PART TWO : THE WORKING AND OPERATIONS OF THE RESERVE BANK OF INDIA

VIII BANKING AND EXCHANGE MANAGEMENT

COMMERCIAL BANKING

8.1 Continuing with the reforms in the banking sector, the ceiling in respect of permanent investment in approved securities has been brought down gradually in phases from 70 per cent during 1992-93 to 40 per cent in 1997-98 and further to 30 per cent in 1998-99. This would enable the banks to move progressively towards the international practice of valuing all investments on mark to market basis and facilitate the development of an active and healthy secondary market in government securities. Banks would be required to mark to market their entire investment portfolio within the next three years. Under asset classification norms, banks were advised that effective 1997-98, advances granted for agricultural purposes may be treated as NPAs, if interest and/or instalment of principal remain unpaid after these have become past due for two harvest seasons but for a period not exceeding two half years. Banks were also advised in January 1998 to furnish information about seven additional financial ratios *viz*., capital adequacy ratio (CAR) separately for Tier I and Tier II capital, interest income as a percentage of average working funds, non-interest income as a percentage of average working funds, operating profits as a percentage of average working funds, return on assets, business per employee and profit per employee in the 'notes on account', effective the balance sheet date of March 31, 1998.

Developments in Supervision

8.2 The Board for Financial Supervision (BFS), set up in November 1994 under the aegis of the Reserve Bank exercises integrated supervision over the financial system, comprising commercial banks, development financial institutions (DFIs) and non-banking financial companies (NBFCs). The BFS adopted a new approach to on-site inspection of banks from July 1997 in accordance with the recommendations of the Padmanabhan Working Group (1995). The on-site inspections focus on the statutory mandated aspects of solvency, liquidity, financial and operational health, based on a modified version of the CAMEL model *viz*., CAMELS which evaluates banks' capital adequacy, asset quality, management, earnings, liquidity and systems and control, but excludes the audit elements existing under the earlier inspection system.

8.3 The Reserve Bank prepared the supervisory rating model based on CAMELS factors for rating of Indian commercial banks which would enable the identification of banks whose conditions warrant special supervisory attention. A supervisory rating model based on CACS factors *i.e*., capital adequacy, asset quality, compliance and systems, on the lines recommended by the Padmanabhan Working Group (1995) has also been prepared and introduced in respect of the foreign banks in India. The Reserve Bank reviewed the supervisory framework in India in relation to the Basle Core Principles for effective banking supervision and is taking measures to upgrade the supervision framework so as to fulfil the requirements of the Core Principles. The BFS had set up an off-site surveillance system in 1995 to ascertain the financial condition of banks in between on-site examinations, identify banks showing financial deterioration and act as a trigger for supervisory actions over banks. The major component of this function is the establishment of a computerised data base system based on a prudential supervisory reporting framework which provides quarterly returns of financial data from banks and enables building of a 'profile' of all commercial banks.

8.4 The recommendations of the Working Group on Internal Control and Inspection/ Audit System in Banks (Chairman: Shri R. Jilani) were implemented and banks have made satisfactory progress in the implementation of mandatory recommendations. The role of external auditors in bank supervision has also been strengthened. Besides auditing the annual accounts, auditors are now required to verify and certify certain other aspects such as adherence to statutory liquidity requirements, prudential norms relating to income recognition, and financial parameters to be disclosed in the balance sheets of banks. Steps have also been taken to further improve the element of transparency and disclosure in the published accounts of banks.

8.5 During 1997-98 (July-June), the BFS held 10 meetings deliberating on the supervisory strategy for banks and other financial institutions, restructuring of the system of bank inspections, and strengthening of the statutory audit of banks, internal control and management information system. The Advisory Council met twice during 1997-98 and considered *inter alia*, reports on the capital adequacy standards of commercial banks, the parameters of banks' performance to be disclosed to the public, the new supervisory mechanism for NBFCs and the methodology for on-site inspections through outside chartered accountants. It also approved the modalities for issuance of certificates of registration to NBFCs.

8.6 The Audit Sub-Committee held two meetings wherein it reviewed, *inter alia*, the position and the need for more disclosure and transparency in the final accounts of banks and decided that seven additional financial ratios (as elaborated earlier) should be disclosed in the 'notes on account' in the Annual Reports of banks from the year 1997-98.

Commercial Banks

8.7 During 1997-98 (July-June), Annual Financial Inspection was completed in respect of 27 public sector banks and 11 Local Head Offices of the State Bank of India. The Bank also undertook financial inspection of 35 private sector banks and 37 foreign banks.

8.8 During 1997-98 (July-March), commercial banks reported 1,827 cases of frauds involving an amount of Rs.377 crore. In addition, eight cases involving Rs.0.37 crore were reported in the overseas branches of the banks. These cases were followed up with the banks for necessary remedial measures and fixing staff accountability. Eight circulars were issued during the year to alert banks giving *modus operandi* adopted by various fraudsters. Consequent to the problems involving CRB Capital Markets Ltd., banks were advised to prescribe a package of safeguards on the basis of their risk perception and judgement on the standing of corporates, the investor base of the company, the arrangements for pre-funding facility and the monitoring of drawals.

8.9 During 1997-98 (July-June), 95 cases of bank robberies/dacoities involving an amount of Rs.3.08 crore were reported by public sector banks and 38 caution advices were issued to all commercial banks (excluding RRBs) in respect of firms/companies committing serious irregularities in their borrowal accounts.

Financial Institutions

8.10 Effective June 28, 1997, term lending institutions (IDBI, ICICI, IFCI, IIBI, Exim Bank and TFCI) and refinancing institutions (NABARD, SIDBI and NHB) were subjected to credit exposure norms. The exposure limit – defined to include both funded and non-funded credit limit, underwriting and other commitments - was linked to the institution's capital funds (paid–up capital and reserves as per published accounts) and was not to exceed 25 per cent in the case of individual borrowers and 50 per cent (60 per cent inclusive of the additional 10 per cent in respect of infrastructure projects effective September 11, 1997) for group borrowers.

8.11 As a part of prudent credit management, the all India financial institutions (AIFIs) were advised on February 11, 1998, to ensure that assisted companies do not grant loans at an interest rate lower than that on their borrowings from banks/FIs, without the prior approval of their Board of Directors. Further, AIFIs were required to strengthen the existing arrangements for monitoring the proper end-use of funds disbursed by them. Effective December 4, 1997, it was clarified that although the government guaranteed advances need not be classified by AIFIs as NPAs if dues in such accounts were in arrears, these were not to be reckoned for income recognition purposes. However, such advances were to be treated as NPAs if the concerned government repudiates its guarantee. Effective January 23, 1998, the ban on sanction of bridge loans to companies (other than NBFCs) by AIFIs against expected equity flows/ issues was lifted.

8.12 To introduce level playing field in the matter of raising resources by AIFIs, limited companies and statutory bodies were allowed to issue bonds with maturity of five years and above without prior approval but with simple registration with the Reserve Bank, provided the bonds are plain *vanilla* instruments (i.e., without options etc.) and the interest rate on such bonds is not more than 200 basis points above the yield on government securities of equal residual maturity at the time of issuing bonds. All other bond issues were required to be referred to the Reserve Bank for approval. Approval from other authorities like SEBI etc. was also to be obtained as hitherto.

Non-Banking Financial Companies

8.13 The Reserve Bank of India (Amendment) Act, 1997, made it obligatory for non-banking financial companies (NBFCs) to apply to the Reserve Bank for a certificate of registration. One of the conditions for a certificate of registration is that the NBFC must have a minimum net owned fund (NOF) of Rs.25 lakh. NBFCs which did not have the minimum NOF at the commencement of the Act were required to achieve the stipulated minimum NOF within three years. Of the 37,478 applications received for registration, 8,500 were from NBFCs with NOF of Rs.25 lakh and above. The Bank issued certificates of registration to 6,006 companies and rejected the applications of 45 companies. During 1997-98, 25 companies not complying with the Reserve Bank's directions regarding acceptance of public deposits were debarred from accepting fresh deposits.

8.14 The Reserve Bank introduced a new regulatory framework for NBFCs in January 1998 with the focus on NBFCs accepting public deposits with a view to safeguarding the interests of depositors (Box VIII.1). Accordingly, NBFCs falling short of the stipulated minimum NOF were precluded from accepting public deposits. Obtainment of the minimum investment grade credit rating and mandatory compliance with the prudential norms are other preconditions for acceptance of public deposits. Ceiling on the quantum of public deposits was related to the level of credit rating given by approved credit rating agencies. NBFCs not accepting public deposits are, however, exempt from the requirement of submission of returns and financial statements.

8.15 NBFCs were required to achieve capital adequacy ratio of 10 per cent by end-March

Box VIII.1

Supervision of NBFCs : Recent Initiatives

The main plank of supervision of NBFCs is off-site monitoring. A comprehensive mechanism of off-site supervision of NBFCs is under implementation. Under this mechanism, periodical returns submitted by NBFCs would be critically examined through a computerised system. Those NBFCs which show disturbing features would, however, be subjected to an on-site inspection as well. Additionally, NBFCs having large public deposits would be subject to annual on-site inspection. A revised set of guidelines on prudential norms relating to income recognition, asset classification, provisioning for bad and doubtful debts, capital adequacy and concentration of credit/investments were issued by the Reserve Bank. Market research units have been created to get first-hand knowledge of functioning of NBFCs.

Under off-site supervision, NBFCs are required to submit to the Reserve Bank a set of periodical returns certified by their auditors. With a view to ensuring compliance, directions were issued to the statutory auditors of NBFCs requiring them to include in their report to the Board of Directors of the concerned NBFCs certain aspects of supervisory concern to the Reserve Bank. The auditors of NBFCs are also required to furnish to the Reserve Bank a report on contravention, if any, by NBFCs, of the provisions of the RBI Act or the directions issued by the Reserve Bank.

To ensure better appreciation of the supervisory concerns of the Reserve Bank and to have feedback of the functioning of the NBFCs, an Informal Advisory Group on NBFCs was constituted in May 1998 consisting of representatives of the Reserve Bank, industry majors and NBFC associations. The Group will review the implementation of the regulations and act as a forum to which specific issues could be referred to. The Group will be meeting at quarterly intervals and submit its recommendations to the Reserve Bank.

1998 and 12 per cent by end-March 1999. The liquid assets requirement was made applicable only to public deposits and fixed at 12.5 per cent, effective April 1, 1998, to be increased to 15 per cent, effective April 1, 1999. NBFCs facing default in repayment of public deposits were directed not to extend credit or make investments. The interest rate ceiling on public deposits was fixed at 16 per cent per annum.

Working Group on NBFCs

8.16 Consequent upon the suggestion made by the Supreme Court in its judgement dated January 4, 1996 in the case relating to Peerless General Finance and Investment Company Ltd., the Reserve Bank, in consultation with the Government, had set up a Working Group (Chairperson: Smt. K.S. Shere) in September 1996 to examine the issues relating to creation of a separate instrumentality for regulation and supervision of residuary and other NBFCs and extension of deposit protection scheme. The report of the Committee submitted to the Reserve Bank on September 1, 1997 has been forwarded to the Government for further consideration.

Liquidation & Amalgamation

8.17 As at end-December 1997, 88 banks were under liquidation. The matter with regard to completion of liquidation proceedings continues to be pursued with the concerned officials/ court liquidators.

Number of Foreign Banks in India

8.18 During 1997-98 (July-June), the number of foreign banks operating in India increased from 41 to 42 with the opening of a branch of Toronto Dominion Bank at Mumbai. The number of branches also increased from 180 to 182; while eight branches were opened by existing foreign banks, ANZ Grindlays merged its seven branches with its nearby branches.

Indian Banks' Presence Abroad

8.19 The number of foreign branches of Indian banks declined from 98 to 97 during 1997-98. While Bank of Baroda opened a branch at Durban in South Africa, State Bank of India closed its branch at Panama. Two branches – Tanjong Pagar branch and Singapore main branch – of UCO Bank were merged.

Credit to Small Scale Industries (SSIs)

8.20 As at the end of March 1998, in all 370 specialised SSI bank branches were in operation. In March 1998, banks were advised to identify centres for opening more such branches in those districts having a large concentration of SSIs but where no specialised SSI branch had been operationalised. The total outstanding credit provided by the public sector banks to small scale industries as on the last Friday of March 1998 was of the order of Rs.38,109 crore which formed 17.5 per cent of their net bank credit and 41.7 per cent of their total priority sector advances.

Credit for Sick Industrial Undertakings

8.21 As at the end of March 1997, there were 2,35,032 sick SSI units with outstanding credit worth Rs.3,609 crore. Of these, 16,220 units with credit outstanding of Rs.479 crore were considered potentially viable. In respect of non-SSI sick units, of 1,948 such units with credit outstanding at Rs.8,614 crore, 550 units with Rs.3,107 crore of credit outstanding were considered viable.

Banking Ombudsman Scheme

8.22 The Banking Ombudsman Scheme, 1995 was announced in June 1995, under the provisions of the Banking Regulation Act, 1949 for expeditious and inexpensive resolution of customer complaints about the deficiencies in banking services. All scheduled commercial banks having business in India (except RRBs) and scheduled primary co-operative banks are covered under the scheme. With the appointment of a banking Ombudsman in Thiruvananthapuram in September 1997, the number of Ombudsmen functioning in the country stands at 15 covering all the states and Union territories in India. The number of complaints received increased to 6,542 during 1997-98 from 3,358 complaints received during 1996-97. The maximum number of complaints pertained to deficiency in servicing of deposit accounts followed by loans and advances and delay in collection of cheques/bills, *etc.*

CO-OPERATIVE BANKING

Registration/Licensing of new Primary (Urban) Co-operative Banks

8.23 A liberal policy of allowing new primary (urban) co-operative banks (PCBs) on the basis of need, business potential and prospects of achieving viability within a specified time frame continued to be followed. The number of PCBs, including salary earners' societies, which stood at 1,653 as at end-March 1997 increased to 1,811 as at end-March 1998. Licensed PCBs whose demand and time liabilities are not less than Rs.100 crore qualify to be included in the Second Schedule to the RBI Act, 1934. The number of scheduled PCBs which stood at 24 as at the end of March 1997 increased to 29 as at the end of March 1998. During 1997-98 (July-June), out of 342 fresh proposals received for setting up of new PCBs, 163 were cleared for registration. During the same period, 140 new PCBs were issued licence for commencement of banking business.

Branch Licensing of PCBs

8.24 In order to grant greater freedom to financially strong and well-managed PCBs which satisfy prescribed norms, the branch expansion policy was liberalised by permitting them to open branches at centres of their choice without prior approval of the Reserve Bank. PCBs were also permitted to extend their area of operation to the entire district and those registered in metropolitan cities were allowed to extend their area of operation to the entire city limits. During 1997-98 (July-June), 388 centres were allotted to 54 PCBs. 388 licences were issued to 86 banks for opening branches.

Revision of Entry Point Norms for Organisation of new PCBs

8.25 Based on the population criteria, the entry point norms for new PCBs were revised effective April 1, 1998. The centres were reclassified into three categories, *i.e.*, i) metropolitan (10 lakh and above), ii) urban (1 lakh and above but less than 10 lakh and iii) semi-urban (10,000 and above but less than 1 lakh). The share capital norms (Rs.100 lakh, Rs.50 lakh and Rs.25 lakh) and initial membership (2,000, 1,500 and 1,000), respectively, of the three categories, were also revised. Entry point norms continue to remain relaxed for banks in less/least developed states as well as for those organised for *Mahilas*/SCs/STs.

Refinance

8.26 The Reserve Bank sanctioned credit limits aggregating Rs.4.62 crore to three PCBs as refinance facilities against their advances to tiny/cottage industrial units during 1997-98 (July-June).

Rehabilitation/Liquidation of Weak PCBs

8.27 The number of PCBs classified as 'weak' as at end-March 1997 stood at 242 as against 222 during the previous year. The performance of weak banks is closely monitored by the regional offices of the Reserve Bank in close co-ordination with the respective State Federations of urban co-operative banks/ Registrars of Co-operative Societies (RCS). The RCS issued orders for liquidation of two weak banks in 1997-98 (July-June). Of the 1,811 primary co-operative banks, 53 co-operative banks and 2 salary earners' societies were under liquidation.

Complaints/Frauds

8.28 During 1997-98 (July-June), 182 complaints were received and 81 cases of frauds were reported.

FOREIGN EXCHANGE MANAGEMENT

Delegation of Powers to Authorised Dealers (ADs)

8.29 The process of giving greater freedom to banks and corporates in respect of external current account transactions was continued. Important measures relating to Authorised Dealers (ADs) have been detailed in Section I of Part One of this Report. Besides, rating stipulation for investment of foreign currency funds by ADs in respect of which they have to manage the exchange risk, in foreign currency Treasury Bills and/or with banks abroad, was dispensed with and Boards of Directors of concerned banks were to lay down guidelines for such investment.

Facilities to Non-Resident Indians (NRIs) and Overseas Corporate Bodies (OCBs)

8.30 The following recommendations of the Working Group on NRI Investments (Chairman: Shri O.P.Sodhani, 1995) were accepted for implementation to further facilitate investment by NRIs/OCBs : i) further liberalisation of the scheme for 100 per cent investment by NRIs in sick units; ii) general permission for interest free non-repatriable loans from NRI relatives for personal purposes and for business activities; iii) permission for funds transfer between NRE account holders; iv) permission to NRIs/OCBs to establish schools and colleges on the same terms and conditions as resident individuals/corporate bodies; v) permission to NRI/OCBs to invest in unlisted companies in non-Annexure-III industries with full repatriation benefits; vi) permission to NRIs/OCBs to remit income/interest on investments, deposits etc. in India subject to clearance from income tax authorities; vii) permission to NRIs to participate in venture capital activity on the same terms and conditions as foreign investment; viii) grant of housing loans to NRIs for acquisition of houses also for improvement to the existing houses on the same terms and conditions as those applicable to residents; and ix) providing access to all information relating to NRIs/foreign investment through India Investment Centre and Indian embassies.

Foreign Investment Policy

8.31 In order to encourage inflows under foreign direct investment in India, several measures have been initiated in the recent period. The number of industries and items eligible for automatic approval by the Reserve Bank has been expanded. Furthermore, Indian companies that have foreign investment approval from SIA/FIPB no longer require any further approval from the Reserve Bank for receiving inward remittance or issuing shares to foreign investors. Similarly, Indian companies no longer require to seek approval of the Reserve Bank in the case of foreign investment eligible for approval under the automatic route of the Reserve Bank. Such companies can issue and export shares to non-resident investors if the conditions stipulated in the notifications issued by the Reserve Bank are complied with. In the Union Budget 1998-99, the procedures for foreign direct investment were streamlined under which each foreign direct investment proposal exceeding Rs.100 crore (US $ 25 million) would be cleared within a period of 90 days and an officer of the administrative ministry would be specially designated as a monitoring officer to help processing and implementation of the project in conjunction with central and state authorities to ensure its clearance within the stipulated 90 day period.

Joint Ventures/Wholly Owned Subsidiaries Abroad

8.32 The guidelines issued for Indian direct investment in joint ventures (JVs) and wholly owned subsidiaries (WOS) abroad under the Fast Track Route (FTR) clearance scheme were further modified. In addition to the existing FTR, two more new FTRs were introduced: i) investments up to US $ 15 million including the amount of investments approved by the Reserve Bank under its FTR would be allowed by ADs from out of the balances held in the EEFC account of the Indian promoter company without reference to the Reserve Bank; and ii) proposals of investments in JV/WOS abroad up to a maximum of 50 per cent of GDRs to be raised would be cleared by the government under its GDR approval process with overseas investments as permitted end-use. In addition to exports, foreign exchange earnings from other sources and export/foreign exchange earnings (track records) of parent/subsidiary companies, the quantum of EEFC/GDR funds proposed to be utilised by the Indian promoter companies would also be taken into account for determining the eligibility under FTR. The other conditions regarding fulfilment of good track record, minimum net-worth, prudential norms, eligibility criteria, feasibility reports etc., would, however, be kept in view while considering proposals under FTR, particularly in the financial services sector.

Capital Account Convertibility (CAC) Committee and Foreign Exchange Management Act (FEMA)

8.33 The following recommendations of the Capital Account Convertibility Committee (Chairman : Shri S.S.Tarapore, 1997) were accepted for implementation to facilitate further liberalisation of the capital account : i) ADs were permitted to borrow/invest abroad up to 15 per cent of their unimpaired Tier I capital; ii) loans for periods with average maturity of 10 years and above were kept outside the ECB ceiling; iii) prior approval of the Reserve Bank as regards project exports after the proposals have been cleared by the Working Group/EXIM Bank/ADs, as the case may be, were dispensed with; iv) ADs were delegated powers to release exchange for opening of offices abroad subject to fulfilment of certain conditions; v) EEFC entitlement was raised to 50 per cent from 25 per cent; vi) ADs were permitted to introduce scheme of forfaiting of medium term export receivables; vii) ADs were permitted to provide forward cover to holders of FCNR/NRE accounts and to FIIs in respect of their investment in equity and debt instruments; and viii) banks fulfilling certain criteria were permitted to import gold. Further, banks would be allowed to provide a) credit/non-credit facilities to Indian JVs/WOS abroad; and b) buyer's credit/acceptance finance for facilitating exports of goods and services from India. Besides, SEBI registered Indian fund managers including mutual funds would be permitted to invest in overseas markets subject to SEBI guidelines.

8.34 As per announcement made in the Union Budget 1998-99, a new legislation termed as the Foreign Exchange Management Act (FEMA), consistent with full current account convertibility and the objective of progressively liberalising capital account transactions, will be enacted which will replace the existing Foreign Exchange Regulation Act, 1973 (FERA). Accordingly, the FEMA Bill 1998, along with the Prevention of Money-Laundering Bill, 1998 were tabled in the Parliament on August 4, 1998.

Equity Investments in Commodity Exchange

8.35 Four banks *viz*., Indus Ind Bank Ltd., Global Trust Bank Ltd., Union Bank of India and Canara Bank were permitted to contribute Rs.50 lakh each to the share capital of the First Commodities Clearing Corporation of India Ltd. (FCCCI) to act as institutional members. FCCCI, set up in Kochi, is the first international exchange to deal in pepper futures in India.