regulator's perspective, there are four steps to the management of NPAs, *viz.*, assessment, provisioning, recovery and prevention of fresh NPAs. The recent initiatives in management of NPAs relate in greater measure to the third and the fourth aspects, *viz.*, recovery and prevention aspects although norms relating to the first and second aspects have been progressively tightened to bring them at par with international best practices.

In May 1999, the Reserve Bank issued guidelines for the constitution of settlement advisory committees (SACs) for compromise settlements of chronic NPAs of the small sector. Modified guidelines were issued in July 2000 to provide a simplified, non-discretionary and non-discriminatory mechanism for recovery of the stock of NPAs.

Debt recovery tribunals (DRTs) form another mechanism for recovery of NPAs. To enhance the effectiveness of DRTs, the Central Government amended the Recovery of Debts Due to Banks and Financial Institutions Act in January 2000. As on March 31, 2002, there were 22 DRTs and five debt recovery appellate tribunals (DRATs). In respect of PSBs, the number of cases disposed of by the DRTs increased from 8,080 (Rs.1,542 crore) during 2000-01 to 12,575 (Rs.2,603 crore) during 2001-02.

An appropriate mechanism for CDR as prevalent in countries like the United Kingdom, Thailand, Korea and Malaysia was finalised in August 2001 to ensure a timely and transparent mechanism, outside the purview of BIFR, DRT and other legal proceedings, for restructuring of the debts of viable corporate entities affected by internal or external factors.

Lok Adalats have proved an effective institution for settlement of dues in respect of smaller loans. Guidelines were issued to banks and FIs in 2001 indicating that: (i) ceiling of amount for coverage under *Lok Adalats* would be Rs.5 lakh, (ii) the scheme may include both suit-filed and non-suit filed accounts in the doubtful and loss category, and (iii) the settlement formula must be flexible. Furthermore, DRTs have been empowered to organise *Lok Adalats* to decide on cases of NPAs of Rs.10 lakhs and above. The PSBs had recovered Rs.40 crore by September 30, 2001 through the forum of *Lok Adalats.*

PSBs were advised to examine all cases of wilful default of Rs.1 crore and above and file suits in such cases. The Board of Directors are required to review NPA accounts of Rs.1 crore and above with special reference to fixing of staff accountability.

(Contd....)

(Concld....)

The constitution of an Asset Reconstruction Company (ARC) is another channel to remove NPAs from the balance sheets of the banks through the process of securitisation of assets (see Box X-5).

In view of the need to have an institutional mechanism for sharing of information on borrowers/potential borrowers by banks and FIs, the Credit Information Bureau (India) Limited (CIBIL) has been set up. Banks and notified FIs have been advised to go for parallel reporting of data on suit filed accounts to both the Reserve Bank and CIBIL up to March 31, 2003 and switch over such reporting to the CIBIL effective April 1, 2003.

The entrepreneurs/promoters of companies where banks/ FIs have identified siphoning/diversion of funds, misrepresentation, falsification of accounts and fraudulent transactions are debarred from institutional finance from SCBs, development FIs, government-owned NBFCs and investment institutions for floating new ventures for a period of five years from the date the name is published in the list of wilful defaulters by the Reserve Bank.

These mechanisms have led to a perceptible increase in the recoveries by the SCBs from Rs.9,716 crore during 1998-99 to Rs.17,588 crore during 2001-02 (Table).

Table: Recovery of NPAs

(Rupee crore)

	Public Sector Banks	Other Scheduled Commercial Banks	Total
1	2	3	4
1998-99	8,438	1,278	9,716
1999-2000	10,367	1,605	11,972
2000-01	13,628	2,780	16,408
2001-02(P)	14,226	3,362	17,588

P : Provisional.

Government and the Reserve Bank would closely monitor the performance and achievement of milestones before deciding on any further recapitalisation. The Indian Bank, after recording losses consecutively since 1995-96, showed a turnaround with a net profit of Rs.33 crore during 2001-02. As on March 31, 2002, the UCO Bank, the United Bank and the Indian Bank had CRAR of 9.6 per cent, 12.0 per cent and 1.7 per cent, respectively.

10.34 Recapitalisation is one of the three options available to deal with weak banks, the other two being the exit route and merger with other institutions (Box X.3).

Table 10.4 : Recent Initiatives by Select Countries for Resolution of NPAs

Country	Initiatives
1	2
1. Japan	Non-performing loans (NPLs) sought to be resolved within a period of three years; measures to enhance and intensify the final resolution of NPLs include introduction of special inspections to improve banks' self-assessment of their assets, and enhancement of the functions of the Resolution and Collection Corporation.
2. Thailand	Thai Bankruptcy Act amended in 1998 and again in 1999; a legal regime for court controlled corporate debt restructuring set in place; guidelines for out-of-court debt restructuring modelled; a binding framework in the form of Debtor-Creditor and Inter-Creditor Agreements formulated to encourage corporate debt restructuring; emergency decree on Thai Asset Management Company promulgated on June 9, 2001.
3. China	Supervision and evaluation of the quality of newly extended loans strengthened and a responsibility restraint mechanism instituted; post-lending management given due attention; special recovery teams established; an evaluation system on recovery of NPLs established; debt restructuring vehicles employed to reduce NPLs.
4. Korea	Large amounts of NPLs sold to Korean Asset Management Company; FLC system which evaluates companies' ability to redeem debt in the future and deal with NPLs introduced and extended; a corporate restructuring vehicle introduced to expedite NPL resolution.
5. Pakistan	Banks and NBFIs required to provide for rescheduled/restructured loans/advances for a period of one year; banks directed that the decision to write-off bad loans may be made by their boards; due diligence (along prescribed lines) to be carried out before write-off proposal is put before competent authority; the Corporate and Industrial Restructuring Corporation established to restructure/liquidate NPLs of public sector banks.
6. Kenya	A Credit Reference Agency where banks can exchange information on the bad borrowers constituted; initiatives taken to improve the judicial system; proposals made to form a NPAs recovery trust to take over NPAs from the banking system.
7. Czech Republic	Large parts of NPLs of the three large state owned banks transferred to the Konsolidacni Banca (KOB) – a government facility created to manage and recover distressed assets; in the pilot phase of the project, KOB auctioned US $ 500 million worth of NPLs; a number of legal reforms including a revised Bankruptcy Act introduced; the state owned Revitalization Agency selected eight large industrial companies for organisational and financial restructuring.
8. Mexico	Large volumes of NPLs transferred to the central bank in exchange for government bonds.

Box X.3

A Perspective on Recapitalisation of Banks

In a healthy and well-regulated banking system, banks are expected to generate sufficient business to enable them plough back retained earnings into capital. Market discipline and supervisory intervention is expected to isolate weak institutions and minimise moral hazard. If the banking system experiences stress, the potential negative externalities associated with widespread bank failures may call for intervention beyond what can be accomplished by the market or standard supervisory instruments. Under such circumstances, systemic bank restructuring is undertaken to rehabilitate a significant part of the banking system and maintain vital banking services on a sustainable basis.

Any systemic restructuring strategy typically includes the twin measures of financial and operational restructuring. The former, in essence, attempts to address the stock issue whereas the latter seeks to tackle the flow problem by ensuring that the sources of losses to the bank are eliminated. A crucial component of the financial restructuring process is recapitalisation. Infusion of capital is often dictated by the need to stem the erosion in the net worth of the bank or alternately, to enable the bank to meet the prescribed capital adequacy standards.

There are several forms that such capital injection can assume. An increase in paid-up equity capital is the preferred form of recapitalisation. This requires the existing owners to provide cash to the bank. Alternately, the owners might issue subordinated, long-term debt. This would raise regulatory capital (but not equity capital) and provide additional funds to allow the bank to acquire new earning assets. In the case of state-owned commercial banks, there are limited avenues with the Government to make public money available for recapitalisation. Such assistance can take the form of provision of cash as in Finland (1991-94), Philippines (1986), Sweden (1991) or negotiable/non-negotiable bonds as in Chile (1982-83), Hungary (1993-94) and Mauritiana (1993). Government contribution to capital, however, has direct fiscal implications and may also foster expectations of future bailouts and encourage poor management in the future.

An important aspect in the recapitalisation process has been whether to recapitalise banks before, or after, corporate restructuring. Under an *ex ante* recapitalisation, the Government recapitalises banks based on an assessment of probable losses. Some loans may be transferred at the time of recapitalisation or afterwards, to ARCs. *Ex ante* recapitalisation can be fast and provide a positive signal to the market if accompanied by substantive improvements in corporate governance and bank operations. It can also, if properly monitored, lead to lower ultimate costs. On the other hand, *ex ante* recapitalisation also carries big risks if governments routinely respond to such systemic bank insolvency problems by injecting capital into insolvent banks, without change in governance and bank operations.

In the alternate case of *ex-post* recapitalisation, banks receive public funds as and when they provide relief to corporations. This provides more time to undertake the necessary reforms and maintains pressure on banks and corporations to agree quickly on realistic financial and operational restructuring. The appropriate design of the recapitalisation exercise depends on country-specific circumstances, including the overall macroeconomic environment and the institutional framework.

In India, recapitalisation of the banking sector was initiated in 1993-94 roughly coinciding with the reforms in the financial sector. The Government's capital contributions over the period 1992-93 to 1998-99 aggregated Rs.20,446 crore. No recapitalisation support was provided to banks for the years 1999-2000 and 2000-01. The Working Group on Restructuring Weak Public Sector Banks (Chairman: Shri M.S. Verma) had observed that recapitalisation must be accompanied by strict conditions relating to operating as well as managerial aspects of the recipient bank's working. Subsequently, the Union Budget 2000-01 announced that the Government would consider recapitalisation of the weak banks to achieve the prescribed capital adequacy norms, provided a viable restructuring programme acceptable to the Government as the owner and the Reserve Bank as the regulator is made available by the concerned banks. Accordingly, during the year 2001-02, a sum of Rs.1,300 crore was provided to one nationalised bank taking the aggregate recapitalisation figure to Rs.21,746 crore.

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Issue and Pricing of Shares of Private Sector Banks

10.35 Norms for issue and pricing of shares of private sector banks were revised to allow freedom to price and issue rights shares without prior approval of the Reserve Bank. Moreover, bonus issues are now delinked from the rights issue. Though the Reserve Bank's prior approval would be necessary for initial public offerings (IPOs) and preferential shares, banks are free to price subsequent issues once their shares are listed on the stock exchanges. The issue price

should be based on the merchant banker's recommendation. Pricing of preferential issues by listed banks is to be according to the SEBI formula; for unlisted banks, the fair value may be determined by a chartered accountant or a merchant banker. It has been further clarified that banks would have to meet the SEBI's requirements on issue of bonus shares.

Subsidiaries of Foreign Banks

10.36 In India, foreign banks were so far allowed to set up branches but not subsidiaries. The Union Budget 2002-03 announced the elimination of this restriction to allow foreign banks to set up subsidiaries in India. A foreign bank could choose either to set up a subsidiary or have branch presence (Box X.4). Such subsidiaries will have to adhere to all banking regulations, including priority sector lending norms, applicable to other domestic banks. Necessary amendments to the Banking Regulation Act, 1949 to relax the maximum ceiling of voting rights of 10 per cent for such subsidiaries would be brought about. Guidelines in this regard are being worked out by the Reserve Bank.

Consultative Group on the Role of Board of Directors of Banks and Financial Institutions

10.37 The Consultative Group of Directors of Banks/ FIs (Chairman: Dr. A.S. Ganguly) made important recommendations to strengthen the supervisory role of the Boards of banks. The recommendations relate to appointment of one more whole-time director on the Boards of large-sized nationalised banks; due diligence procedures for appointment of directors on the boards of private sector banks; setting up of Nomination Committees of Boards of banks to recommend appointment of independent/non-

Box X.4

Setting Up of Locally Incorporated Subsidiaries by Foreign Banks

The Narasimham Committee on Banking Sector Reforms had recommended that in addition to branches, foreign banks may be allowed to set up subsidiaries or joint ventures in India which should be treated on par with other private banks and be subject to the same conditions with regard to branches and directed credit as the latter.

Internationally, country practices vary considerably on the issue of branches *versus* subsidiaries. Most countries in Asia allow foreign bank entry only through branches. The exceptions are Malaysia (which allows only subsidiaries), Singapore and Philippines (where foreign banks can operate as both branches and subsidiaries). Israel allows foreign banks to open either a branch or a subsidiary while South Africa, Central European and Latin American countries are much more flexible and leave the decision to foreign banks, supervising both entities on an equal, consolidated basis. The relative position of entry through branches and subsidiaries of foreign banks is presented below.

Issues/Areas	Position of Branches *vis-a-vis* Subsidiaries
1	2
Financial strength of parent bank	Access to the financial strength of the parent bank is perceived as the main advantage of a branch. Subsidiaries are stand-alone entities with recourse to funding from parent only in the case of crisis. In reality, it would be difficult for a banking institution with international operations to allow a subsidiary to fail in view of the potentially harmful effect this would have on its reputation.
Access to capital of parent bank	In terms of capital, there is no distinct advantage of a branch over a subsidiary. This is because it is local capital, comprising regulatory capital prescribed plus the local reserves and un-remitted profits built up over the years, which governs functioning of branches and is recognised for CRAR and credit exposures to individual/group borrowers.
Entry norms	More stringent for subsidiaries; keeps out non-serious, short range players.
Supervision	Both branches and subsidiaries would come under close supervision of home country regulators. Therefore, subsidiary has no disadvantages relative to branch.
Introduction of technology and risk management systems	Subsidiaries are more likely to bring in new technology and risk management systems.
Priority sector targets	Branches receive concessions with respect to priority sector targets. Subsidiaries will be subject to the same requirements as Indian banks.

executive directors; and, building and creation of a pool of professional and talented people for board level appointments in banks. The recommendations also focus on the role and responsibilities of independent/non-executive directors, their training and remuneration, commonality of directors of banks and NBFCs, information flow to/from the Board, composition of Financial Committees of the Board, *etc.* The Group's recommendations have been accepted. Subsequently, the Reserve Bank has requested SCBs, excluding foreign banks, RRBs and LABs, to place the Report as well as the list of recommendations before their Board of Directors. Based on the decision taken by the Board, these recommendations could be adopted and implemented by the banks. Certain recommendations of the Group require legislative amendments and these have been referred to Government for consideration.

Off-site Monitoring and Surveillance (OSMOS)

10.38 Under the OSMOS system set up in 1995 with the primary objective of analysing the financial position of banks in between on-site inspections, banks are required to submit 14 DSB returns comprising 11 quarterly returns, one half-yearly return and two annual returns to the Reserve Bank. To strengthen the off-site supervision system, the frequency of some of the returns was increased to a monthly basis with effect from October 2001. The monthly DSB returns cover data on assets, liabilities and off-balance sheet exposures, exposure to sensitive sectors, interest rate and liquidity risks (both in domestic and foreign currencies) and operations of domestic subsidiaries. In addition to the regular reviews and analysis, the OSMOS database is also used as the main input for preparation of half-yearly reviews on macro-prudential indicators.

Risk-Based Supervision

10.39 To optimise the use of supervisory resources through focus on the targeted banks and specific areas within banks that pose the greatest risk to the system, the risk-based supervision (RBS) project entered the implementation phase in June 2001. A Project Implementation Group set up in the Reserve Bank is addressing the transitional and management issues for facilitating a smooth switchover to RBS based on the recommendations of Pricewaterhouse Coopers, London. A discussion paper on the background, objectives, processes involved and specific bank level preparedness required for RBS was circulated among banks. They have also been involved in a consultative process through high-level meetings to identify areas requiring assistance/guidance. The central plank of RBS is the compilation of risk profile of banks. The Project Implementation Group has designed templates for compilation of risk profile and these have been sent to banks for suggestions and adoption in due course.

Supervisory Rating

10.40 A system of supervisory rating of banks operating in India - the 'CAMELS' model for Indian banks and the 'CACS' model for branches of foreign banks in India - has been in existence since 1998-99. A Working Group comprising officials of the Reserve Bank, commercial banks, ICAI, and Credit Rating and Investment Services India Limited (CRISIL) reviewed the supervisory rating models in order to minimise the element of subjectivity in certain rating components and to make the composite rating more broad based. On the basis of the recommendations of the Group, a revised rating model (CALCS) has been developed which incorporates the component of "Liquidity" in the rating of branches of foreign banks in India.

Other Supervisory Initiatives

10.41 A scheme of Prompt Corrective Action (PCA) based on certain early warning triggers is being developed as a supervisory tool. The scheme is aimed at taking action at an early stage when banks show weakness. This is in addition to existing supervisory tools. Some of the actions envisaged involve action on the part of the Government of India. The views of the Government were, therefore, sought which have since been received. The scheme is being examined taking into account the suggestions of the Government.

10.42 Foreign banks were allowed to borrow, from their Head Office, foreign currency subordinated debt to be reckoned for Tier II capital, without prior approval of the Reserve Bank, subject to their complying with the guidelines issued in this regard.

Legal Initiatives

10.43 The Committee on Legal Aspects of Bank Frauds (Chairman: Dr. N.L. Mitra) set up by the Reserve Bank in September 2000 to examine, *inter alia,* laying down procedural law to deal with financial

frauds submitted its report in September 2001. Recommendations which can be implemented without any legislative changes were forwarded to banks on May 3, 2002 for implementation.

10.44 The Central Vigilance Commission (CVC), at the instance of the Reserve Bank, had set up a High Level Group to look into certain matters relating to frauds in the banking sector. The Group submitted its Report in April 2002 and recommended measures for reducing delay in banks taking action against officials involved in frauds as also measures required to strengthen internal control systems in banks.

Credit Information Bureau

10.45 The Credit Information Bureau (India) Ltd. (CIBIL) was set up in January 2001 with an authorised capital of Rs.50 crore and a paid- up capital of Rs.25 crore with equity participation of 40 per cent each by State Bank of India and HDFC and two foreign technology partners. A draft legislation was submitted to Government in May 2001 for strengthening the legal mechanism and allowing the Bureau to collect, process and share information on the borrowers. Pending enactment of the Credit Information Bureaus Regulation Bill, it is proposed to permit CIBIL to take over gradually the collection and dissemination of information in the public domain in phases without causing any inconvenience to the system. Towards this end, the Reserve Bank would consider carrying out these functions along with CIBIL over the next year.

Asset Reconstruction Company

10.46 The Union Budget for 2002-03 announced the setting up of a pilot Asset Reconstruction Company (ARC) with the participation of public and private sector banks, FIs and multilateral agencies. This company will initiate measures for taking over NPAs in the banking sector and also develop a market for securitised loans (Box X.5).

Box X.5

Asset Reconstruction Companies

An Asset Reconstruction Company (ARC) specialises in recovery and liquidation of assets. The NPAs can be assigned to ARC by banks at a discounted price. The ARC has the objective of floating bonds and making the recovery from the borrowers directly. This engenders a one-time clearing of the balance sheet of banks of sticky loans.

ARCs can have several alternate structures. They can either be publicly or privately owned or a combination of both, and can be either separately capitalised units or wholly-owned subsidiaries. In several countries, including Czech Republic (1995), Sweden (1992) and Thailand (1998), the troubled bank was split into a 'good' bank and a 'bad' bank. This approach is probably best when only one or a few banks are in serious difficulty. In Hungary, bad banks issued bonds guaranteed by the government, which were bought by the good banks. In Poland, bad banks were not established as separate entities but many banks were required to establish a special organisational section for the management of impaired loans. However, when such an approach is followed, it is important that the 'bad' bank does not end up with the 'bad' assets.

The alternate approach, used in the United States (1989) during the Savings and Loan crisis and more recently in Korea (1997) and Malaysia (1998), has been to establish a single asset management corporation to purchase NPLs from a number of banks; in effect, there will be one large 'bad' bank for the whole banking industry. In case a large number of banks are in difficulty and the assets acquired have a certain degree of homogeneity, a single entity may reap economies of scale and make best use of scarce managerial talent.

Other countries have tried variants of both types of approaches. Japan, for instance, established a type of private sector AMC, the Japanese Cooperative Credit Purchasing Company, to which the NPLs of banks were sold, while providing the banks with some tax benefits. In view of its limited success, the government launched a new scheme in November 1998 under which a troubled bank would be taken under government control after a report from the inspection agency. The NPLs of these 'bridge banks' are to be transferred to the Resolution and Collection Organisation, funded by the Deposit Insurance Corporation. The remaining good banks are to become subsidiaries of a new government holding company.

In the Indian context, the Committee on the Financial System (Chairman: Shri M. Narasimham) (1991) had recommended the setting up of an Asset Reconstruction Fund (ARF). A number of concerns were expressed. First, it was felt that a centralised all-India fund would be severely handicapped in its recovery efforts by lack of widespread geographical reach which individual banks possess. Secondly, there could be a moral hazard problem and banks could become complacent about recovery and even the healthy accounts could also become sick accounts in course of time. Thirdly, given the large fiscal deficits, there would be a problem of financing the ARF. Subsequently, the Committee on Banking Sector Reforms (Chairman: Shri M. Narasimham) in 1998 recommended transfer of sticky assets of banks to an ARC. Thereafter, the Committee on Restructuring Weak Public Sector Banks (Chairman: Shri M.S. Verma) also viewed the separation of NPAs and its

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transfer thereof to an ARF as an important element in a comprehensive restructuring strategy for the weak banks.

In recognition of the same, the Union Budget, 2002-03, proposed setting up of a Pilot ARC. Accordingly, an Ordinance was promulgated in June 2002 to regulate securitisation and reconstruction of financial assets and enforcement of security interest. The Ordinance empowers the Reserve Bank to determine policy and issue directions in matters relating, *inter alia*, to income recognition, accounting standards, making provisions for bad and doubtful debts, capital adequacy and deployment of funds.

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CO-OPERATIVE BANKING

10.47 The co-operative credit sector in India comprises rural co-operative credit institutions and urban co-operative banks (UCBs). State co-operative banks, district central co-operative banks and primary agricultural societies comprise rural co-operative credit societies specialising in short-term credit, while state co-operative agriculture and rural development banks and primary co-operative agriculture and rural development banks are active in longer-term loans and advances. UCBs are supervised by the Reserve Bank, while rural co-operative credit societies are supervised by the NABARD. State Governments also regulate certain types of functions of both urban and rural co-operative banks/societies. Furthermore, multi-State UCBs are regulated by the Union Government as well.

10.48 At the end of March 2002, the number of UCBs stood at 2,090 (inclusive of 89 salary earners' banks and 130 banks under liquidation). Of these, 52 banks were scheduled UCBs spread across the States of Andhra Pradesh, Goa, Gujarat, Karnataka, Maharashtra and Uttar Pradesh.

10.49 Total deposits, and loans and advances of UCBs increased by 15.1 per cent and 14.1 per cent, respectively, during 2001-02 (Table 10.5). At end-March 2002, the deposits and advances of scheduled UCBs accounted for 35.2 per cent and 35.0 per cent, respectively, of the deposits and advances of the entire urban co-operative banking sector.

Table 10.5 : Deposits and Advances of UCBs

(Rupees crore)

End-March	Number of Banks	Number of Reporting Banks	Owned Funds	Deposits	Loans and Advances
1	2	3	4	5	6
2000	2,050	1,783	9,314	71,189	45,995
2001	2,084	1,681	10,826	80,840	54,389
2002	2,090	1,854	13,796	93,069	62,060

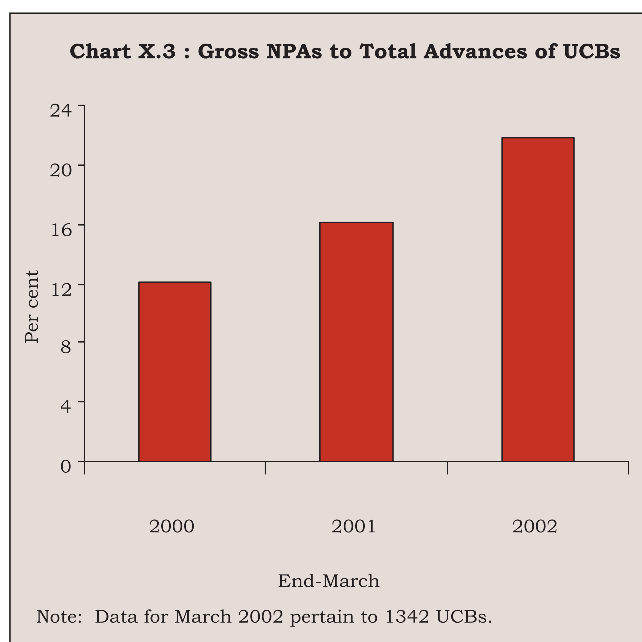
10.50 Available information for 1,854 UCBs for 2001-02 indicates that 1,569 UCBs posted profits while the remaining 285 UCBs incurred losses. In the previous year, out of 1,868 UCBs for which information was available, 1,629 UCBs had posted profits and 239 UCBs had reported losses. The loss making banks either fall under the classification of 'weak' banks or are new banks which posted losses on account of initial operating expenses. Of the 52 scheduled UCBs, 10 banks reported losses during 2001-02 as compared with 11 banks during 2000-01.

10.51 The gross NPAs of 1,942 reporting UCBs stood at Rs.9,245 crore or 16.1 per cent of total advances as at end-March 2001 as compared with Rs.5,589 crore or 12.1 per cent of total advances for 1,866 reporting UCBs as at end-March 2000. For the year ending March 2002, gross NPAs, based on data available for 1,342 UCBs, stood at Rs.11,472 crore or 21.9 per cent of total advances (Chart X.3). The increase in gross NPAs was primarily due to certain large UCBs.

Policy Initiatives in the Co-operative Banking Sector

Registration and Licensing

10.52 In order to screen applications received under the new licensing norms for setting up new UCBs, an external Committee consisting of persons with expertise in banking, finance and co-operation was formed. The role of the Committee is advisory and the Reserve Bank decides on the proposals after considering the recommendations of the Committee.



10.53 The branch licensing policy for salary earners' banks was reviewed and it was decided that salary earners' banks may be permitted to open offices subject to the following criteria: (i) minimum membership requirement corresponding to the place where the bank wants to open the branch, (ii) profits during the last two years, (iii) level of net NPAs not more than ten per cent, and (iv) compliance with CRAR norm.

Management Issues

10.54 To professionalise the management of UCBs, the High Power Committee on Urban Co-operative Banks (Chairman: Shri K. Madhava Rao) had recommended that the Boards of Directors of newly-constituted UCBs should, at all times, have at least two directors with suitable banking experience or with relevant professional qualifications, *i.e.*, chartered accountants with bank accounting/auditing experience. It was decided that the recommendation of the High Power Committee should be implemented by all the existing UCBs. Towards this end, all UCBs are to incorporate a suitable provision in their bye-laws to ensure that at all times there are at least two directors with experience in banking (at middle/senior management level) or with relevant professional qualifications. All UCBs have been advised to initiate steps for compliance.

10.55 All UCBs were required to form Audit Committee of the Board to oversee the audit functions. Compliance in this regard is a prerequisite for opening new branches.

Prudential Guidelines

10.56 The major risk exposure of UCBs includes not only credit risk but also interest rate risk. In this context, observance of risk and ALM principles by UCBs assumes importance. Appropriate guidelines were issued to UCBs on the basis of the recommendations of a Working Group. To begin with, the guidelines have been made applicable to scheduled UCBs who are required to put in place an effective ALM system by June 30, 2002.

10.57 With a view to moving towards international best practices, the norm for classification of an account as non-performing will be reduced from 180 days as at present to 90 days with effect from March 31, 2004 as for commercial banks. UCBs are to make additional provisions for NPAs starting from the year ended March 31, 2002 to facilitate smooth transition to the 90 days norm by March 31, 2004.

10.58 Accretion to or reduction in the share capital after the balance sheet date may be taken into account for determining exposure ceiling at half yearly intervals and the banks may, if they so desire, fix a fresh exposure limit taking into account the amount of share capital available as on September 30th. Accretions to capital funds other than to share capital will not be eligible for reckoning the exposure ceiling. Banks should also ensure that they do not take exposures in excess of the ceiling prescribed, in anticipation of infusion of capital on a future date.

10.59 UCBs were cautioned against indiscriminate financing against the security of real estate and were advised to strictly follow the Reserve Bank's policy guidelines issued in January 1994.

Interest Rates

10.60 As interest rates on deposits offered by a number of UCBs were much higher than those offered by commercial banks, UCBs were advised to review their interest rate structure on term deposits of different maturities and to make them comparable with the rates offered by commercial banks. On the lending side, as a step towards the self-discipline of prime lending rate and interest rate band, the stipulation of minimum lending rate (MLR) was withdrawn and the co-operative banks are now free to determine their lending rates. They are, however, required to publish their minimum and maximum lending rates for the information of customers.

Classification of UCBs as "Weak" and "Sick"

10.61 Pursuant to the recommendations of the High Power Committee on Urban Co-operative Banks (Chairman: Shri K. Madhava Rao), UCBs would be classified as "weak", commencing from March 31, 2002, if they fail to achieve 75 per cent of prescribed level of CRAR, or the level of their net NPAs exceeds 10 per cent, or they incur losses for two of the previous three years. They will be classified as "sick" if they fail to achieve 50 per cent of prescribed level of CRAR and the level of their net NPAs exceeds 15 per cent or they have incurred losses continuously for the previous three years. The UCBs should formulate action plans for revival on their own or with the help of experts in the field of bank management. The system of constituting Bank Level Rehabilitation Review Committee for monitoring progress of rehabilitation has been discontinued.

Initiatives Relating to NPAs

10.62 Detailed guidelines were issued to the State Governments on compromise settlement of NPAs of UCBs. Some State Governments have issued the guidelines to UCBs under their jurisdiction for settlement of dues under the Scheme.

Supervisory Measures

10.63 A system of off-site surveillance was introduced for scheduled UCBs, to begin with, based on returns collected at quarterly intervals to ascertain the conditions of the banks in terms of various indicators. The accuracy of the data submitted by banks is to be verified through on-site inspection. Off-site surveillance will be extended to all UCBs in due course.

10.64 In order to bring UCBs under a rigorous supervisory regime, it was felt necessary to introduce a rating system for UCBs similar to that in commercial banks. Accordingly, a Working Group was appointed to evolve a suitable rating mechanism for UCBs, keeping in view their sector-specific requirements. Based on the Group's report, the modalities for implementation of the rating system are being examined.

New Apex Supervisory Body

10.65 The recent problems in the co-operative banking sector have made it clear that present system of dual/triple regulatory and supervisory control is not conducive to efficient functioning of co-operative banks in the interest of their depositors. In view of the local interest involved, it is also clear that there is no consensus, at present, in favour of removing supervisory and regulatory responsibilities at Central/ State Government levels, and for entrusting it exclusively to the Reserve Bank. As a result, the managements and boards of several co-operative institutions continue to reflect political interests rather than genuine co-operative spirit and are not always amenable to normal banking discipline in their operations. The Reserve Bank proposed the establishment of a separate supervisory authority with representatives of the Centre, States and other interested entities. Such a body can be exclusively responsible for efficient functioning of the co-operative institutions and the safety of public deposits. A draft legislative bill proposing amendments to Banking Regulation Act, 1949 has been forwarded to the Government of India for providing wider power to the Reserve Bank, in line with the advice of the Government of India and recommendations of the High Power Committee on UCBs.

Irregularities in Government Securities Transactions

10.66 Following the detection in November 2001 by the Reserve Bank of unusually high transactions between broker entities and some banks in the co-operative sector in SGL transactions, a scrutiny of co-operative banks as also inspection by NABARD brought out gross violations of the Reserve Bank's guidelines as well as manifestly fraudulent transactions in a few cases. The broad nature of the violations relating to investment transactions was the use of broker in the settlement process, disproportionate transactions through one or few brokers, undertaking large value transactions in the physical mode, delivery of securities without funds being received, issue of power of attorney to brokerage firm for mobilisation of funds and for deployment of resources and absence of the management oversight, internal controls and audit. UCBs were advised to strictly follow the extant guidelines relating to investment portfolio, empanelment of brokers and other matters relating to investment transactions. Scheduled UCBs were advised to conduct a special audit of the securities transactions by a Chartered Accountant and to place a report before the Board.

10.67 It was decided that concurrent auditors shall also certify that investments held by the bank as on the last reporting Friday of each quarter and as reported to the Reserve Bank are actually owned/ held by it as evidenced by physical securities or the custodians' statement. Those banks not having the system of concurrent audit may have the certification furnished by an auditor appointed by the Registrar of Co-operative Societies.

10.68 An internal Group was constituted to monitor the developments, suggest remedial measures and/ or appropriate action. The Group has focussed on the systemic issues and streamlining of the procedures for undertaking securities transactions as well as course of action in specific cases.

FINANCIAL INSTITUTIONS

10.69 During 2001-02, the Reserve Bank continued its policy initiatives towards strengthening the regulation and supervision of select all-India financial institutions[1] (FIs) in the context of their financial performance, the market conditions for resource mobilisation and increasing competition from banks.

Capital Adequacy

10.70 All the FIs, except IFCI Ltd., had a CRAR much above the stipulated norm of 9 per cent as at end-March 2002. IFCI Ltd. has been facing asset-liability mismatches arising out of bunching of repayments aggravated by the retiring of high cost old debts and its downgrading by the rating agencies. In order to mitigate these problems and augment its capital, a capital infusion package of Rs.1,000 crore was initiated; of this, Rs.400 crore was contributed by the Government of India on a cash neutral basis which qualified for Tier I capital while the remaining Rs.600 crore was equally contributed by the major institutional shareholders, *viz.,* the Life Insurance Corporation of India (LIC) (Rs.200 crore), the IDBI (Rs.200 crore) and the SBI (Rs.200 crore).

Non-Performing Assets

10.71 The ratio of net NPAs to net loans of select all-India FIs stood at 8.8 per cent as at end-March 2002 as compared with 8.6 per cent at end-March 2001 (Table 10.6).

Table 10.6 : Non-Performing Assets (NPAs) of Select All-India Financial Institutions

(Amount in Rupees crore)

Name of Financial Institution	Net NPAs			
	end-March 2001		end-March 2002	
	Amount	As per cent to net loans	Amount	As per cent to net loans
1	2	3	4	5
IDBI	8,371	14.8	6,355	13.4
ICICI	2,982	5.2	$	$
IFCI	3,897	20.8	3,873	22.5
IIBI	625	22.9	539	24.1
EXIM Bank	407	8.2	448	7.4
TFCI	155	20.5	157	20.3
IDFC	0	0.0	0	0.0
Total TLIs	16,437	11.6	11,372	15.0
NABARD	0.2	0.0	0	0.0
NHB	0	0.0	0	0.0
SIDBI	174	1.2	382	2.9
Total RFIs	174	0.3	382	0.7
All FIs	**16,611**	**8.6**	**11,754**	**8.8**

Note : For NHB, the closing of accounts is at end of June.

TLIs Term Lending Institutions.

RFIs Refinancing Institutions.

Data for end-March 2002 and end-March 2001 are not strictly comparable at the aggregate level as the number of constituents have undergone change.

$ Since merged with the ICICI Bank Ltd.

Data are provisional.

Policy Initiatives for FIs

Capital Adequacy

10.72 The norms for computation of the amount of "grant equivalent" were modified to obviate certain anomalies. In respect of preference shares (existing as well as those that may be issued in future) of 20 years original maturity, the amount of "grant equivalent" that can be reckoned towards Tier I capital of the FIs would be computed after making certain adjustments taking into account the amount of corpus created, dividend outflows, tax payable, cash inflows, *etc.* In case the amount left after creating the corpus is not deployed in separate identifiable investments/securities, but is used as part of the overall working funds of the institution, then the cash inflow on account of income thereon should be notionally computed at the rate equal to the return on average working funds of the FI concerned during the preceding financial year. As the tax rates on dividend payments/investment income might change over the life of the preference shares/ investments, the computation should be reviewed at the balance sheet date every year, or more frequently if possible, to account for such changes and the amount of "grant equivalent" adjusted suitably.

[1] Consist of Industrial Development Bank of India (IDBI), ICICI Ltd (since merged with ICICI Bank Ltd), IFCI Ltd., Industrial Investment Bank of India Ltd. (IIBI), Tourism Finance Corporation of India Ltd. (TFCI), Infrastructure Development Finance Company Ltd. (IDFC), Export-Import Bank of India (Exim Bank), National Bank for Agriculture and Rural Development (NABARD), National Housing Bank (NHB), and Small Industries Development Bank of India (SIDBI).

10.73 FIs are required to assign a risk weight of 20 per cent on all loans and advances granted to their own employees which are fully covered by superannuation benefits and mortgages of flats/houses. All other loans and advances granted to their own employees would now be subject to 100 per cent risk weight.

Income Recognition, Asset Classification and Provisioning

10.74 Refinancing institutions were advised that Government guaranteed accounts need not be classified as NPAs even if such accounts are in arrears and are not to be reckoned for income recognition purposes. Consequently, no provisioning is required to be made in respect of such assets. However, if the State Government concerned repudiates the guarantees, it should be treated as NPA and provided for.

10.75 To avoid long time overruns in projects under implementation which impair the viability and the quality of assets, projects under implementation have to be grouped into three categories, with effect from March 31, 2002, for determining the date of completion. Norms for determining the date of completion of the project and classification of the underlying loan assets have also been specified for these three categories.

Initiatives Relating to NPAs

10.76 Guidelines relating to compromise settlement issued to PSBs are also to be uniformly implemented by all the central public FIs. The period of the guidelines for settlement of the outstanding dues was extended up to June 30, 2001 and these FIs were advised that all applications received up to June 30, 2001 should be processed and decision taken thereon at the earliest but not later than September 30, 2001.

10.77 In view of the advantages of the institution of *Lok Adalat* for loan settlements, the Reserve Bank issued guidelines to banks and FIs in May 2001 for making increased use of the forum of *Lok Adalats* to settle disputes involving smaller amounts. The guidelines related, *inter alia,* to ceiling of amount, coverage of borrower, settlement formula and organisational arrangements.

10.78 On August 25, 2001, a three-tier structure of CDR system was introduced. The CDR system is a non-statutory, voluntary mechanism based on the debtor-creditor and inter-creditor agreements envisaged to provide a transparent mechanism for restructuring of corporate debts of viable corporate entities affected by internal or external factors outside the purview of BIFR, DRT and other legal proceedings. The CDR system is to be applied only to multiple banking/syndicates/consortium accounts in the standard and sub-standard category with outstanding exposure of Rs.20 crore and above with the banks and FIs. The disclosure in respect of the accounts restructured under the CDR system should be made by the FIs in their published annual reports under the "Notes to accounts" as (1) total amount of loan assets (2) amount of standard assets and (3) amount of sub-standard assets which are subjected to restructuring under CDR.

Amendments to ALM Guidelines

10.79 As most FIs are still in a nascent stage of developing risk management systems, the trading books continue to be covered under the ALM system till FIs are able to migrate to more sophisticated techniques for management of interest rate risk separately for the banking and the trading book. In the interregnum, the securities in the trading book may be slotted according to the residual maturity or re-pricing maturity for floating rate securities as against the defeasance period prescribed at present. The related items in the time bucket were accordingly amended.

Additional Disclosures

10.80 To bring about greater transparency in the published annual reports of the FIs and in tune with the international best practices, FIs have to disclose, effective financial year 2001-02, certain additional parameters in their published reports, *viz.,* the movement in the provisions held towards (a) NPAs and (b) depreciation in investment portfolio. The disclosure has to be made as part of the "notes to accounts" to enable the auditors to authenticate this information, even if the information may be contained elsewhere in the published annual report. The prescribed disclosures constitute the minimum and a FI desiring to make any further disclosures is free to do so.

Entry of FIs into Insurance Business

10.81 The Reserve Bank had issued guidelines on entry into insurance business to banks and NBFCs during April 2000 and June 2000, respectively. Following banks and NBFCs, some of the all-India FIs within the

regulatory and supervisory ambit of the Reserve Bank evinced interest in entering the insurance business. Accordingly, the Reserve Bank issued norms in November 2001 for their entry into insurance business.

Transition to Universal Banks

10.82 As mentioned in the previous year's report, the FIs were advised to work out the transition paths for their evolution towards universal banks. Accordingly, ICICI Ltd. approached the Reserve Bank to convert itself into a universal bank through a reverse merger proposal with its banking subsidiary, ICICI Bank Ltd. The Mumbai High Court approved the proposal and the Reserve Bank gave the final clearance in April 2002. The Reserve Bank's approval for merger was subject to the merged entity fulfilling conditions relating, *inter alia*, to reserve requirements and other prudential norms. At the same time, relaxations were made in respect of priority sector lending targets and equity exposure ceiling. Compliance with all prudential requirements, guidelines and other instructions as applicable to banks concerning capital adequacy, asset classification, income recognition and provisioning issued by the Reserve Bank from time to time on the entire portfolio of assets and liabilities of the bank after the merger was also required.

10.83 Considering that the advances of ICICI Ltd. were not subject to the requirement applicable to banks in respect of priority sector lending, the bank, after merger, was required to maintain an additional 10 per cent over and above the requirement of 40 per cent, *i.e.*, a total of 50 per cent of the net bank credit on the residual portion of the bank's advances. This additional 10 per cent by way of priority sector advances will apply until such time as the aggregate priority sector advances reach a level of 40 per cent of the total net bank credit of the bank.

10.84 The investments of ICICI Ltd. acquired by way of project finance as on the date of merger would be kept outside the exposure ceiling of five per cent of advances towards exposure to equity and equity-linked instruments for a period of five years since these investments need to be continued to avoid any adverse effect on the viability or expansion of the project. The bank should, however, mark to market the above instruments and provide for any loss in their value in the manner prescribed for the investments of the bank. Any incremental accretion to the above project-finance category of equity investment will be reckoned within the 5 per cent ceiling for equity exposure for the bank.

10.85 Similarly, the IDBI approached the Government of India to corporatise itself and repeal the IDBI Act to provide flexibility in its operations. The Government agreed to its proposal and the Union Budget 2002-03 announced a proposal to make legislative changes to corporatise IDBI within the coming year to provide it with the required flexibility.

Supervision of Financial Institutions

10.86 The Reserve Bank continued to undertake on-site inspection of select all-India FIs. With a view to strengthening the on-site inspection mechanism, it was decided to conduct inspections annually instead of once in two years. This enabled speeding up of the supervisory process during 2001-02.

10.87 A Prudential Supervisory Reporting System (PSRS) for an on-going off-site surveillance was introduced in July 1999 as part of the integrated supervisory strategy. In view of the suggestions received from the FIs on the PSRS returns and for computational reasons, the formats of some of the returns were modified. The frequency of all the seven returns prescribed for the FIs was made quarterly with effect from September 2001.

10.88 A system of supervisory rating of commercial banks in India has been in existence since 1998-99 based on CAMELS model. Based on the recommendations of an in-house group, the Reserve Bank introduced a similar CAMELS based supervisory rating model for the FIs, effective annual financial inspection conducted with reference to the position as on March 31, 2002 (June 30, 2002 in the case of NHB).

NON-BANKING FINANCIAL INSTITUTIONS

10.89 As on June 30, 2002, applications for grant of Certificate of Registration (CoR) were received from 36,269 NBFCs. Applications for grant of CoR received from 14,077 NBFCs were approved; of these, 784 companies were authorised to hold or accept public deposits. Applications for grant of CoR were rejected or CoR already issued were cancelled in the case of 19,109 companies. During the period April 2001 to June 2002, inspection of 417 companies and snap scrutiny of books of account of 2,324 companies were conducted.

Capital Adequacy

10.90 Norms relating to capital adequacy issued in January 1998 were made applicable to NBFCs accepting or holding public deposits with effect from

March 31, 1998. Accordingly, CRAR shall not be less than 12 per cent and for the purposes of CRAR, Tier II capital shall be reckoned up to 100 per cent of Tier I capital. A higher CRAR of not less than 15 per cent is stipulated for deposit-accepting equipment leasing and hire purchase finance companies without credit rating, and loan and investment companies. These requirements are to be complied with on an on-going basis and not on the reporting dates alone.

10.91 At end-March 2001, 667 out of 723 reporting NBFCs (92.3 per cent) had a CRAR of 12 per cent and above, with as many as 534 companies (73.9 per cent) registering a CRAR in excess of 30 per cent. At end-September 2001, 570 out of 615 reporting companies (92.7 per cent) reported a CRAR equal to or in excess of the stipulated minimum with as many as 448 companies (72.8 per cent) having a CRAR above 30 per cent (Chart X.4).

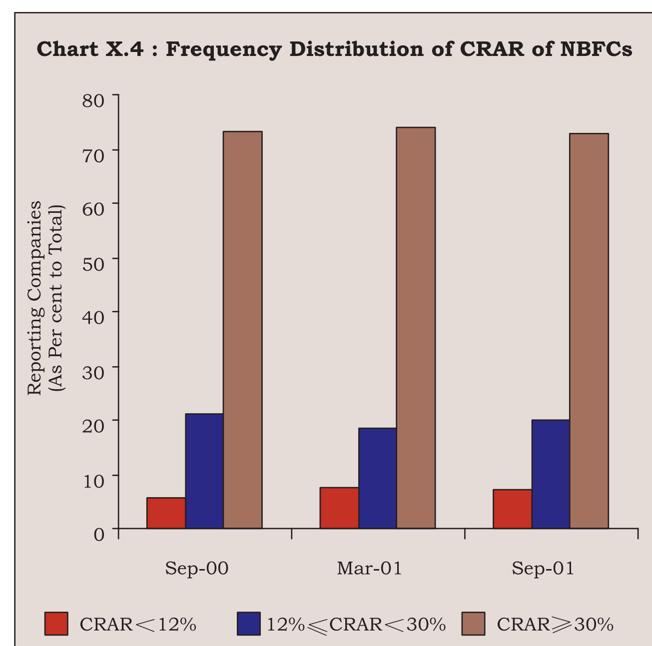
Interest Rates on Public Deposits

10.92 The maximum rate of interest that NBFCs can pay on their public deposits was reduced from 14 per cent to 12.5 per cent per annum effective November 1, 2001 and this ceiling on interest rate has been made applicable to deposits received by chit funds and *nidhi* companies also.

Regulation of NBFCs

10.93 The regulatory framework announced in January 1998 consequent upon the Reserve Bank of India (Amendment) Act, 1997 has been fine tuned from time to time. Companies whose applications for CoR have been rejected or cancelled have been advised to dispose of their financial assets or convert themselves into non-banking non-financial companies within three years. The Reserve Bank permitted NBFCs, subject to certain conditions, to treat loans against hypothecation of automobiles, ships and aircrafts as equipment leasing or hire purchase assets for the purpose of classification. The NBFCs and Residuary Non-Banking Companies (RNBCs) were permitted to keep the liquid asset securities with a depository participant registered with the SEBI, subject to prior approval of the Reserve Bank. Certain changes were made to align the Reserve Bank regulations with the provisions of the Companies Act, 1956, as amended by Companies (Amendment) Act, 2000.

Chart X.4 : Frequency Distribution of CRAR of NBFCs



10.94 Guidelines on formulation of an investment policy, classification of the investments into current and long-term, identification of loss assets for the purpose of compliance with prudential norms as also those in respect of call/demand loans have been issued. The concept of 'past due' for the purpose of income recognition norms is to be done away with, effective from the balance sheet for the year ended March 31, 2003. The guidelines for ALM system for NBFCs issued on June 27, 2001 became operational from the year ended March 31, 2002. NBFCs with public deposits of Rs.20 crore or more are required to submit the first set of half-yearly ALM returns as on September 30, 2002 by October 31, 2002.

Other Supervisory Initiatives

10.95 The Reserve Bank continued its efforts of educating the NBFC depositors about the regulatory framework, the role of the Reserve Bank in monitoring the functioning of NBFCs and some of the factors to be considered before investing their money in NBFCs, *etc.* The education campaign was conducted both through print and electronic media. Training programmes were also organised for personnel of NBFCs to educate them about the regulatory and supervisory framework. Seminars for police officials and State Government authorities were also conducted to disseminate the knowledge of the provisions of the Reserve Bank of India Act and the expectations of action from them against the wrong doers. In view of the important role assigned to statutory auditors of NBFCs in ensuring regulatory compliance, the Reserve Bank, in association with ICAI, has identified 46 centres throughout the country to conduct seminars for auditors to apprise

them of the Reserve Bank regulations as also the expectations of the Reserve Bank on prompt submission of exception reports. Such seminars have already been held at 14 centres.

10.96 The Reserve Bank continues to maintain close liaison with the Government of India, civil and police officials of State Governments, the Department of Company Affairs, stock exchanges, the SEBI, the ICAI, credit rating agencies, *etc.* for sharing of information regarding unauthorised deposit acceptance by NBFCs and unincorporated bodies and for initiating appropriate action. Periodic meetings are being conducted for this purpose. In addition, the Reserve Bank has been urging the State Governments/Union Territories to enact legislation on the lines of The Tamil Nadu Protection of Interests of Depositors (in Financial Establishments) Act, 1997 for protecting the interests of depositors in case of fraudulent non-repayment of deposits by financial establishments. As a result of these efforts, 12 State Governments/Union Territories have already enacted legislation or taken substantial steps in this regard.

Miscellaneous Issues in Regulation and Supervision

10.97 Recognising the need to have an off-site surveillance system for NBFCs not authorised to hold/accept public deposits, a Working Group was constituted by the Reserve Bank for devising a return for such companies (Chairman: Shri M.R. Umarji). The Group submitted its report in November 2001 and its major recommendations include: (a) a half-yearly return from companies not authorised to hold/ accept public deposits (non-PD) with asset size of Rs. 10 crore and above, containing information on net owned funds, other sources of funds, composition of assets, business information, and income and expenditure details along with audited annual financial statements; and, (b) non-PD companies with asset size below Rs.10 crore will be required to submit only audited financial statements. The recommendations are being examined by the Reserve Bank.

10.98 A majority of the recommendations of the Expert Committee (Chairman: Shri P. Sabanayagam) constituted by the Government of India in March 2000 to examine various aspects of the functioning of the *Nidhi* companies were implemented by the Government of India on July 26, 2001 by issuing detailed guidelines applicable to both existing *Nidhis* and potential *Nidhis*. In view of some difficulties expressed by *Nidhis* in complying with these guidelines, the Government of India constituted an Expert Group (Chairman: Shri A.R. Rao) in February 2002. The Group submitted its report in March 2002 recommending certain changes to the guidelines. The Department of Company Affairs has issued amending notifications for implementing these recommendations.

Outlook

10.99 In keeping with the vision of an internationally competitive and sound banking system, strengthening the financial system to achieve the best internationally recognised standards has been the core of the Indian approach to financial sector reforms. Provisioning and exposure norms have been progressively tightened. India has made considerable progress in the identification of international standards and codes in relevant areas, expert assessment regarding their applicability, including comparative country evaluation and building up possible course of action for the future. The calibration of the convergence with international standards is conditioned by the specific realities of the Indian situation.

10.100 At the same time, there are a few areas regarding the efficiency of the Indian banking system - rather than its stability - that raise concerns, especially in an uncertain economic environment. The level of NPAs continues to be high. The process of debt recovery and asset restructuring initiatives undertaken as part of financial sector reforms has also been somewhat slow. In the cooperative banking sector, the present system of dual/triple regulatory and supervisory control needs to be replaced with a separate supervisory authority exclusively responsible for efficient functioning of the co-operative institutions and the safety of public deposits.