X FINANCIAL REGULATION AND SUPERVISION

10.1 The blurring of the distinction between financial intermediaries under the combined effect of domestic and cross-border integration, innovations in instruments and processes, advances in technology and the massive volumes of capital intermediated by the financial system has necessitated a pro-active strengthening of the regulatory and supervisory framework. Recent international experience has highlighted the critical role played by the regulatory and supervisory system in ensuring the stability of the financial system. This has made the upgradation and refinement of the regulatory and supervisory function of the Reserve Bank a concurrent priority. The approach of the Reserve Bank in this context has been to pursue a progressive upgrading of prudential norms and benchmarking of these norms against international best practices, although there has been a strong emphasis on adapting these standards to the country-specific situation.

10.2 This Section presents an overview of the regulatory and supervisory policy initiatives undertaken in 2003-04 to intensify and broaden the ongoing process of financial sector reforms. It reviews the measures initiated during the year to strengthen the financial sector with a view to calibrating the approach to a new supervisory regime compatible with the Basel II process. An overview of various measures initiated to enhance the co-ordination with other regulatory agencies, to strengthen the transparency and corporate governance practices and to improve customer service is also presented. The performance of various intermediaries - commercial banks, co-operative banks, financial institutions and non-bank financial companies - is evaluated in terms of key financial and prudential indicators.

REGULATORY FRAMEWORK FOR THE INDIAN FINANCIAL SYSTEM

10.3 The Reserve Bank regulates commercial and urban co-operative banks, development finance institutions (DFIs) and non-banking financial companies (NBFCs). There are 293 commercial banks (289 scheduled and 4 non-scheduled), 1,926 urban co-operative banks (UCBs), 9 DFIs and 13,671 NBFCs (of which 584 NBFCs are permitted to accept/hold public deposits). In addition, the Reserve Bank is also the regulator in respect of State and district central co-operative banks [(the supervision is vested with the National Bank for Agriculture and Rural Development (NABARD)]. Life insurance companies and mutual funds are regulated by the Insurance Regulatory and Development Authority (IRDA) and the Securities and Exchange Board of India (SEBI), respectively.

10.4 The main objective of regulation and supervision has been to maintain confidence in the financial system by enhancing its soundness and efficiency. For this purpose, the Reserve Bank evaluates system-wide risks and promotes sound business and financial practices. It also conducts analyses of institution-wise risks to detect deficiencies in their operations, if any, in a timely manner and ensures that institution-specific problems do not spread to the system as a whole. The Board for Financial Supervision (BFS), constituted as a Committee of the Central Board of the Reserve Bank in November 1994 and headed by the Governor with a Deputy Governor as Vice Chairperson and other Deputy Governors and four Directors of the Central Board as members, held 12 meetings during the period July 2003 to June 2004. During this period, it examined 105 inspection reports. While State and district co-operative banks are supervised by the NABARD, certain problem cases are reviewed by the BFS. The Reserve Bank closely monitors these banks to enforce regulatory provisions and takes corrective action in respect of problem banks.

REGULATORY AND SUPERVISORY INITIATIVES

10.5 As the financial sector matures and becomes more complex, the process of deregulation must continue, but in such a manner that all types of financial institutions are strengthened and financial stability of the overall system is safeguarded. As deregulation gathers momentum, the emphasis of regulatory practice has to shift towards effective monitoring and implementation of regulations. To ensure this shift in regulatory practice, corporate governance within financial institutions must be strengthened and internal systems must be developed. Furthermore, as financial institutions expand and grow more complex, it is also necessary to ensure that the quality of service to customers is focused upon and improved.

10.6 Various issues which received regulatory attention during the year included ownership and governance in banks, further progress towards international best practices in prudential norms with country-specific adaptation, greater deregulation and rationalisation of banking policies, compliance with Know Your Customer (KYC) norms, strengthening the financial system for global integration in the light of the ongoing liberalisation of the capital account, greater inter-regulatory co-ordination and the drive for improving the quality of public services rendered by banks. In the evolution and implementation of policy, a consultative approach continues to be followed through formal institutional structures such as the BFS, the newly-formed Standing Committee on Financial Regulation, the Technical Committee on Money and Government Securities Markets and also through specific working groups and committees as well as formal and informal consultations with the regulated entities, external experts and professionals.

Scheduled Commercial Banks

Ownership and Governance of Banks

10.7 Corporate governance has assumed crucial significance for ensuring the stability and soundness of the financial system in recent years. The ongoing debate is focused on shareholders' rights and shareholder influence on corporate behaviour in respect of banks. Furthermore, in order to protect the interests of depositors and integrity of the financial system, it is necessary that owners and managers of banks are persons of sound integrity. Keeping these considerations in view, the Reserve Bank initiated several measures to enhance transparency and strengthen corporate governance practices in the financial sector in India.

10.8 The Reserve Bank provided guidelines for acknowledgment for transfer of shares of private sector banks in February 2004. The guidelines set out the factors that would be taken into account by the Reserve Bank for permitting acquisition of 5 per cent or more of the paid-up capital of banks. Due diligence would be intensified at higher threshold levels, keeping in view the desirability of diversified ownership and public interest. It was also decided that an independent advisory committee will make appropriate recommendations to the Reserve Bank for dealing with such applications.

10.9 In pursuance of the discussions held at the BFS for ensuring that suitable persons are appointed as directors in private sector banks, the Reserve Bank advised banks in June 2004 that they should undertake due diligence to ensure that persons appointed as directors satisfy 'fit and proper' criteria upfront. Also, such persons should be required to sign a deed of covenant undertaking to follow good governance principles.

10.10 The BFS formulated a draft comprehensive policy framework with regard to ownership of and governance in private sector banks and placed it in the public domain on July 2, 2004 for wider consultation and feedback before it is finalised. The draft policy framework envisages diversified ownership and restrictions on cross holding by banks (Box X.1).

10.11 In terms of the existing legal framework, mergers between banking companies and non-banking companies do not require specific approval by the Reserve Bank. As such mergers could involve significant changes in ownership and control of banks with implications for depositor interest, the Reserve Bank advised banks in June 2004 that banks should obtain prior approval of the Reserve Bank for any merger with a non-banking financial company.

10.12 In order to minimise cross holding of equity and other instruments eligible for capital status within the financial system, banks/DFIs were advised in July 2004 to restrict their investments in these instruments issued by other entities in the financial system to 10 per cent of the investing bank's capital funds. Furthermore, the equity holding in any other bank/ DFI is required to be restricted to 5 per cent of the capital of the investee bank. Banks/DFIs are required to indicate to the Reserve Bank the time frame for reducing the equity holding where such holding exceeds 5 per cent.

Strengthening Prudential Norms

10.13 Banks were advised to ensure that the building up of the Investment Fluctuation Reserve (IFR) to 5 per cent of their investments in 'Held for Trading' (HFT) and 'Available for Sale' (AFS) categories is achieved earlier, though they have time up to March 2006. In order to ensure that the internationally accepted norms for capital charge for market risk under Basel I are adopted, banks were also advised in June 2004 to maintain an explicit capital charge for market risks on the lines of the standardised duration method prescribed under the 1996 Amendment to the Capital Accord issued by the Basel Committee on Banking Supervision (BCBS). This would apply to the trading portfolio by March 2005 and to the AFS category by March 2006.

Box X.1

Ownership and Governance in Private Sector Banks - Draft Guidelines

The objective of the draft guidelines issued by the Reserve Bank in July 2004 is to have a regulatory road map for ownership and governance in private sector banks in the interests of the depositors and financial stability. The underlying thread of the draft guidelines is to ensure that the ultimate ownership and control of banks is well diversified, banks are owned and managed by 'fit and proper' persons/entities and well capitalised and that the processes are transparent and fair. Several countries, both developed and developing, have regulatory stipulations and clearance for significant shareholding and control. The threshold level may vary from country to country and can also involve more stringent conditions for higher thresholds.

The draft guidelines allow for a level of shareholding of a single entity or a group of related entities beyond 10 per cent with the prior approval of the Reserve Bank. Such approval will be governed by the principles enunciated in the February 2004 guidelines. Apart from more intensive due diligence at higher levels of shareholding, the February 2004 guidelines require public interest objectives to be served for shareholding beyond 30 per cent. Where the ownership of a bank is by a corporate entity, diversified ownership of that corporate entity will be considered among other factors. The draft guidelines do not cover foreign bank investment in Indian banks, which will be released separately, consistent with the policy in the Government press note of March 2004 to allow only one form of operational presence for foreign banks in India.

In order to minimise vulnerability due to small size, the guidelines provide for increasing the net owned funds to Rs.300 crore for all private sector banks within a reasonable period. Cross holding beyond 5 per cent is sought to be discouraged and where such holding exceeds five per cent, the objective is to reduce it to 5 per cent. Promoters with existing shareholding beyond 10 per cent will be required to indicate the time table for reduction - the requests would be considered on the basis of the underlying principles of 'fit and proper' governance and public interest. As a matter of desirable practice, not more than one member of a family or close relative or associate should be on the board. Based on the feedback received, a second draft of the guidelines would be prepared and put in the public domain.

10.14 Banks were advised to examine the soundness of their risk management systems and draw up a road map by end-December 2004 for migration to Basel II. They were also advised to review the progress made thereunder at quarterly intervals. The Reserve Bank is closely monitoring the progress made by banks in this direction.

10.15 In terms of the earlier guidelines, all eligible direct agricultural advances would become NPA when interest and/or instalment of principal remains unpaid, after it has become due for two harvest seasons, not exceeding two half years. In the case of long duration crops, the prescription of “not exceeding two half-years” was considered to be inadequate. In order to align the repayment dates with crop seasons, with effect from September 30, 2004 a loan granted for a short duration crop (*i.e.,* with a crop season less than one year) would be treated as a non-performing asset (NPA), if the instalment of principal or interest thereon remains overdue for two crop seasons. A loan granted for a long duration crop (*i.e.*, with a crop season beyond one year) would be treated as NPA, if the instalment of principal or interest thereon remains overdue for one crop season.

10.16 Banks were advised to increase the provisioning on the secured portion of doubtful assets which have remained in that category for over three years from 50 to 100 per cent. In the case of existing assets in this category, a time period of three years is allowed. It is expected that this will facilitate speedy resolution of doubtful assets including through transfer to asset reconstruction companies (ARCs).

10.17 The Reserve Bank’s guidelines on country risk management issued in February 2003 require banks to maintain provisions on a graded scale relating to the level of risk in respect of countries to which they have net funded exposure of two per cent or more of total assets. With effect from the year ending March 31, 2005 the coverage would be enlarged to include countries to which a bank has net funded exposure of one per cent or more of its total assets.

10.18 As banks have been putting in place risk management systems and considering the requirement of banks to cater to the evolving requirements of their clientele, the Reserve Bank permitted banks to consider enhancement of the exposure up to a further 5 per cent of capital funds to 20 per cent of capital funds for a single borrower and 45 per cent of capital funds for group borrowers. The additional limits to be sanctioned are subject to approval by banks’ boards and the borrower consenting to the banks making appropriate disclosures in their annual reports.

10.19 The reporting mechanism for cases of wilful default by banks/DFIs was strengthened in July 2003. Decisions to classify borrowers as wilful defaulters were entrusted to a committee of senior functionaries headed by an Executive Director. The decision to declare a borrower as a wilful defaulter should be

supported by sufficient evidence *vis-á-vis* the Reserve Bank's guidelines. Banks/DFIs should create a grievance redressal mechanism, headed by the Chairman and Managing Director, for allowing representation by borrowers who have been wrongly classified as wilful defaulters.

Resolution of NPAs

10.20 During the year, the Reserve Bank strengthened the existing mechanisms for NPA management and initiated some new measures to strengthen the efforts of banks to recover their dues.

10.21 A recent addition to the menu of options available to banks for resolving NPAs is the establishment of ARCs. In terms of the provisions of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002 the Reserve Bank prescribed guidelines for the formation and functioning of securitisation companies (SC) and reconstruction companies (RC). Guidelines were also provided to banks/DFIs to facilitate sale of NPAs to SCs/RCs. One ARC, *viz*., Asset Reconstruction Company of India Ltd. (ARCIL) was set up during 2003-04. Banks and financial institutions sold assets aggregating Rs.7,099 crore to ARCIL.

10.22 Corporate debt restructuring offers an avenue for reorganising the indebtedness of viable entities without reference to the Board for Industrial and Financial Reconstruction (BIFR), debt recovery tribunals (DRTs) and other legal proceedings. The process of corporate debt restructuring gained momentum during 2003-04 after revised guidelines were provided by the Reserve Bank in June 2004 (Table 10.1). The major beneficiaries were iron and steel, refinery, fertilisers and telecommunication sectors which accounted for more than two-thirds of the total value of assets restructured.

10.23 In pursuance of the recommendations of the Working Group to review the existing provisions of the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 (Chairman: Shri S. N. Aggarwal), the Central Government amended substantially the Debt Recovery Tribunal (Procedure) Rules in 2003, especially Rules 7 and 10 relating to application fee and plural remedies, respectively. A Working Group was also set up for reviewing and streamlining the functioning of DRTs. Out of 61,301 cases (involving Rs.88,876 crore) filed with DRTs by banks as on December 31, 2003, 25,510 cases (involving Rs.23,273 crore) were adjudicated with recovery amounting to Rs.6,874 crore.

Table 10.1: Progress under Corporate Debt Restructuring Scheme

(Amount in Rupees crore)

Item	No. of cases	Amount involved
1	2	3
Cases referred to CDR forum	135	72,139
Final schemes approved	94	64,017
Rejected	30	5,445
Pending	11	2,677

10.24 A scheme for settlement of chronic NPAs up to Rs.10 crore in public sector banks was introduced in January 2003 to give one more opportunity to borrowers for settlement of their outstanding dues. As on March 31, 2004, 2,12,370 cases amounting to Rs.1,977 crore were decided by banks and recovery was effected in 1,80,117 cases aggregating Rs.1,095 crore.

10.25 The SARFAESI Act, 2002, *inter alia*, provides for enforcement of security interest for realisation of dues without the intervention of courts or tribunals. In April 2004, the Supreme Court upheld the right of banks and financial institutions to attach and sell assets of the defaulting companies and the borrower's right to appeal. It struck down the provisions contained in Section 17 (2) of the SARFAESI Act requiring the defaulting borrower to pre-deposit 75 per cent of the liability in case the borrower wants to appeal against the order of the attachment of the assets. The Union Budget, 2004-05 has proposed to amend the relevant provisions of the Act to appropriately address the Supreme Court's concerns regarding a fair deal to borrowers while ensuring that the recovery process is not delayed or hampered. Up to December 31, 2003 27 public sector banks issued 49,169 notices involving an amount of Rs.16,318 crore. An amount of Rs.1,037 crore from 16,490 cases was recovered.

Inter-Regulatory Co-ordination and Co-operation

10.26 The Reserve Bank announced in November 2003 that it would set up a monitoring system in respect of systemically important financial intermediaries (SIFIs), including (i) a reporting system for SIFIs on financial matters of common interest to the Reserve Bank, the SEBI and the IRDA; (ii) the reporting of intra-group transactions of SIFIs; and (iii) the exchange of relevant information among the Reserve Bank, the SEBI and the IRDA. A Working Group (Chairperson : Smt. Shyamala Gopinath) was set up by the Reserve Bank in December 2003 with representation from the SEBI and the IRDA to recommend a framework for monitoring financial conglomerates. The Working Group, which submitted its report in June 2004, recommended

the introduction of a framework for the complementary supervision of financial conglomerates (Box X.2).

10.27 The High Level Co-ordination Committee on Financial and Capital Markets (HLCCFCM), set up in 1992 with the Governor of the Reserve Bank as its Chairman and Finance Secretary, Government of India and the Chairman, SEBI as its members (subsequently, the Chairman, IRDA was also made a member), constituted three Standing Technical Committees in order to provide a more focused inter-agency forum for sharing of information and intelligence. These Committees meet at regular intervals. Reports detailing the outcome of the meetings are presented before the HLCCFCM for its information and any further directions.

10.28 The responsibilities of the Technical Committee on RBI Regulated Entities include reviewing exposure of the Reserve Bank regulated entities to the capital market on an ongoing basis in the light of market developments. In case a policy issue of wider interest requires inter-agency co-ordination, it also decides whether the case should be referred to the RBI-SEBI Technical Committee of the HLCCFCM.

Opening up of the Financial Sector

10.29 In terms of the agreement arrived at under the *aegis* of the World Trade Organization (WTO), India is committed to permitting the opening of 12 new branches by foreign banks per year in the country. Thirty two foreign banks now operate 217 branches in India. During 2003-04, permission was granted to 5 foreign banks to open 18 branches. Three foreign banks, *viz*., Toronto Dominion Bank, Overseas Chinese Banking Corporation Ltd. and Bank Muscat (SAOG) shut down their branches in India. There was a worldwide merger of Credit Lyonnais and Credit Agricole Indosuez into CALYON Bank, which resulted in the merger of their operations in India as well. In addition to opening of branches, foreign banks can open representative offices which cannot do any banking business. During the year, Everest Bank Ltd., Nepal was permitted to open a representative office in New Delhi and with West LB AG, Germany closing down its representative office, the number of operating representative offices stands at 26.

10.30 Indian banks continued to expand their presence overseas. During the year, ICICI Bank opened representative offices in Dubai (UAE) and Shanghai (China), while IndusInd Bank set up offices in Dubai (UAE) and London (UK) and Punjab National Bank opened an office in London (UK). The number of Indian banks with overseas operations increased by one to 10, although the number of branches remained at 93. The number of representative offices increased by four to 22. The total number of subsidiaries set up by Indian banks stood at 16.

10.31 During 2003-04, ten banks were given ‘in principle’ approval to open 14 overseas banking units (OBUs) in Special Economic Zones (SEZs). Of these, six banks, *viz*., State Bank of India, Bank of Baroda, Union Bank of India, ICICI Bank and Punjab National Bank have begun operations in the Santa Cruz Electronics Export Processing Zone, Mumbai and Canara Bank in NOIDA, Uttar Pradesh.

Box X.2

Working Group on Monitoring of Financial Conglomerates

The major recommendations of the Working Group on Financial Conglomerates comprise:

- Identifying financial conglomerates for focused regulatory oversight; capturing intra-group transactions and exposures amongst ‘group entities’ within the identified financial conglomerates and large exposures of the group to outside counter parties; identifying a designated entity within each group to furnish group data to the principal regulator for the group; and formalising a mechanism for inter-regulatory exchange of information.
- Segments under the jurisdiction of the Reserve Bank, the SEBI, the IRDA, and the NHB should be subjected to complementary regulation. The framework could later be extended to the segment covered by the Pension Fund Regulatory and Development Authority.
- The new reporting framework should track: (i) any unusual movement in respect of intra-group transactions manifested in major markets; (ii) build-up of any disproportionate exposure (both fund based and non-fund based) of any entity to other group entities; (iii) any group-level concentration of exposure to various financial market segments and outside counter parties; and (iv) direct/indirect cross-linkages amongst group entities.
- Individual intra-group transactions beyond threshold levels (Rs.1 crore for fund based transactions and Rs.10 crore for others) should be included in the reporting format, supplemented by exposure ceilings in respect of intra-group exposures.

Reference

Reserve Bank of India (2004), *Report on Monitoring of Financial Conglomerates,* June.

Towards More Deregulation

10.32 As a part of the move towards greater deregulation, banks fulfilling certain minimum criteria regarding CRAR and net NPAs have been given the discretion to pay dividend without the prior approval of the Reserve Bank, provided the dividend payout ratio does not exceed 33.3 per cent. Banks which do not meet the minimum criteria or which seek a higher payout ratio are required to obtain the prior approval of the Reserve Bank. Foreign banks operating in India were advised that they may remit net profits/surplus (net of tax) arising out of their Indian operations on a quarterly basis, without the prior approval of the Reserve Bank. This is conditional on (i) audit of the accounts on a quarterly basis, (ii) appropriate transfers to statutory reserves as per Section 11(2)(b)(ii) and other relevant provisions of the Banking Regulation (BR) Act, 1949, and (iii) compliance with the directions issued by the Reserve Bank.

10.33 Banks were not allowed to assume unsecured exposures by way of guarantees and advances beyond a prescribed ceiling in terms of the Reserve Bank's guidelines prescribed in 1967. In view of the ongoing shift towards financing borrowers based on estimated cash flows rather than on collateral and in recognition of the availability of financial assistance through credit substitutes, *viz.*, commercial paper, bonds and debentures, the restriction on unsecured exposures was withdrawn. Banks' boards are allowed to formulate their own policies on unsecured exposures. The unsecured exposures would, however, attract a higher provisioning of 20 per cent when they become sub-standard.

10.34 Effective September 22, 2003 banks are not required to obtain prior approval of the Reserve Bank for engaging in insurance agency business or referral arrangement without any risk participation, subject to their complying with the prescribed conditions. Banks intending to set up insurance joint ventures with equity contribution on a risk participation basis or making investments in insurance companies for providing infrastructure and services support would still require prior approval of the Reserve Bank.

Towards Greater Transparency

10.35 In recent years, banks have turned out to be the major investors in bonds issued on a private placement basis. In view of the fact that issuance of such bonds lacked transparency, banks were advised in November 2003 to restrict their fresh investments in unlisted securities to 10 per cent of their overall non-SLR portfolio. A time period was also prescribed for getting the existing outstanding bonds listed. Simultaneously, the SEBI also prescribed guidelines requiring all debt issuances, including private placements, to be rated and listed within a specified time period.

10.36 With a view to aligning standards adopted by the Indian banking system with global standards, the Reserve Bank issued detailed guidelines relating to several Accounting Standards (AS) in March 2003. In April 2004, guidelines for compliance with three more standards, *viz.*, AS 24 (discontinuing operations), AS 26 (intangible assets) and AS 28 (impairment of assets) were issued. Banks are required to ensure that there are no qualifications by the auditors in their financial statements for non-compliance with any of the accounting standards.

10.37 The Credit Information Bureau (India) Ltd. (CIBIL) took over from the Reserve Bank the responsibility of disseminating the information on suit-filed accounts at banks/FIs in India in respect of defaulters and wilful defaulters with effect from March 31, 2003. The Reserve Bank issued instructions to banks/DFIs to obtain the consent of all their borrowers - not only defaulters - for dissemination of credit information to enable CIBIL to compile and disseminate comprehensive credit information.

Preserving the Integrity of the Banking System

10.38 Preventing misuse of the financial system and preserving its integrity is vital for orderly development of the financial system. Prevention of frauds and implementation of anti money laundering (AML) measures are two important aspects of the efforts being made by the Reserve Bank to prevent misuse of the financial system by criminals whose transactions threaten the stability of financial transactions worldwide.

10.39 In 2002, banks were advised to follow certain KYC norms while opening accounts, with specific focus on verification and identity. These norms were also required to be applied to the existing accounts in a given time frame. With a view to adopting a risk-based approach and to mitigate the inconvenience to the common man, banks were advised to apply the new KYC norms only to those accounts where the annual credit or debit summation were Rs.10 lakh or more or where the transactions in the account was of a suspicious nature.

Improving Customer Service

10.40 The Reserve Bank set up a Committee on Procedures and Performance Audit on Public Services (Chairman : Shri S.S.Tarapore) to advise it on

improving the quality of such services. Banks were asked to constitute similar *ad hoc* committees to undertake procedures and performance audit on public services rendered by them and co-ordinate with the Tarapore Committee. Based on the reports of the Committee on personal transactions of individuals in foreign exchange, government transactions, banking operations and currency management, a number of guidelines have been issued with a view to improving the customer service rendered by banks and the Reserve Bank.

10.41 The Reserve Bank provided detailed operational guidelines for banks for the process of takeover of bank branches in rural and semi-urban centres. Due publicity is required to be given to the constituents of the branch concerned by the existing bank as well as of the bank taking over. In cases where the rural branch being taken over is the only one functioning in the village/town, the bank taking over would not be permitted to merge it with any of its existing branches in rural/semi-urban areas (with service area obligation).

Technology Upgradation/ Training

10.42 The Reserve Bank has been emphasising the need to harness the developments in information technology in the business of banking (Box X.3).

Strengthening the Consultative Process

10.43 The relationship between the Reserve Bank and market participants has continued to evolve over a period through the expansion and reinforcement of the consultative processes. A Standing Technical Advisory Committee on Financial Regulation was set up during the year on the lines of the Reserve Bank's Technical Advisory Committee on Money and Government Securities Market. The Committee would advise the Reserve Bank on regulations covering banks, non-bank financial institutions and other market participants on an ongoing basis, in addition to the existing channels of consultation. The Committee, constituted with Smt K.J.Udeshi, Deputy Governor as the Chairperson, comprises experts drawn from academia, financial markets, banks, non-bank financial institutions and credit rating agencies. During the year, the Committee's views were sought on a wide range of topical regulatory issues, including (i) issuance of long-term bonds by banks; (ii) adequacy of present prudential credit exposure ceilings; (iii) review of prudential norms in respect of unsecured exposures; (iv) norms for declaration of dividend by public and private sector banks; and (v) review of the calendar of reviews placed before the boards of banks.

10.44 With a view to reinforcing this consultative process further and making the regulatory guidelines more user-friendly, a Users' Consultative Panel was constituted comprising representatives of the Indian Banks' Association (IBA), public sector, private sector and foreign banks and market participants. The panel provides feedback on regulatory instructions at the formulation stage to avoid ambiguities and operational glitches.

Supervisory Initiatives

10.45 Keeping in view the emerging scenario under the Basel II accord and the need to use supervisory resources more productively, a beginning towards risk-based supervision (RBS) of banks was made. The Risk-Based Supervision Manual (RBS Manual), customising the international best practices to Indian conditions, was finalised during the year. A pilot study of eight banks was taken up during the year, which was later extended to 15 additional banks. Extensive training was imparted to the Reserve Bank's supervision staff as also to the risk managers of various banks across the country. The review of the current methodology, based on the first pilot study, is under examination.

10.46 The scheme of Prompt Corrective Action (PCA), indicating 'structured' and 'discretionary' actions to be initiated by the Reserve Bank against banks

Box X.3

Computerisation of Banks - Aligning Technology Plan with Business Strategy

The Reserve Bank sponsored a study by the National Institute of Bank Management (NIBM), Pune to assess the computerisation in the banking system with a view to suggesting a broad methodology with which banks could smoothly integrate their technology plan with their business objectives. The report suggested a business-technology model termed as 'Enterprise Maturity Model' (EMM). It has five layers with defined business objectives at each layer starting with 'increasing operational efficiency' and leading up to higher strategic objectives such as 'maximising wealth and stakeholder value'. While every individual bank will need to chart its own course in integrating its business and technology plans, the NIBM report serves as a benchmark for banks to review the direction of their progress. The Reserve Bank advised banks which have not adopted core banking solutions to identify the level at which they are in the Enterprise Maturity Model and accordingly chart their future course of action with the approval of their boards.

which had hit the trigger points under the PCA framework, was introduced in 2002-03. Since the scheme was introduced on an experimental basis, banks that could potentially attract the provisions of the PCA framework were informed of the possible corrective action required to be taken in case the same were made applicable to them.

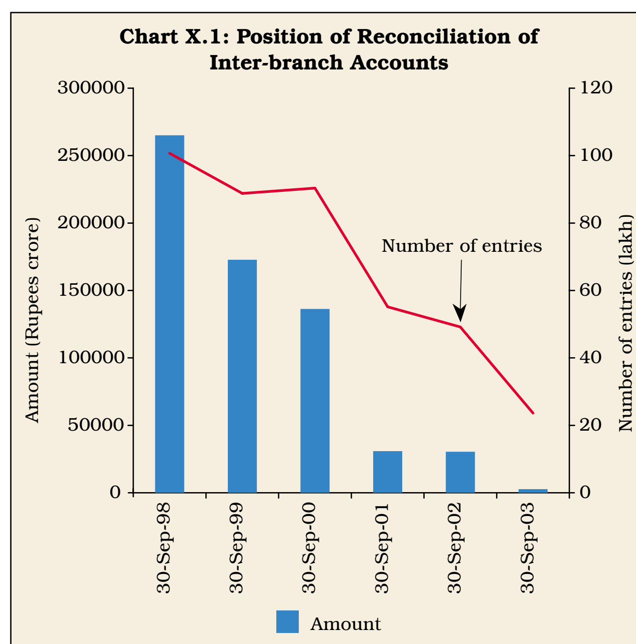
10.47 Frauds in banks reflect in most cases failure of well laid down systems and procedures, and the boards and the top management in banks need to view frauds with utmost seriousness. With a view to ensuring prompt reporting of frauds, a software package for fraud reporting and monitoring system was developed and supplied to all commercial banks. They were also advised to constitute a special board-level committee for monitoring and follow-up of cases of frauds involving Rs. one crore and above exclusively, while the audit committee of the board may continue to monitor all the cases of frauds in general.

10.48 A separate Fraud Monitoring Cell has been set up at the Reserve Bank to pay focused attention to the monitoring and follow-up of frauds in commercial banks, co-operative banks, financial institutions, NBFCs, local area banks and regional rural banks.

10.49 On an application by the Reserve Bank, the Central Government issued an Order of Moratorium in respect of Global Trust Bank (GTB) on July 24, 2004 in public interest, in the interest of depositors and the banking system. Keeping in view the need to minimise the period of moratorium, the available options and the synergies of strategic advantages in merging with Oriental Bank of Commerce (OBC), the Reserve Bank prepared a draft scheme of amalgamation of GTB with OBC and announced it on July 26, 2004 soon after both the banks, which are listed, had notified the information to the stock exchanges. After due sanction from the Central Government, the scheme came into force with effect from August 14, 2004 from which date customers, including depositors of GTB, were able to operate their accounts as customers of OBC.

10.50 The BFS took several steps to streamline the long outstanding entries under inter-branch accounts, balancing of books, reconciliation of inter-bank accounts (including *nostro* accounts) and clearing differences, especially in respect of public sector banks. While institution-specific action, as advised by the BFS, was taken, the time period allowed for reconciliation of accounts was also reduced from one year to six months with effect from March 31, 2004. On account of the initiatives taken by the BFS, the amount of outstanding entries under inter-branch accounts declined steadily (Chart X.1).

Chart X.1: Position of Reconciliation of Inter-branch Accounts



Co-operative Banks

10.51 Membership of co-operative credit institutions comprises largely lower and middle-income sections of society. UCBs are supervised by the Reserve Bank, while district central co-operative banks (DCCBs) and state co-operative banks are supervised by the NABARD. Both are regulated by the State Governments in respect of certain types of functions. In addition, multi-State UCBs are regulated by the Central Government. UCBs are concentrated in five states, *viz.*, Maharashtra, Gujarat, Karnataka, Andhra Pradesh and Tamil Nadu which account for 79 per cent of the urban co-operative banking sector and 90 per cent of deposit resources. The focus of supervision of urban co-operative banks by the Reserve Bank has been on strengthening the prudential norms, resolving the issue of dual control, addressing the lack of professionalism, use of unscientific loan policy and increasing incidence of financial weakness.

10.52 A system of gradation of UCBs, based on critical financial parameters, *viz.*, capital adequacy, net non-performing advances and profitability was introduced as a framework for initiating prompt corrective action. The gradation is communicated to problem banks to enable them to formulate action plans for corrective action. The content and structure of off-site surveillance returns were modified and the revised returns came into effect from the quarter ended March 2004 (Box X.4).

10.53 The period for recognition of loan impairment was reduced from 180 days to 90 days with effect from March 31, 2004 in line with the international best practice and to ensure greater transparency. Gold

Box X.4
Off-site Surveillance System for UCBs

The system of off-site surveillance, introduced in April 2001 under Section 27 (2) of the Banking Regulation Act, 1949 (As Applicable to Co-operative Societies), requires scheduled urban co-operative banks to submit returns to the Reserve Bank on a quarterly basis. The content and structure of OSS returns was modified to enlarge the breadth and depth of information obtained while reducing the volume of data submission. Seven quarterly returns (submitted from April 2004) and one annual return have been prescribed to obtain information on areas of supervisory concern, and at the same time, to strengthen MIS systems within the scheduled UCBs and sensitise their managements about the prudential concerns of the supervisory authority. The OSS is proposed to be extended to non-scheduled UCBs with a deposit base of Rs.100 crore and above and thereafter to other UCBs. A project is underway for development of software for UCBs that would assist them in preparation and submission of all the regulatory and supervisory returns including OSS returns in an electronic format.

loans and small loans up to Rs. one lakh, however, continue to be governed by the 180-day impairment norm. The Registrars of Co-operative Societies of all States were advised to issue suitable instructions enabling UCBs to take recourse to the SARFAESI Act for recovery of NPAs. UCBs were also advised to build up Investment Fluctuation Reserves (IFR) out of realised gains on sale of investments of a minimum of 5 per cent of the investment portfolio within a period of 5 years, subject to available net profit, in order to mitigate interest rate risk.

10.54 It was observed by the BFS that some of the large UCBs are facing serious problems with regard to solvency and liquidity. The State Governments concerned were advised to infuse capital funds to ensure that the banks attain the minimum CRAR level.

10.55 In pursuance of the recommendations of the Joint Parliamentary Committee (JPC) on Stock Market Scam and Matters relating thereto, a complete ban was imposed on granting of loans and advances to the directors and their relatives or the concerns in which they are interested, with effect from October 1, 2003. Only UCBs with strong financials are allowed to declare dividend.

10.56 The Reserve Bank is concerned with the existence of a large number of financially weak UCBs, some of which are unlicensed. As some UCBs have faced problems of liquidity and solvency in recent years, a scheme of reconstruction was approved by the Reserve Bank in respect of two scheduled UCBs in exceptional circumstances which, *inter alia*, require payment of insured deposits by the DICGC. However, the Reconstruction Scheme has not yielded the desired results. Therefore, in the light of experience gained, the Reserve Bank decided that it would only consider a scheme of reconstruction which envisages recapitalisation by the stakeholders, *viz*., the shareholders/co-operative institutions/Government to the extent of achieving the prescribed capital adequacy norms, without infusion of liquidity through settlement of insurance claims by the Deposit Insurance and Credit Guarantee Corporation (DICGC). Furthermore, the scheme should lay a clear road map for reducing the NPA level to a tolerable limit within the stipulated time frame.

10.57 In order to examine new applications for licence by proposed UCBs, the Reserve Bank constituted a Screening Committee consisting of eminent experts. In the light of experience gained, the policy of licensing co-operative banks was revised and it was decided to consider applications for licence of UCBs only after a comprehensive policy, including an appropriate legal and regulatory framework for the sector, is put in place and a policy for improving the financial health of the urban co-operative banking sector is formulated.

10.58 Scheduled UCBs with a minimum net worth of Rs.100 crore and complying with the exposure norms and connected lending were allowed to act as corporate agents for undertaking insurance business without risk participation, after obtaining the approval of the Reserve Bank.

10.59 The Central Government had enacted a Multi-State Co-operative Societies (MSCS) Act, 2002 by repealing the MSCS Act, 1984. The MSCS Act, 2002 does not contain provisions empowering the Reserve Bank on matters relating to supercession of boards of UCBs, which is one of the pre-requisites for banks to have deposit insurance cover of the DICGC in terms of Section 2(gg) of the DICGC Act, 1961. Therefore, deposits of UCBs registered under the MSCS Act, 2002 lose insurance cover of the DICGC.

10.60 The Supreme Court, in its judgement in a case relating to the Apex Urban Co-operative Bank of Maharashtra and Goa Limited, Mumbai in October 2003 ruled that the UCBs registered under the MSCS Act, 2002 do not fall within the meaning of 'primary co-operative bank' as defined under the Banking Regulation Act, 1949. In order to rectify the deficiencies,

the Reserve Bank has suggested to the Government amendments in the BR Act, 1949 and the DICGC Act, 1961 with the objective of bringing all UCBs registered under the MSCS Act, 2002 under the BR Act, 1949 and extend deposit insurance cover of the DICGC.

10.61 In 2003-04, licence applications of two DCCBs were rejected by the Reserve Bank in view of their precarious financial position. Besides, show cause notices were issued to 3 DCCBs as to why their licence applications should not be rejected. As on June 30, 2004 seven DCCBs were placed under the Reserve Bank's directions prohibiting them from granting any loans and advances and/or accepting fresh deposits.

Development Finance Institutions (DFIs)

10.62 With the change in the operating environment, DFIs have been facing difficulties in sustaining their operations. Several policy initiatives have been taken to facilitate the process of transition of DFIs opting for conversion into banks through a series of measures aimed at financial restructuring, provision of regulatory relaxation for restructured investments of creditor banks or providing Government support, transfer of stressed assets of DFIs to asset reconstruction companies/asset management trusts for managing the NPA level and harmonisation of prudential norms between banks and DFIs.

10.63 A Working Group on DFIs (Chairman : Shri N. Sadasivan) was set up by the Reserve Bank. The Working Group, which submitted its Report in May 2004, has suggested a road map for development financing and the future role of DFIs (Box X.5).

Strengthening of Prudential Norms

10.64 DFIs were advised that, with effect from end-March 2006, an asset should be classified as non-performing if the interest and/or instalment of principal remain overdue for more than 90 days. DFIs would have the option to phase out the additional provisioning required for moving over to the 90-day income recognition norm over a period of three years beginning from the year ending March 31, 2006, subject to at least one fourth of the additional provisioning being made in each year. Guidelines provided to banks to prevent the slippage of accounts in the 'sub-standard' category to the 'doubtful' category were extended to DFIs as well. They were advised to place the guidelines before their boards of directors and take appropriate actions for implementing the recommended measures. As in the case of banks, "special mention" accounts,

Box X.5

Report of the Working Group on Development Financial Institutions

The major recommendations of the Group are set out below:

- Banks may be encouraged to extend high risk project finance with suitable Government support.
- As a market-driven business model of any DFI is inherently unsustainable, a detailed social cost benefit analysis should identify activities which require development financing. The rest of the DFIs must convert to either a bank or a NBFC, as recommended by the Narasimham Committee.
- Concessions in the form of according "approved investment" status to paper issued and a lower risk weight of 20 per cent allowed for exposure by banks, DFIs, NBFCs and RNBCs should be withdrawn for public financial institutions, as many of them have become financially weak and act without any assurance of Government support.
- DFIs which convert into banks could be accorded certain exemptions/relaxations for a period of 3-5 years after conversion.
- Regulation of DFIs should ensure that overall systemic stability is not endangered.
- The Reserve Bank should continue to regulate the Exim Bank, NABARD, SIDBI and NHB which would continue to function as DFIs. As there is a scope for conflict of interest, the Reserve Bank may divest its ownership in NABARD and NHB.
- The Reserve Bank may ensure that the standards of regulation and/or supervision exercised by NHB (in case of Housing Finance Companies), SIDBI (SFCs and SIDCs) and NABARD (state co-operative banks, district central co-operative banks and RRBs) are broadly at par with those maintained by the Reserve Bank.
- DFIs which have been constituted as companies and are performing developmental roles should be classified as a new category of NBFCs called 'Development Financial Companies' (DFCs) and subjected to uniform regulation. Considering the nature of business of development financing, DFCs may be permitted to maintain 9 per cent CRAR as against 15 per cent prescribed for NBFCs in general.
- Public deposit mobilisation by RNBCs should be capped at 16 times the net owned fund (NOF) as an initial measure and finally to the level for other NBFCs in five years. This should be accompanied by deregulation in the quantitative restrictions (alongside more stringent quality criteria) on the asset side.

Reference

Reserve Bank of India (2004), *Report of the Working Group on Development Financial Institutions*, May.

which would track potentially weak accounts, would only be for internal control and follow-up purposes and would not constitute an additional category under the extant asset classification norms.

10.65 In December 1998, DFIs were advised that their investments in the bonds/debentures of certain Public Financial Institutions (PFIs) would attract a uniform risk weight of 20 per cent. In the Annual Policy Statement for the year 2004-05, it was announced that with effect from April 1, 2005 exposures to all PFIs will attract a risk weight of 100 per cent. In terms of the guidelines provided in January 2004, FIs must not, *inter alia*, invest in unrated debt securities or in debt securities of original maturity of less than one year other than CP and CDs, effective April 1, 2004. All fresh investments in debt securities are required to be made only in listed debt securities.

Transformation into Banks

10.66 During 2003-04, the Industrial Development Bank (Transfer of Undertaking and Repeal) Act, 2003 was passed by the Parliament and received assent of the President of India on December 30, 2003. In terms of the provisions of the Act, the undertaking of Industrial Development Bank of India (IDBI) would vest in the company named Industrial Development Bank of India Limited, which has to be incorporated as a Company under the Companies Act, 1956. On the 'Appointed Date', the new company would assume all assets and liabilities of IDBI. In this regard, the Government of India has already approved the IDBI's proposal to set up a Stressed Asset Stabilisation Fund (SASF) wherein stressed assets of IDBI amounting to Rs.9,000 crore would be transferred to the SASF against transfer of an equivalent amount of 20-year maturity bonds issued by the Central Government in favour of the SASF on cash/ fisc neutral basis.

10.67 The Board of Directors of the IFCI Limited approved, in principle, a merger with a bank. The Central Government has already decided to take over certain liabilities of the IFCI and correspondingly the Reserve Bank has provided certain regulatory relaxations for restructured liabilities of the IFCI.

10.68 While sending the inspection reports of the IDBI, the IFCI and Industrial Investment Bank of India (IIBI) Limited, action was taken on the various directives given by the BFS that included conveying the concerns on IIBI to the Government.

Consolidated Accounting and Consolidated Supervision

10.69 Guidelines on consolidated accounting and consolidated supervision, which were prescribed for banks, were extended to DFIs as well, effective April 1, 2003 (July 1, 2003 in the case of the NHB). They comprise three components in the supervisory framework, *viz.*, (i) consolidated financial statements (CFS); (ii) consolidated prudential returns (CPR); and (iii) application of prudential regulations such as capital adequacy, large exposures and liquidity gaps on group-wide basis in addition to the solo prudential norms applicable to the parent DFIs/subsidiaries. The publication of the CFS as per the Accounting Standard (AS) 21 of the Institute of Chartered Accountants of India (ICAI) is mandatory for the listed FIs in terms of the Listing Agreement with the Stock Exchanges. The Reserve Bank's guidelines sought to make such publication mandatory even for the non-listed DFIs from the financial year beginning April 1, 2003.

Non-Banking Financial Companies (NBFCs)

10.70 The policy initiatives in respect of NBFCs related to measures for protecting depositors, aligning interest rates offered by NBFCs with those of banks in respect of NRI deposits on a repatriable basis, issuance of KYC guidelines and allowing diversification into insurance business.

10.71 The maximum rate of interest that NBFCs (including *Nidhi* companies and Chit Fund companies) could pay on their public deposits was reduced from 12.5 per cent per annum to 11.0 per cent per annum with effect from March 4, 2003 in line with the general softening of interest rates. Similarly, the minimum rate of interest payable by the Residuary Non-Banking Companies (RNBCs) was reduced from 4 per cent per annum to 3.5 per cent per annum on daily deposit schemes and from 6 per cent per annum to 5 per cent per annum on other types of deposits. The rate of interest which NBFCs and Miscellaneous Non-Banking Companies (MNBCs) could pay on NRI deposits was also aligned with that payable by scheduled commercial banks on such deposits. It was clarified that NBFCs were not allowed to accept such deposits for a period less than one year (with a maximum period of three years).

10.72 NBFCs were allowed to take up insurance agency business for a fee on a non-risk participation basis without the approval of the Reserve Bank, subject to certain conditions. NBFCs intending to set up joint ventures in insurance with equity contribution on a risk participation basis or making investments in the insurance companies would continue to obtain prior approval as envisaged in the guidelines issued on June 9, 2000.

10.73 The KYC guidelines, akin to those issued for commercial banks, were prescribed for NBFCs,

including MNBCs (Chit Fund Companies) and RNBCs in January 2004.

10.74 The inspection policy of NBFCs was revised in July 2003 to increase the frequency. Inspections of 460 deposit taking companies and 385 non-deposit taking companies as also scrutiny and *ad hoc* scrutiny of books of accounts of 568 companies were carried out. Important findings of inspection and scrutiny reports were placed before the BFS.

10.75 An Internal Group in the Reserve Bank examined the scope of providing insurance cover to depositors of NBFCs on a suggestion made by the Joint Parliamentary Committee (JPC) on Stock Market Scam and Matters Relating Thereto. The Group did not favour extending deposit insurance to NBFCs in view of high risks and inadequate compliance with the regulatory and supervisory framework. These recommendations were endorsed by an external group.

10.76 The Reserve Bank issued final guidelines and directions to Securitisation Companies and Reconstruction Companies on April 23, 2003 relating to registration, owned funds, permissible business, operational structure for giving effect to the business of securitisation and asset reconstruction, deployment of surplus funds, internal control system, prudential norms and disclosure requirements. In order to ensure that the size of capital has some relationship to the value of assets acquired by the securitisation company or reconstruction company, the Reserve Bank in March 2004 issued a notification whereby the minimum owned funds for commencing the business of securitisation or asset reconstruction has been stipulated at an amount not less than 15 per cent of the total financial assets acquired or to be acquired by the securitisation company or reconstruction company on an aggregate basis or Rs.100 crore, whichever is lower. This stipulation is irrespective of whether the assets are transferred to a trust set up for the purpose of securitisation or not. However, the provisions relating to maintaining a capital adequacy ratio which shall not be less than 15 per cent of the total risk weighted assets of the securitisation company or reconstruction company on an ongoing basis, shall continue to be applicable.

10.77 In June 2004, the Reserve Bank rationalised the investment pattern of RNBCs for imparting greater liquidity and safety to their investments, enhancing the protection available to the depositors and reducing the overall systemic risk (Box X.6).

Box X.6

Residuary Non-Banking Companies (RNBCs)

A Residuary Non-Banking Company (RNBC) is a non-banking financial company which, as its principal business, is engaged in collecting deposits under any scheme or arrangement and cannot be placed in any one of the defined categories of NBFC, *i.e.,* leasing company, hire purchase finance company, loan company or investment company. At present, there are four companies registered under Section 45 IA of the RBI Act, 1934 which operate as RNBCs. Aggregate deposits of these companies stood at Rs.15,062 crore as on March 31, 2003, constituting 74.9 per cent of aggregate deposits of all NBFCs. Two large RNBCs account for deposits aggregating Rs.15,058 crore, constituting 99.9 per cent of the deposits with all RNBCs and 77.3 per cent of public deposits of all NBFCs.

RNBCs are required to invest not less than 80 per cent of the aggregate liabilities to the depositors (ALD) in the manner prescribed by the Reserve Bank which include Government securities, Government guaranteed bonds, fixed deposits with scheduled commercial banks, debentures of public financial institutions, commercial paper (CP) issued by companies and units of mutual funds, within certain limits.

The Reserve Bank recently reviewed the current regulations relating to investments by RNBCs. Modifications include stipulation of minimum rating, exposure norms and an increase in investment in government securities as set out below:

- RNBCs should invest only in (i) the fixed deposits and CDs of scheduled commercial banks; and (ii) CDs of specified financial institutions provided such CDs are rated not less than AA+ or its equivalent by an approved credit rating agency, with exposure to a scheduled commercial bank not exceeding 1 per cent of the aggregate deposit liabilities of the bank as on March 31 of the previous accounting year and exposure to any one specified DFI not exceeding 1 per cent of the ALD.
- RNBCs should invest in the Central and State Government securities issued by the Governments in the course of their market borrowing programme an amount which shall not be less than 15 per cent of the outstanding ALD.
- Investment in debt securities should be confined to those having minimum AA+ or equivalent grade rating and listed in any one of the stock exchanges.
- The investment in units of mutual funds should be in only debt-oriented mutual funds, subject to the aggregate investment in mutual funds not exceeding 10 per cent and in any one mutual fund not exceeding 2 per cent of ALD.
- Effective April 1, 2005, RNBCs will be permitted to invest, as per their discretion, only 10 per cent of the ALD as at the second preceding quarter or up to their net owned funds (NOF), whichever is lower. Effective April 1, 2006 the discretionary investment limit would stand abolished.

10.78 The Reserve Bank directed that the NBFCs which were granted Certificates of Registration (CoR) in the non-public deposit taking category should meet the minimum capital requirements of Rs.200 lakh to be eligible to apply to the Reserve Bank for accepting public deposits. Accordingly, NBFCs registered in the non-deposit taking category were advised to ensure compliance with this requirement before applying to the Reserve Bank for approval to accept public deposits.

10.79 During the year under review, the Reserve Bank cancelled CoR of twenty NBFCs for reasons other than conversion from category 'A' (deposit accepting NBFCs) to category 'B'(non-deposit accepting NBFCs). The Reserve Bank launched prosecution proceedings against 63 companies so far and winding up petitions have been filed with the courts in respect of 71 companies.

MACRO-PRUDENTIAL INDICATORS REVIEW

10.80 Macro-prudential indicators (MPIs), which comprise both aggregated micro-prudential indicators of the health of individual financial institutions (FIs) and macroeconomic variables associated with financial system soundness, are a useful tool to assess the health and stability of the financial system. The Reserve Bank has been compiling MPIs from March 2000 onwards. Over the last few years, the compilation exercise has been refined in consonance with the methodology given by the International Monetary Fund (IMF). In the Annual Policy Statement for 2004-05, it was indicated that the salient features of the MPI review would be published on an annual basis. Accordingly, the MPI review for the year 2003-04 is set out below.

Capital Adequacy

10.81 The capital position of financial intermediaries was generally above the minimum requirement (Table 10.2). The core capital ratio of banks showed some decline during 2003-04. The Capital to Risk-weighted Assets Ratio (CRAR) of the majority of banks as also major bank groups was well above the regulatory stipulation, except for two banks (Tables 10.3 and 10.4). This should enable the meeting of requirements relating to the capital charge for market risk and provisioning for doubtful assets as announced in the Policy Statement. Tier I capital of scheduled UCBs also recorded an improvement, in absolute terms, partly because of the liquidation of two banks with negative net worth, inclusion of one bank in the scheduled category and the attainment of 9 per cent CRAR level by some banks (Table 10.5).

10.82 In the case of DFIs, although the aggregated CRAR was high, the erosion of capital of two large Government-owned DFIs due to the high level of NPAs resulted in negative CRAR in respect of these institutions (Table 10.6). The average aggregate

Table 10.2: Select Financial Indicators

(per cent)

Item	Year	Scheduled Commercial Banks	DFIs	PDs	NBFCs
1	2	3	4	5	6
CRAR	2003	12.7	22.4	29.8	21.9
	2004	13.0	22.0	42.7	19.2
Gross NPAs to Gross Advances	2003	8.8	14.3	n.a.	8.8
	2004	7.3	16.4	n.a.	8.6
Net NPAs to Net Advances	2003	4.5	9.7	n.a.	2.7
	2004	3.0	10.5	n.a.	2.6
Return on Total Assets	2003	1.0	0.9	6.6	1.4
	2004	1.2	-0.2	5.9	n.a.
Return on Equity	2003	17.5	4.1	24.1	10.4
	2004	19.8	-1.2	19.9	n.a.
Cost/Income Ratio	2003	48.3	11.8	13.6	67.1
	2004	45.7	26.1	16.9	n.a.

n.a. : Not available.

Note : 1. Data for March 2004 are provisional.

2. Data for 2004 in respect of NBFCs pertain to the period ended September 2003.

3. Data for scheduled commercial banks pertain to domestic operations only and may not tally with the balance sheet data.

Table 10.3: Scheduled Commercial Banks – Performance Indicators

(Per cent)

Item / Bank Group	2004-05	2003-04				2002-03			
	Q1	Q4	Q3	Q2	Q1	Q4	Q3	Q2	Q1
1	2	3	4	5	6	7	8	9	10
Operating Expenses/Total Assets*									
Scheduled Commercial Banks	2.3	2.1	2.3	2.3	2.2	2.3	2.2	2.3	2.2
Public Sector Banks	2.2	2.2	2.2	2.3	2.2	2.4	2.2	2.3	2.3
Old Private Sector Banks	2.1	1.6	2.1	2.2	2.0	1.9	2.1	2.1	2.0
New Private Sector Banks	2.3	1.7	2.0	2.3	2.2	1.8	2.1	2.0	1.9
Foreign Banks	2.9	2.4	3.3	2.7	2.6	2.7	2.9	2.9	2.7
Net Interest Income/Total Assets*									
Scheduled Commercial Banks	3.1	2.5	3.1	2.9	3.1	2.6	2.8	2.9	2.9
Public Sector Banks	3.1	2.8	3.2	3.0	3.2	2.8	2.9	3.1	3.0
Old Private Sector Banks	2.9	1.9	2.8	2.7	2.7	2.0	2.8	2.4	2.6
New Private Sector Banks	2.4	1.5	2.1	2.1	2.0	1.6	1.7	1.5	1.7
Foreign Banks	3.7	3.0	3.8	3.0	4.0	2.7	3.6	3.6	3.5
Net Profit/Total Assets*									
Scheduled Commercial Banks	1.2	1.0	1.2	1.3	1.3	0.9	1.2	1.0	1.0
Public Sector Banks	1.2	1.1	1.2	1.2	1.2	0.9	1.1	0.9	0.9
Old Private Sector Banks	0.9	0.2	1.5	1.5	1.6	0.7	1.6	1.1	1.2
New Private Sector Banks	1.2	0.6	1.3	1.4	1.2	0.3	1.2	1.0	1.0
Foreign Banks	1.8	1.4	0.9	1.8	2.5	2.0	1.5	1.3	1.5
Gross NPAs to Gross Advances**									
Scheduled Commercial Banks	7.3	7.3	9.3	9.7	9.8	8.8	10.9	11.1	11.2
Public Sector Banks	8.1	8.1	9.6	10.0	10.2	9.4	11.2	11.6	11.6
Old Private Sector Banks	7.9	7.7	10.1	10.1	9.8	8.9	12.5	12.8	12.3
New Private Sector Banks	3.9	4.8	9.6	10.4	10.4	7.6	11.4	11.3	11.3
Foreign Banks	4.7	4.9	5.2	5.3	5.4	5.2	5.6	5.5	5.6
Net NPAs to Net Advances**									
Scheduled Commercial Banks	2.8	3.0	3.7	4.0	4.6	4.5	5.1	5.5	5.7
Public Sector Banks	3.0	3.1	3.6	4.0	4.7	4.7	5.2	5.8	6.0
Old Private Sector Banks	3.8	3.9	5.7	6.1	6.2	5.8	7.8	8.3	8.1
New Private Sector Banks	1.8	2.4	4.0	4.4	4.6	4.5	5.1	5.0	5.2
Foreign Banks	1.4	1.5	1.3	1.5	1.7	1.7	2.0	1.9	1.9
CRAR**									
Scheduled Commercial Banks	13.7	13.0	13.5	13.2	13.0	12.7	12.8	12.5	12.3
Public Sector Banks	13.5	13.2	13.8	13.3	13.0	12.6	12.6	12.3	11.9
Old Private Sector Banks	14.3	13.7	15.0	14.4	13.5	12.8	13.4	13.1	13.3
New Private Sector Banks	13.7	10.6	11.2	11.3	11.3	11.3	12.8	12.6	12.9
Foreign Banks	14.7	15.0	14.8	14.9	14.7	15.2	13.5	13.0	13.2

* : Annualised to ensure comparability between quarters. ** : Position as at the end of the quarter.

Note : Data for March and June 2004 are provisional.

Source : DSB returns submitted by banks covering domestic operations.

capital ratio in respect of NBFCs remained well above the regulatory minimum of 12 per cent (Chart X.2). The number of NBFCs not complying with the regulatory stipulation has shown a declining trend. The CRAR of primary dealers (PDs) also recorded a significant improvement.

Asset Quality

10.83 A sharp decline in the gross and net NPAs of scheduled commercial banks, in spite of the change over to 90-day delinquency norm, reflects the impact of various initiatives undertaken for resolution of NPAs (Table 10.7). Similarly, the net NPA to capital

Table 10.4: Frequency Distribution of CRAR (end-March 2004 P)

Bank Group	Negative	Between 0 and 9 per cent	Between 9 and 10 per cent	Between 10 and 15 per cent	15 per cent and above	Total
1	2	3	4	5	6	7
Public Sector Banks						
SBI Group	0	0	0	8	0	8
	(0)	(0)	(0)	(8)	(0)	(8)
Nationalised Banks	0	0	1	16	2	19
	(0)	(0)	(1)	(16)	(2)	(19)
Private Sector Banks						
Old Private Sector Banks	0	0	0	12	8	20
	(0)	(0)	(3)	(13)	(5)	(21)
New Private Sector Banks	1	1	0	7	1	10
	(1)	(1)	(1)	(5)	(1)	(9)
Foreign Banks	0	0	0	8	25	33
	(0)	(0)	(0)	(8)	(28)	(36)
All Banks	1	1	1	51	36	90
	(1)	(1)	(5)	(50)	(36)	(93)

P : Provisional.
Note: Figures in parentheses relate to March 2003.

ratio, which is a worst-case scenario measure, steadily declined between end-March 2003 and end-March 2004.

Table 10.5: Key Financial Indicators of Scheduled UCBs

(Amount in Rupees crore)

Indicator	March 2004	March 2003	Percentage variation
1	2	3	4
Number of Scheduled UCBs	55	56	
Paid up capital	707	608	16.1
Reserves (excluding loan loss provisions)	2,488	2,195	13.4
Tier I capital	297	-10	
Tier II capital	529	434	21.7
Deposits	39,305	36,024	9.1
Investment in Government and other approved securities	13,954	10,806	29.1
Loans and Advances	23,962	22,941	4.5
Gross NPAs	6,892	6,927	-0.5
Net NPAs	3,509	3,827	-8.3
Net Profit#	497	354	40.4
Net Loss*	101	326	-69.1
Accumulated Losses	2,320	2,276	2.0
Memo items : Ratios (in per cent)			
Gross NPAs as percentage of gross advances	28.8	30.2	
Net NPAs as percentage of net advances	17.1	19.3	

: Relates to 47 banks in March 2003 and 50 banks in March 2004.
* : Relates to 9 banks in March 2003 and 5 banks in March 2004.
Note : Data as on March 31, 2004 are unaudited and provisional.

10.84 A large concentration of credit in a few sectors is an indicator of vulnerability since the lending institutions are exposed to the heightened credit risk, especially in the downturn phase of the business cycle. Data on sector-wise deployment of gross bank credit by 48 major banks showed that the share of food credit declined. The share of credit to the priority sector remained more or less unchanged up to September 2002 before increasing gradually,

Table 10.6: CRAR and Net NPAs of Select FIs (end-March 2004)

Financial Institution	CRAR (Per cent)	Net NPAs (Rupees crore)	Net NPAs to net loans (Per cent)
1	2	3	4
Term-Lending Institutions (TLIs)			
IDBI	18.3	8,693	21.1
IFCI	-12.8	4,177	34.1
EXIM Bank	23.5	129	1.3
IIBI	-18.1	703	52.1
TFCI	23.1	145	21.2
IDFC	37.0	0	0.0
All TLIs	**14.2**	**13,847**	**19.8**
Refinancing Institutions (RFIs)			
NABARD	39.1	1	0.0
NHB	29.4	63	1.0
SIDBI	53.8	226	2.4
All RFIs	41.8	290	0.5
All FIs	22.0	14,137	10.5

Source : Off-site returns submitted by FIs.

Chart X.2: Frequency Distribution of CRAR - Number of Reporting NBFCs

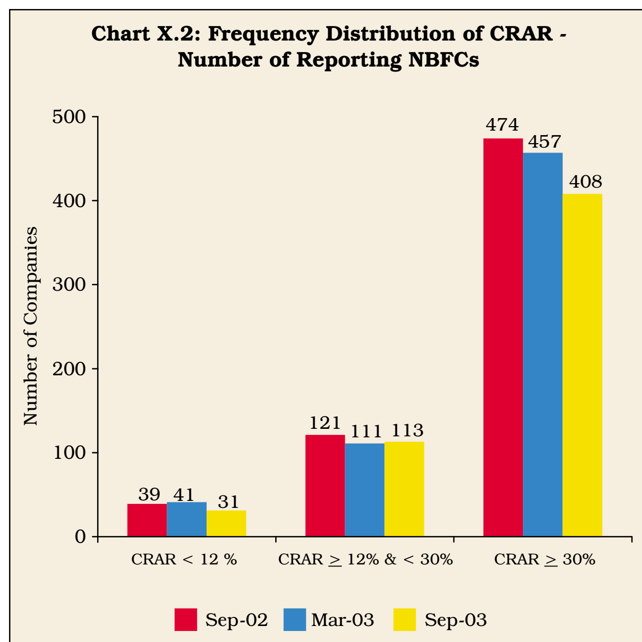
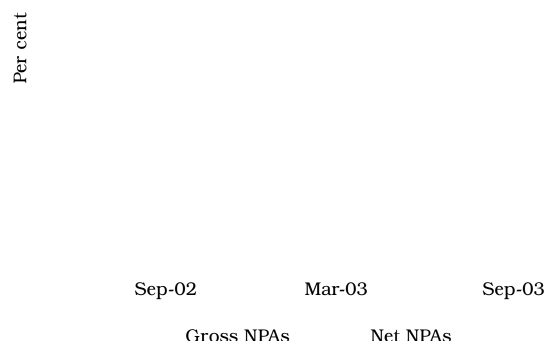


Chart X.3 : Ratio of Non-Performing Assets to Credit Exposure - NBFCs



reflecting the broadening of the definition of the priority sector over the period. The share of 'other sectors' recorded a steady increase, mainly due to the growth in the housing and retail sectors. Industry-wise data showed a steady increase in share of credit to infrastructure industries. The share of engineering industries, however, declined steadily.

Table 10.7: Net NPAs to Net Advances of Scheduled Commercial Banks

(Frequency Distribution)

Year	Public Sector Banks		Private Sector Banks		
	SBI Group	Nation-alised Banks	Old	New	Foreign Banks
1	2	3	4	5	6
1996-97					
Up to 10 per cent	5	12	22	9	36
Above 10 per cent and up to 20 per cent	3	6	3	–	1
Above 20 per cent	–	1	–	–	2
2000-01					
Up to 10 per cent	8	14	16	8	31
Above 10 per cent and up to 20 per cent	–	5	4	–	6
Above 20 per cent	–	–	3	–	5
2001-02					
Up to 10 per cent	8	16	17	8	25
Above 10 per cent and up to 20 per cent	–	3	3	–	5
Above 20 per cent	–	–	3	–	9
2002-03					
Up to 10 per cent	8	17	19	8	28
Above 10 per cent and up to 20 per cent	–	2	1	1	4
Above 20 per cent	–	–	1	0	4
2003-04 P					
Up to 10 per cent	8	18	18	9	27
Above 10 per cent and up to 20 per cent	0	1	2	0	2
Above 20 per cent	0	0	0	1	4

P : Provisional.

10.85 The asset quality of DFIs as a group has been deteriorating due to very high NPA ratios in respect of two DFIs. NPA ratios were low in respect of NBFCs (Chart X.3).

Earnings and Profitability Indicators

10.86 The earnings and profitability indicators for the financial system as a whole were positive, except in the case of DFIs. The return on total assets (ROA) in respect of DFIs was negative, reflecting persistent losses combined with limited recourse to low cost funds. Although the ROA of the PDs declined marginally due to increased volatility in securities market, it was still high. The ROA of scheduled commercial banks has been improving steadily even after making substantial provisions. Continued higher income from securities trading, profits from foreign exchange operations and decline in interest expenses are some of the reasons for the buoyancy in banks' profitability. The return on equity (ROE) of the commercial banking system remained high which augurs well for their efforts towards raising capital from the market.

10.87 The operating costs of banks witnessed an increase during April-September 2003, due to increases in staff costs and other operating expenses as a percentage to income. However, the cost income

Table 10.8: Operational Results of Scheduled Commercial Banks - Key Ratios

(Per cent)

Ratio to Total Assets	2003-04	2002-03
1	2	3
Earnings before Provisions and Taxes (EBPT)	2.70	2.43
Profit after Tax	1.18	1.01
Total Income	9.48	10.29
Interest Income	7.41	8.39
Non-Interest Income	2.07	1.91
Total Expenditure	6.76	7.86
Interest Expenses	4.52	5.59
Operating Expenses	2.24	2.27
Provisions and Contingencies	1.53	1.42

Note : Data are provisional and relate to domestic operations only.

ratio (ratio of operating expenses to total income net of interest expended) declined, reflecting improved efficiency. While containment of such costs is imperative to sustaining improved profitability, the impending wage revision in the financial sector may put pressure on its operating costs in the near future.

10.88 A sharp improvement in the commercial banks' bottomline was due, in large part, to the treasury profits which were fuelled by the decline in interest rates and profit-booking on sale of Government securities. These sources of profits may not be sustained in the future. Banks' earning capacity would increasingly depend on other sources such as interest earned from lending operations and fee-based business (Tables 10.8 and 10.9).

Sensitivity to Market Risk

Interest Rate Risk

10.89 Given the significant share of investments in Government securities in the assets of commercial banks, the interest rate sensitivity of their balance sheets is critical. The Reserve Bank, therefore, conducts periodic sensitivity analyses of banks' balance sheets.

Currency Risk

10.90 An appreciation in the rupee *vis-à-vis* the US dollar, combined with soft global interest rates during 2003-04, led to increased recourse to external commercial borrowings as also increased borrowings in foreign currency from the domestic banks. The foreign currency positions of importers and other corporates going in for such borrowings have, however, remained largely unhedged. Banks have, therefore, been sensitised to the need to assess the foreign currency risk of their borrowers spilling over to the credit risk.

Commodity Risk

10.91 Banks in India generally do not trade in commodities. Certain banks have, however, been allowed to trade in precious metals and in gold derivatives subject to fulfilment of certain prudential norms. The exposure of the banking system to precious metals is insignificant and is not a cause of systemic concern.

Table 10.9: Operational Results of Scheduled Commercial Banks – 2003-04

(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)	7	16	8	3	19	53
Profit after Tax	7	15	11	6	22	61
Total Income	1	0	3	0	5	9
Interest Income	0	0	1	0	5	6
Non-Interest Income	7	15	6	1	15	44
Total Expenditure	0	1	1	0	4	6
Interest Expenses	0	0	0	0	3	3
Operating Expenses	3	5	9	6	12	35
Provisions and Contingencies	7	14	7	5	17	50

Note : Data are provisional and relate to domestic operations only.

Equity Risk

10.92 Banks' exposure to the capital market at 1.8 per cent of total advances at end-March 2004 was well below the stipulated ceiling of 5 per cent. Some new private sector banks have exposures close to the limit prescribed.

Liquidity

10.93 The ratio of liquid assets to total assets of banks declined to 42.6 per cent at end-March 2004 from 44.2 per cent at end-September 2003. This was indicative of the increased credit offtake from the banking system during the last half year.

10.94 MPIs also include key indicators of the global economic outlook, prospects for the domestic economy, financial markets, corporate profitability and credit offtake. These have been covered extensively elsewhere in the Report. Besides, exposure of banks to retail credit has also assumed considerable significance as an MPI, which is covered in Section III.

10.95 To sum up, the response of the financial sector to the Reserve Bank's initiatives has been encouraging. This has resulted in improvement in key banking parameters, especially in increased capital adequacy and reduced net NPA ratios. The improved macroeconomic outlook and the pick-up in industrial activity have also resulted in an improved credit offtake. The financial sector has acquired greater strength, efficiency and stability. The performance of the banking sector is noteworthy considering the legacy of past NPAs and progressive tightening of prudential norms. Overall rigidity in lending rates as well as inadequacy in quality of service to some sections continue to be matters of concern.

Outlook

10.96 The process of financial liberalisation has exposed financial institutions to a wide range of market risks than before. This has necessitated an ongoing restructuring of the regulatory framework, adaptation to the changing landscape of the financial system and a continuous sharpening of the focus of monitoring. Furthermore, recent events have brought issues relating to corporate governance and internal control systems to the centre-stage of the responsibility for financial stability. It also calls for watchfulness among all stakeholders.

10.97 The Reserve Bank would continue to strengthen its supervisory initiatives. Risk-based supervision and the PCA framework would be strengthened further. Consolidated supervision would be complemented by a supervisory framework for financial conglomerates. Regulators and regulated entities would have to enhance their risk detection and management systems in order to prepare themselves for the eventual adoption of the new capital adequacy norms under the Basel II process. The improvement in the asset quality in spite of the adoption of the 90-day delinquency norm is indeed a noteworthy development. The Reserve Bank would continue to ensure a sustained reduction in the non-performing assets to levels comparable with those of industrial countries and even below.