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Regulation of the Financial System

Part I: Commercial Banks

Introduction

In keeping with the financial market reforms, the period covered in this study saw the Reserve Bank move away from development banking, which focused on channelling credit to desired fields, towards managing competition, new entry and corporate governance of institutions. This chapter, or Part I of Chapter 10, describes changes in the regulation of commercial banks. Part II deals with the regulation of other financial institutions. The supervisory function will be covered in Chapter 11.

The next section outlines the broad pattern of reforms in the regulation of banks. Subsequent sections deal with prudential norms; private sector banks; governance issues; public sector banks; foreign banks; rehabilitation of weak banks, amalgamations and mergers; branch licensing; customer identification; deregulation of credit regime, mortgage debt and global crisis; and miscellaneous regulatory issues. The concluding section considers what was achieved and what was left unfinished during the reference period.

Broad Patterns of Regulatory Reform

In March 1997, there were four categories of commercial banks: the public sector, the old private sector, the new private sector and foreign banks. Their asset shares were 83 per cent, 7 per cent, 2 per cent and 8 per cent, respectively. The dominance of the public sector declined markedly by the end of the reference period.

From several years before the reference period, regulatory practices were beginning to change to give these banks more freedom of operation and allow them to become more efficient market players. These efforts strengthened in 1997 and 1998. In 1997, an in-house working group reviewed the guidelines and instructions issued by the Department of Banking Operations and

Development (DBOD). In April 1998, a further review by Deputy Governor S. P. Talwar indicated that more areas of micro-management should be left to the banks, with a greater focus on monitoring compliance. On 3 June 1998, in a meeting between Governor Jalan and the Deputy Governors, it was decided to delegate freedom to banks in many areas.[1] And in April 2000, the Governor had a meeting with the chief executive officers (CEOs) of major commercial banks to discuss autonomy.

Structural reforms were undertaken at the same time with the same broad aim to allow banks more freedom while improving corporate governance. Following the report of the Narasimham Committee II, an expert group formed by the government in 1998 suggested amendments to key banking statutes.[2] The Bank approached the group for making amendments to the Banking Regulation Act, 1949, to give it more power to monitor corporate governance. In the wake of the East Asian crisis of 1997–98, measures were announced to improve capital adequacy, income recognition, provisioning norms, and disclosure and transparency practices in banking operations. The cash reserve ratio (CRR), which was essentially an instrument of monetary policy, was reduced.[3] The statutory liquidity ratio (SLR) was also reduced.[4] These changes gave greater flexibility both in the operation of the banks and to the Reserve Bank to administer its monetary and regulatory policies.

There had been a gradual move away from an administered interest rate regime to a flexible interest rate one. Among other specific areas, freedom was given to banks to set the minimum maturity of term deposits, penal interest rates, higher interest rates on deposits by senior citizens, the hiring of selling agents, and rationalisation of operational guidelines pertaining to deposits. In April 2003, a Working Group on Interest Rates on Deposits and Procedure recommended that the Bank discontinue its Manual of Instructions issued in 1998 and retain only the Master Circular on Interest Rates on Deposits issued in July 2002.[5] The recommendations were implemented with some modifications over a period. More flexibility was offered to banks mobilising funds through certificates of deposit (CDs) and commercial paper (CP) and on the prime lending rate (PLR, also see Chapter 3). The selective credit controls, which aimed to control the prices of some agricultural commodities, had been removed (except sugar and, briefly, wheat) from 1996.

This paradigm shift in the approach to regulation involved frequent interactions with international agencies and market participants. For example, India first participated in the Pilot Program on Financial Sector Assessment in 2001 conducted by the International Monetary Fund (IMF) and the World Bank and was also associated with the independent assessment of standards and codes by these bodies. Market participants were invited to join several committees and working groups. Faith in a more consultative approach was reflected in a 2000 speech by Governor Jalan where he said, '[W]e do not have the monopoly of wisdom.'[6] The initiative by Governor Reddy to start a users' consultative panel was further evidence of the shift. The panel for commercial banks was constituted with representatives from banks, the Indian Banks' Association (IBA) and the Fixed Income Money Market and Derivatives Association of India (FIMMDA) in June 2004. All draft regulatory guidelines (except market sensitive circulars) were e-mailed to members of the panel for comments and suggestions before implementation. The top management followed media reports on the Bank and banking-related matters more closely during the reference period.

A cornerstone of the new approach was to make banks conform to prudential norms.

Prudential Norms

Prudential norms were introduced in 1992 and their strengthening continued into the period of study. The performance of banks in meeting these norms was somewhat uneven at the start of the reference period.

Capital Adequacy

In March 1997, twenty-five of twenty-seven public sector banks had achieved the minimum stipulated capital to risk weighted assets ratio (CRAR) of 8 per cent. Only Indian Bank with a negative CRAR and UCO Bank with 3.2 per cent CRAR had not achieved the minimum norm. Among old private sector banks, four out of twenty-five banks had not achieved the minimum of 8 per cent; of these four, three banks – Bareilly Corporation Bank Ltd, Lord Krishna Bank Ltd and Benares State Bank Ltd – merged with other banks subsequently. The fourth, Catholic Syrian Bank Ltd, achieved the stipulated level of CRAR by March 2002 through rights issues and internal accruals.

In October 1998, the CRAR requirement was raised to 9 per cent, and the risk weights of assets were revised.[7] In February 1999, banks were given the freedom to raise Tier II capital through subordinated bonds. In the same year, seven old private sector banks of relatively small size (capital funds of less than ₹0.5 billion) were advised to reach a size of ₹0.5 billion within three years. State Bank of India (SBI) was called upon to augment the share capital of its associate banks to maintain the required CRAR. The Reserve Bank encouraged banks to plough back their earnings as much as possible.

Given the differences between segments of the banking system, in the implementation of Basel I norms,[8] a three-track approach was followed. Commercial banks were required to maintain capital for both credit and market risks, cooperative banks for only credit risk, and the regional rural banks (RRBs) were required to maintain a level of capital not on par with the Basel I framework. The large holding of SLR securities was one of the reasons that banks could comfortably maintain the required CRAR.[9] In 2003, as a step towards attaining convergence towards Basel I risk-weighted capital charges and facilitate the transition to Basel II norms, the Reserve Bank issued instructions and guidelines to banks to provide capital charge for market risk in a phased manner over a two-year period. The Basel II framework had three 'pillars', namely minimum capital requirement, supervisory review process and market discipline. Basel II had more comprehensive coverage of risks than Basel I, which addressed only credit and market risks. The framework offered two general approaches to assess capital against operational risk. The Basic Indicator Approach linked capital charge for operational risk to a single risk indicator (for example, gross income) for the whole bank. And, under the Advance Measurement Approach, banks would use the results of their internal operational risk measurement systems subject to standards set by the Basel Committee on Banking Supervision (BCBS).

In October 2004, a committee formed with representation from banks considered the process of migration to Basel II. It was decided that from March 2007, all banks would use ratings from external credit rating agencies to quantify the required capital for credit risk, and use the Basic Indicator Approach (for operational risk), eventually implementing more complex systems with increasing capability. Following these discussions, a New Capital Adequacy Framework (NCAF) was announced in February 2005. To facilitate the transition, the Bank issued a guidance note, helped in accreditation of rating agencies, and trained bank personnel.

To provide banks with an adequate menu of options for raising capital, operational guidelines were issued in 2005. Banks were permitted to issue innovative hybrid debt instruments (Tier II capital) and short-term subordinated debt instruments (Tier III capital). Subordinated debt is a loan taken by a company that ranks below all other liabilities relating to claims on its assets or earnings.[10] In October 2007, after receiving the government's clearance, the Reserve Bank permitted banks to issue preference shares of different variants to raise Tiers I and II capital. The dates for migration to Basel II were adjusted according to the preparedness of different categories of banks.

Following the international best practices to minimise contagion risks, the Bank stipulated prudential limits for cross-holding of capital among banks. In September 2003, investment in Tier II bonds issued by banks was subjected to a ceiling of 10 per cent of the investing bank's capital funds (Tiers I and II). In July 2004, the ceiling was made applicable to banks' investments in all types of instruments of other financial institutions. Banks were also advised to not acquire a fresh stake in a bank's equity shares if, by such acquisition, the investing bank's holding exceeded 5 per cent of the investee bank's equity capital. The investments in instruments issued by banks and eligible for capital status would attract a risk weight of 100 per cent for credit risk.

Investments

In 1992–93, the Reserve Bank had advised banks to categorise their investments into 'permanent', which were likely to be held until their maturity, and 'current', which were likely to be traded before maturity. Initially, banks were allowed to keep not more than 70 per cent of their total investments in the permanent category. Current investments had to be 'marked to market', that is, valued at market rates, and if there was depreciation, it had to be provided for. The share of permitted 'current' investments was raised, from 50 per cent in 1996–97 to 60 per cent in 1997–98 and 75 per cent in 1999–2000. In respect of securities for which market quotations were not available, banks could value them by yields, provided by the Bank, for different maturities while drawing up their balance sheets.

In 2000, new guidelines were issued on the classification of investments into held to maturity (HTM), available for sale (AFS) and held for trading (HFT) categories. The HTM category, where marking to market was not necessary, would not exceed 25 per cent of total investments, as they were intended to be held until their maturity. The yields of securities rose sharply in 2004 and a business daily estimated losses of the banking sector at ₹500 billion. The Reserve Bank arranged a meeting in August 2004 with the IBA, FIMMDA, the Foreign Exchange Dealers' Association of India (FEDAI) and other bodies to discuss the situation. In September 2004, the Reserve Bank permitted banks to exceed the limit of 25 per cent in HTM, subject to conditions, including permission to shift SLR securities to HTM as a temporary measure to protect banks from depreciation in bond prices.[11]

In September 2004, an internal group reviewed these guidelines in relation to the global best practice and submitted new draft guidelines to the Standing Technical Advisory Committee on Financial Regulation (STACFR) (Box 10.1.1).[12]

To mitigate the risk from a reversal of interest rates, banks were advised (March 1999) that they should appropriate the provision towards depreciation on investments, rendered excess due to fall in interest rates, to an investment fluctuation reserve (IFR) account instead of capital reserve. Banks could utilise the IFR to meet future interest rate shocks without jeopardising their capital. In September 2004, it stood at an aggregate average of 3 per cent against the prescribed level of 5 per cent of investment in AFS and HFT categories. Only seventeen out of the eighty-eight banks had attained the prescribed level of 5 per cent of investments held in these categories, and thirteen private banks had drawn down their IFR balance in September 2004. Banks were asked to reach 5 per cent by March 2006.

Box 10.1.1 Standing Technical Advisory Committee on Financial Regulation

The STACFR was set up by Governor Reddy in late 2003 'to simplify and rationalise the regulatory regime to move towards a clear unambiguous framework', with the Deputy Governor of the regulatory department as the Chairperson, and CEOs of a few major banks (in the public sector, new private sector banks and foreign banks), the Chairman of IBA and Professor N. L. Mitra as members. Mitra was the former Vice-Chancellor of the National Law School of India University, Bangalore, and National Law University, Jodhpur. He had also been the chairman of several important Government of India committees. Two other Deputy Governors were permanent invitees. The committee met as and when required and not at stipulated intervals. It served as a think-tank of experts to advise the Bank on policy issues. The committee discussed issues such as branch licensing policy, exposure norms, concentration risk, interbank liabilities, para-banking activities, accounting standards, transparency and disclosure norms, diversion of funds and wilful defaulters, and unhedged forex exposures.

With a substantial decline in yields of securities after 2004, banks could build up sizable balances in the IFR. The IBA proposed to the Reserve Bank that the IFR should be treated as Tier I capital as it was created out of profits after meeting tax liabilities and appropriation to statutory reserves. The Bank had at first allowed the IFR to be reckoned as Tier II capital. Banks were permitted to set off depreciation against the IFR if they held the IFR above 5 per cent. In October 2005, a conditional relaxation of the rule was allowed.

SLR securities carried a sovereign guarantee; non-SLR investments did not, and yet there was little appraisal by banks before investing. In February 1999, following an internal working group report, the Reserve Bank drafted guidelines that stated that the banks' investments in 'unlisted' non-SLR securities should not exceed 10 per cent of their total investments in non-SLR securities. Limits were fixed for non-rated instruments and measures were taken to make the acquisition of investments through private placements transparent. In 2001, another review showed that some banks had made significant investments in privately placed unrated bonds, and in bonds issued by corporates who were not their borrowers. Since these investments were not regulated, the Reserve Bank wanted the boards of banks to fix prudential limits on these and instructed banks to show more diligence about privately placed or unrated instruments. In 2001–02, based on a working group report, the Bank issued revised guidelines.[13] In October 2001, banks were asked to make fresh investments only in dematerialised form. This measure gained urgency in the wake of the irregularities in the government securities market in early 2001. Later they were advised to convert their equity holdings to demat form by December 2004.

The guidelines on non-SLR investments were revised in 2003.[14] Banks and the media did not react favourably to the new guidelines. To this reaction, the Reserve Bank responded stating that they had time until March 2004 to comply with these. In December 2003, another circular clarified that some segments of the market were exempted from the guidelines and that asset-backed securities and mortgage-backed securities would not be reckoned as unlisted non-SLR securities.[15]

Asset Classification and Provisioning

The asset classification norms introduced in the mid-1990s were progressively tightened. There were four asset categories – standard, sub-standard, doubtful and loss assets. Banks that had difficulty classifying small advances in this way were given time until March 1998 to comply. They were required to provide a flat provision of 15 per cent in respect of such unclassified small advances. An account was treated as a non-performing asset (NPA) if the principal or interest was not paid within 180 days from the due date (reduced to 90 days from March 2004). Earlier, substandard assets migrated to 'doubtful' category after twenty-four months. This period was reduced to twelve months in March 2005. In June 2004, graded provisioning was introduced according to the age of the NPAs.

Advances guaranteed by state governments were earlier treated as risk-free, but after some states refused to honour guarantees, they were treated on a par with general advances. Since the advances portfolio tended to grow faster during an expansionary phase, there was a tendency to underestimate the level of inherent risk. A general provision of a minimum of 0.25 per cent was advised to banks in October 1998 and introduced from March 2000. The provision for standard advances was raised to 0.40 per cent in October 2005, and in specific sectors, such as personal loans, capital market exposure, housing loans over ₹2 million, and commercial real estate loans, to 1 per cent in April 2006. Agricultural advances and advances to small and medium enterprises continued to attract provisioning at 0.25 per cent.

In June 2002, prudential limits for lending in the call money market were introduced.[16] From 30 April 2005, the benchmark for fixing prudential limits on exposures to call/notice money market was linked to the capital funds (sum of Tier I and Tier II capital).

Liabilities

For financial stability, mitigation of counter-party concentration risks and regulation of interbank liabilities were necessary. Counter-party concentration occurs when a significant percentage of a portfolio has exposure to the same or related counterparties. Although limits were in place for call money borrowings, these covered only a portion of the interbank liabilities. In 2005, an interdepartmental group recommended that total interbank liabilities be limited to 200 per cent of the net worth of a bank, to begin with, and the limit lowered to 150 per cent by September 2006. The STACFR, however, held that the concept of fixing limits on interbank liabilities was not an appropriate one, and did not have a parallel in the world.

It was again proposed to fix appropriate limits for interbank liabilities within a band of 200 to 400 per cent of their net worth. But the Board for Financial Supervision (BFS) did not favour the band and in March 2007 the limit was set at 200 per cent of net worth, and for banks with CRAR above 11.25 per cent, at 300 per cent.

Asset–Liability Management and Risk Management Systems

An in-house working group formed in November 1997 prepared a discussion paper on asset–liability management (ALM).[17] The suggested framework gave freedom to banks to lay down gap limits based on their own asset–liability profile. The IBA responded that the Bank 'is giving undue importance to Credit–Deposit ratio as an index of risk evaluation which is not much relevant in today's environment'.[18] The *Business Standard* criticised the Reserve Bank on 29 September 1998 for a 'one size fits all' prescription. The Bank accepted that a uniform ALM system for all banks was not feasible. The guidelines were, it clarified, to serve more as a benchmark. In the final guidelines issued in February 1999, banks were to ensure coverage of at least 60 per cent of their liabilities and assets by September 1999, and 100 per cent by April 2000.[19]

In the wake of the subprime crisis and its impact on the liquidity position of Indian banks, the Bank further revised its guidelines in October 2007, taking into account international practices (see Chapter 11).

Capital Market Exposure

The Reserve Bank's approach to banks' exposure to the capital market was conservative. Guidelines issued in May 1994 stated that acquisition of corporate shares and debentures should be below 5 per cent of the incremental deposits of the previous year. Banks were permitted to sanction bridge loans to companies up to one year against expected proceeds from equity issues, subject to limits. A further limit was prescribed for banks' direct investment in shares, convertible debentures and units of equity-oriented mutual funds at 20 per cent of the bank's net worth. Limits and margins were also set for advances against equity shares, debentures and bonds for individuals. These guidelines were reviewed jointly by the Bank and the Securities and Exchange Board of India (SEBI).[20]

Limit applicable to individual banks was extended in 2004 to consolidated banking groups to ensure that banks did not use group entities to assume exposure in areas where prudential limits were applied to banks. The aggregate capital market exposure limit for a bank was 5 per cent of the bank's advances; this was modified to 2 per cent of the total assets for a consolidated bank, since it was likely that the other entities in the group might not have 'advances' as a balance sheet item. The limit on direct investment in equity for the consolidated bank group was reduced to 10 per cent of net worth (from 20 per cent of the individual bank's net worth).

The banks campaigned to raise the capital market exposure limit above the 5 per cent ceiling, with some success. The Budget speech of 2004–05 announced that 'banks with strong risk management systems' would be permitted 'greater latitude in their exposure to capital market'. Banks wishing to take exposure above the ceiling could apply to the Reserve Bank, which would assess the merits of the application based on their risk management system, CRAR, return on assets and net NPA. On 17 May 2004, the cautious stance was vindicated when the stock market (Sensex) fell 13 per cent in one day. Little intervention was possible to arrest the fall.[21] For banks, this was a high-risk area. In December 2006, the norms were liberalised, and banks' aggregate exposure to capital markets in all forms was fixed at 40 per cent of banks' net worth.[22] For direct exposure to equity, the ceiling was fixed at 20 per cent.[23]

In February 2007, the aggregate capital market exposure of banks was only 2.3 per cent of gross advances. Of eighty commercial banks, three had exceeded the limit. The aggregate direct investments in equity were at 11 per cent of banks' net worth as against the limit of 20 per cent.

Real Estate Exposure

Real estate was an area where both returns and risks were high. This was a socially important activity. But the growing exposure of banks to the real estate sector, including housing loans, caused anxiety because of weaknesses in the valuation practices in vogue, among other problems.

The Bank followed a cautious policy on banks' exposure. In December 2002, it carried out a study of asset–liability mismatch caused by exposure to real estate and NPA levels in the real estate sector. The study revealed that the share of real estate exposure was modest in the overall loan portfolio (2.5 per cent) and the asset quality was reasonably good (NPA at 1.2 per cent) for select banks. In December 2004, the risk weight for housing loans was raised from 50 per cent to 75 per cent while for commercial real estate, retained at 100 per cent. The increase in risk weights was reflective of the anxiety. In July 2005, banks were asked to formulate a policy for such lending and to send monthly reports to the Bank.

The risk weights assigned to commercial real estate were higher than that of housing loans and, therefore, the definition of the term (that is, commercial real estate exposure) mattered to banks. Until 2005, the Bank did not clearly define the term. In June 2005, a circular did this, and in the following month, the risk weight was raised to 125 per cent, and in 2006, given the rapid expansion in credit to commercial real estate, to 150 per cent. Banks resented these steps and questioned the definition of commercial real estate. The Reserve Bank did not relax the norms; in fact, it further tightened them by bringing real estate in special economic zones (SEZ, export processing zones) within the definition in September 2006.

Single Borrower/Group Exposure Norms

Another sensitive area was concentration risk in banks' advances, which resulted from large advances to big borrowers. From 1 April 2000, the ceiling on a bank's exposure to the individual borrower was lowered from 25 to 20 per cent of the capital funds as per last balance sheet to take the limit nearer the international standard of 15 per cent. Banks were advised to take this to 15 per cent by 31 March 2002. Group exposure limit was reduced from 50 per cent to 40 per cent of the capital funds from 31 March 2002. With infrastructure projects, the group exposure limit was extendable by an additional 10 per cent.[24]

The Annual Policy Statement for 2004–05 announced that banks facing difficulties with exposure limits could approach the Reserve Bank for approval. Such difficulties arose frequently with credit extended to public sector companies. Some corporate borrowers sought permission directly from the Reserve Bank for exceeding the prudential limits but the latter insisted the requests come from banks.[25] Banks were still required to make appropriate disclosure of the exposures in excess of the limits.

In June 2005, the exposure of 61 banks to 233 borrowers had exceeded the ceiling of 15 per cent, and that of 20 banks to 64 borrowers exceeded the enhanced ceiling of 20 per cent. A few banks did not disclose the excess over the limits in the Notes on Accounts, and in some other cases, the disclosures were inadequate. Indian Bank, which had negative net worth from the mid-1990s, was unable to comply with exposure norms. The bank was allowed as a special case to continue with its self-prescribed single and group borrower limits.[26] The Oriental Bank of Commerce, whose CRAR declined sharply after its merger with loss-ridden Global Trust Bank Ltd (GTB), was also permitted to continue its normal lending activities during 2004–05. Others were asked to comply.

Unsecured Advances

In 1967, a 15 per cent ceiling on unsecured advances had been introduced in view of the risks involved in such lending. Banks wanted the ceiling to be revised. In 2001, many had exceeded the ceiling. As credit card dues increased, the question came up if these should be treated as unsecured advances. In April 2002, credit cards were excluded from the definition. Advances given to self-help groups against group guarantees were also excluded.

More broadly, the banks' increased exposure to the service sector made a revision of the rule necessary. In January 2004, a working group considered requests for exemption from the norm on a case-to-case basis. The BFS advised (March 2004) that the Bank should refrain from micro-management. By June 2004, the ceiling was dispensed with taking into account that the Bank had by then prescribed stringent prudential norms.

Off-Balance-Sheet (OBS) exposures

Banks enter into off-balance-sheet (OBS) transactions for extending non-fund-based facilities to their clients and for balance sheet management. The OBS exposures take the form of contingent liabilities and derivatives and expose a bank to several risks. Hence, the Reserve Bank had advised the banks to hold defined regulatory capital on all outstanding OBS exposures. Banks were also required to make full disclosure in the balance sheets apart from periodically reporting to the Reserve Bank the data on these exposures. The risk management guidelines covered non-fund-based business too.

The OBS exposure of banks increased sharply, by around 31 per cent and 51 per cent in March 2003 and March 2004, respectively, compared to growth of total assets (on balance sheet) of 12 per cent and 16 per cent. The deregulated interest rate regime, accompanied by a decline in rates during the period and volatility in the foreign exchange market, had contributed to the increase in hedging and trading activities by banks. Fee-based activities complemented banks' income. The gradual opening of the derivatives market also facilitated the process. In March 2005, banks were, therefore, asked to disclose qualitative and quantitative aspects of their derivative portfolio and provide a clear picture of the exposure to risks in derivatives, and how these were managed.[27]

Private Sector Banks

From 1993, the private sector could set up banks. The Reserve Bank received sixty-seven applications. Ten applicants were issued licences; nine started operations. One cooperative bank, Development Credit Bank (DCB), converted to a commercial bank. The licensing conditions prescribed a high level of promoters' holding initially and diversified ownership eventually. The majority shareholder in DCB, which was a foreign body corporate, had a shareholding of over 58 per cent for ten years, brought down to 30 per cent in 2007. IDBI Bank sought time until September 2002 to reduce promoters' equity. Others complied.

Did the entry of private banks increase competition in the business? An in-house working group formed in January 1998 reviewed the situation and suggested that 'large industrial houses', whose applications had been pending with the Bank, 'may not be excluded from *prima facie* consideration for setting up of banks'.[28] The entry of large industrial houses was disallowed (by the government), 'to obviate the problems of connected lending', but their minority participation was allowed.

In 2001, a set of ten applications were considered by, among others, an advisory committee consisting of eminent specialists, including former Governor and economist I. G. Patel, and two approvals were issued. One of these was Kotak Mahindra Finance Ltd, already a non-banking financial company (NBFC), which was asked to convert into a bank, instead of setting up a new one. The other approval was given to Ashok Kapur and two other banking professionals along with Rabobank (with 20 per cent stake) on 7 February 2002.[29] YES Bank commenced operations in August 2004. No further applications were entertained in the next three years.

There were significant differences between new and old private sector banks, on minimum paid-up capital, branch opening policy, dilution of promoters' holdings, remuneration of management, and Reserve Bank nominees on the boards, among others. In a meeting with the Reserve Bank in March 2004, heads of banks urged that these distinctions should be removed. Not much progress, however, occurred during the reference period.

In May 2001, the government announced that foreign direct investment (FDI) up to 49 per cent would be permitted in the banking companies. Foreign institutional investors were already allowed to invest up to 49 per cent in private banks. Governor Jalan preferred that a combined ceiling should be set such that a minimum of 26 per cent holding was with resident Indian investors. 'Our banks,' he said, 'should not become a branch of a foreign entity and should have an Indian character and orientation.'[30]

The Reserve Bank issued a single class of banking licence. All banks could carry on both retail and wholesale banking. In January 1998, the Stock Holding Corporation of India Ltd applied for a licence to set up a limited purpose bank. The company wanted to offer limited banking service to its custodial clients. The Legal Department of the Bank held that the concept was not legally feasible because the Banking Regulation (BR) Act stipulated that the bank would provide services to the general public. In 2004, the government proposed to the Bank that with the development of the financial market and services, 'the one-size-fits-all' approach needed a rethink. The Bank declined to do so in view of the provisions of the BR Act. In November 2006, the Clearing Corporation of India Ltd wanted to become a 'Limited Purpose Bank' following a study and recommendation by the Indian Institute of Management, Bangalore. The idea was that it would help in providing an enhanced level of assurance to the members in the event of unforeseen market shocks. Again, the Reserve Bank did not consider the request.

In 2007, the IBA suggested the issue of Differentiated Bank Licence by the Bank. An internal study reviewed the current policy and international experience and practice on limited bank licensing. Governor Reddy, thereafter, announced in the Annual Policy Statement for 2007–08 that in the interest of efficiency in the banking system, 'a graded approach of licensing may be appropriate which can be equally applicable to both domestic and foreign banks'. A Technical Paper on Differentiated Bank Licences was prepared by the Bank and put on the public domain in October 2007. The IBA sent its suggestions but no progress was made until 2013.

Transfer of Shares and Voting Rights

The Reserve Bank had earlier issued instructions that transfer or allotment of banks' shares in the name of the transferee should occur only after obtaining the Reserve Bank's acknowledgement. This was meant to avoid attempts by individuals or groups to acquire a controlling interest in a bank. The rule was applied when such a transfer would take the aggregate shareholding of the individual or group to 1 per cent or more of the total paid-up capital. The limit was raised to 5 per cent in 1999. Further, a provision in the BR Act said that 'no person holding shares in a banking company shall, in respect of any shares held by him, exercise the voting right in excess of 10 percent of the total voting rights of all the shareholders of the banking company'.

In October 2001, the IBA asked for the ceiling of 10 per cent on voting rights to be raised.[31] The Reserve Bank proposed to the government that this section of the BR Act should be deleted. The intention of restricting voting rights was already met by the restriction on the acquisition of shareholdings. The draft amendment Bill was presented in the Lok Sabha in April 2003 and was referred to the Standing Committee on Finance. In the deposition before the committee on 29 July 2003, it was submitted by the Bank that 'the amendment was necessary to enable foreign banks to set up subsidiaries'. The matter, however, did not end there. On reconsideration, Deputy Governor K. J. Udeshi wrote to the Ministry of Finance in November 2003, expressing concerns about cross border flows to sensitive sectors, like banking, from tax havens as the identities are difficult to establish (see Appendix 10A.1.1). In December 2003, in a subsequent letter, the Bank informed the Ministry that as 74 per cent foreign equity in banks was allowed, it was essential to have restrictions on both shareholdings and voting rights and there was no compelling reason to allow foreign firms to have a controlling stake in Indian banks via the FDI route. After further discussions, the government agreed to drop the proposal to remove the restrictions on voting rights.[32]

Governance Issues

The criteria that the directors on the boards of banks should meet were called 'fit and proper'. The criteria included qualifications, expertise and track record. In 2004–05, draft guidelines on 'ownership and governance for private sector banks' stated that the large shareholders, directors and the CEOs should be persons who could command trust, and that no single entity or group (other than a bank) have shareholding in excess of 10 per cent of the paid-up capital. In case of restructuring of weak banks, the Reserve Bank reserved the right to permit a higher level of shareholding. Until 2008, it had not identified any bank for restructuring.[33]

SEBI had a Committee on Corporate Governance and circulated the recommendations to all stock exchanges for implementation by listed entities as part of the listing agreement in 2000. SEBI had at that time exempted banks and financial institutions and left the matter to the Reserve Bank. The Bank issued these guidelines for the listed banking companies in June 2002.

SEBI guidelines of July 1998 had authorised the Reserve Bank to approve share issues and pricing by banks. In May 1998, the Reserve Bank announced that listed banks need not seek its prior approval for public and rights issues, but bonus issues would be subject to prior approval.[34] There were representations from banks and associations for freedom on this clause. The Reserve Bank did not agree, on grounds that the issue of bonus shares would imply a higher payout ratio of dividend in future and it would benefit only the shareholders and not the bank. In the light of the wide variation in the pricing of rights, the matter was reviewed in March 2002, in terms of which banks were required to obtain the Reserve Bank's approval for initial public offerings (IPOs), but after listing on stock exchanges, banks were free to price their subsequent issues.

Later in the reference period, a matter of wider political implications came before the Reserve Bank. The International Finance Corporation (IFC) had made an investment of 4.99 per cent each in two old private sector banks.[35] The Reserve Bank was not in favour because it was not happy with the track record of the IFC. The IFC had earlier acquired 9.62 per cent in Centurion Bank and 12.15 per cent in GTB and then offloaded the stake in both (in 2003) when the two banks were going through difficult times. Since it had acquired the shares under the FDI route, the Bank was of the view that the IFC ought not to operate like a portfolio investor or a fund manager. The IFC complained to the government, and the government sought an explanation. In its response (in April 2006), the Bank explained its position, following which the government left the decision to the Bank. The World Bank, of which the IFC was a part, essentially agreed to the Reserve Bank's decision. The IFC divested its holdings by September 2008.

With dematerialisation of shares and securities, and setting up of depositories, SEBI made it compulsory for financial investors with a minimum portfolio of ₹100 million to settle all transactions through depositories from 15 January 1998. Accordingly, the Reserve Bank advised all banks to settle transactions in securities through the National Securities Depository Limited (NSDL). Legally (that is, in terms of the Depositories Act, 1996), the transfer of shares in listed banks would be effected automatically in the depository.

Banks would come to know only afterwards and so they were unable to comply with the Bank's instructions to obtain its acknowledgement 'before' effecting the transfer. Initially, the Bank tried to keep banking companies outside the ambit of the Depositories Act but it was not acceptable to SEBI and the government. A meeting in January 1999 held that the Depositories Act and the Companies Act could be amended to empower the Bank to rectify the register of banks and regulate the voting powers of transferees of shares.[36] The Legal Department suggested amending Section 12 of the BR Act instead, to which SEBI objected. A committee to look into this issue recommended (in March 2000) that in the long term, the BR Act should be amended; the short-term measure would be that banks amend their Articles of Association to the effect that acquisition of shares by a person or group, which would take individual holdings to 5 per cent or more, were carried out with the prior approval of the Bank. The Bank accepted the recommendation.[37]

In the case of American depository receipt and global depository receipt issues by banks, overseas investors would hold only the depository receipts and the underlying shares would stand in the name of the depository in the bank's books. The Reserve Bank held that these banks had to obtain its acknowledgement for allotment of shares if the depository's holding was 5 per cent or more. As banks applied for acknowledgement, the Reserve Bank would assess the 'fit and proper' status of the depository, and grant acknowledgement only after the depository agreed not to exercise voting rights. Three cases of acknowledgement received between November 2005 and April 2006 were kept pending until July 2007 because of ambiguities in this regard.[38]

The Bank had been nominating additional directors to serve on the boards of private sector banks.[39] The Ministry of Finance advised the Bank in December 1997 that appointment of serving Reserve Bank officers on the banks' boards could lead to a conflict of interest, especially when such officers were drawn from Reserve Bank offices having territorial jurisdiction over the headquarters of the banks concerned. Agreeing to the suggestion, the Bank nominated its officers from offices that had no direct jurisdiction over the banks concerned. It was also decided that the Bank nominee would not be in any board committee except the Audit Committee unless specifically approved in exceptional cases of grave supervisory concern. The matter was reviewed in January 1998 and the Bank withdrew its officials from the boards of private banks whose performance and the quality of management were satisfactory.[40] The Bank did not nominate its officials to the boards of new private sector banks as these banks were licensed under a different set of conditions and were professionally managed.

Public Sector Banks

Banks had been nationalised under the Banking Companies (Acquisition and Transfer of Undertaking) Acts of 1970 and 1980. In October 2000, the government sent to the Bank the proposal of an amendment to this law, which would enable, among other changes, reduction in the government's stake from 51 per cent to 33 per cent in public sector banks and empowerment of the Bank to assume more regulatory and supervisory powers over them. The amendments, however, did not materialise as the Bill lapsed on the dissolution of Parliament in 2004.

The need for reform in the Reserve Bank's oversight of public sector banks remained. In June 2004, the Bank sent to the Ministry of Finance a draft of a policy framework for public sector banks, on the lines of ownership and governance guidelines issued to private sector banks. The government sent its own draft guidelines on appointment of part-time non-official directors.[41] The Bank persisted with the matter and approached the government on the need to apply stricter criteria on nominee directors.[42] In response, the government asked the Bank in October 2005 to formulate statutory amendments to include 'fit and proper' criteria for elected shareholder directors and procedure for removal of shareholders if not found fit.

Section 9(3) of the Banking Companies (Acquisition and Transfer of Undertakings) Act said that the government would nominate an officer of the Bank on the board of each nationalised bank. The Narasimham Committee I recommended the discontinuance of the practice, the Joint Parliamentary Committee (1993) agreed, and the Narasimham Committee II reiterated the recommendation. Being the regulator or supervisor, it was not appropriate for the Bank to participate in board decisions. The Bank, therefore, informed the government of its readiness to withdraw its nominees. Given the legal position that it was mandatory to have an officer as a nominee on the board of public sector banks, an amendment to the relevant Acts became necessary. The amendment was carried out in 2006. Thereafter, the nominee would be chosen by the government in consultation with the Reserve Bank.[43]

Despite the broad agreement between the Reserve Bank and the government on the point that nominees were on the boards in the aid of corporate governance, there were occasional differences between them. On one such occasion in January 2008, SBI brought a proposal to the board for investment in a private equity firm. Both the nominee directors did not attend the meeting that discussed the matter. The next day, the Reserve Bank nominee wrote to the bank's Chairman that 'private equity venture ... involves high risk for the bank and is not advisable', and asked the board to seek approval of the government. On a copy of the letter sent to the government nominee, who was a Secretary with the Ministry of Finance, the officer concerned wrote by hand that 'these are commercial decisions which can best be taken at the Board level. It need not be referred to the government. This is for future guidance as the government would like to leave all these decisions to the Board of Directors', and faxed the message back to the Bank. But the Bank had the last word. SBI had to come to the Bank for approval as per instructions and did not get it.[44]

Foreign Banks

In July 1998, the Government of India wanted the Bank to examine whether wholly owned subsidiaries of foreign banks could be allowed in India. The proposal was in line with the Narasimham Committee II recommendation. The Bank examined the issue and decided that the existing policy of allowing foreign banks to have branches in India should continue. In March 2001, the government reopened the issue and wanted the Bank to consider the proposal. In June 2001, the Bank again advised the government against the proposal. The argument was that although the BR Act did not disallow subsidiaries of foreign banks, a subsidiary by definition would require a minimum shareholding of 51 per cent, whereas foreign investment in banking was then permitted only up to 49 per cent. Besides, the ceiling on voting rights would be an inhibiting factor in setting up subsidiaries.

The issue returned in the Inter-Departmental Committee (IDC) meetings during 2000–01. The members of the IDC were drawn from various departments of the government and the Bank, which approved the proposals for opening of branches of foreign banks in India. The French Trade Minister criticised the lack of clarity in Indian policy. The IDC wanted the Bank to reconsider its stand. After further discussion, the Bank advised the government in February 2002 that foreign banks could be allowed to set up subsidiaries, but a foreign bank would not be allowed to set up both branches and a subsidiary. The letter added that the government might consider revising the FDI policy in banks, allowing 100 per cent ownership, and removing the ceiling on voting rights. The Finance Minister in his Budget speech for 2002–03 announced both these changes. But the necessary notifications were not issued.[45]

In April 2003, ABN Amro approached the Bank for permission to set up a 100 per cent subsidiary in India, but the application was not processed for over a year for want of government notification in this regard. In November 2003, as discussed earlier, the Bank advised the government of its changed stance to retain the restriction of 10 per cent on voting rights. Since the government eventually agreed with the Bank on this matter, there was no question of considering a 100 per cent subsidiary promoted by a foreign bank. Nor would ABN Amro want to have a 'subsidiary' with only 10 per cent voting rights.

On 28 February 2005, the Reserve Bank released a roadmap for the presence of foreign banks in India. The roadmap had two phases. During the first phase, from March 2005 to March 2009, foreign banks would be permitted to establish a presence by way of operating through branches, or conversion of an existing branch into a wholly owned subsidiary with a minimum capital of ₹3 billion. The Reserve Bank would prescribe market access and national treatment limitations consistent with the World Trade Organization and international practices. In Phase II, after 2009, foreign banks would be permitted mergers with and acquisitions of Indian banks, subject to certain restrictions. The roadmap revealed the Bank's general approach to this issue. The Bank was essentially pursuing a two-track and gradualist path, to first consolidate the domestic banking system, while enhancing the presence of foreign banks.[46]

Rehabilitation of Weak Banks

In December 1998, the Bank initiated a study of the weak public sector banks.[47] The study identified three weak banks (Indian Bank, United Bank of India [UBI] and UCO Bank), and six others that were distressed and facing the risk of becoming weak. The three banks were under restructuring since 1992–93. Their high level of NPAs had been caused by indiscrete lending and poor credit management. UBI and UCO Bank also suffered from trade union activism. Other country supervisors like the Monetary Authority of Singapore and the Hong Kong Monetary Authority pressured Indian Bank and UCO Bank to raise their capital or face withdrawal of licences given to branches operating in those countries. The restructuring had two components: recapitalisation, and improvements in operational efficiency. The three banks had received substantial recapitalisation funds from the government until 1998. While extending such assistance, conditions were imposed on the reduction of costs, recruitment and branch expansion. While the banks could achieve targets for deposit mobilisation and housekeeping, there was not much progress in reduction of NPAs and costs. The strategy, therefore, was abandoned and these banks were brought under 'Strategic Revival Plans' from 1997–98.

The Verma Committee recommended further infusion of funds and the establishment of a Financial Restructuring Authority, which would represent the government as owners. The committee also recommended the setting up of an Asset Reconstruction Fund for taking over the NPAs of weak banks. The Reserve Bank studied the recommendations and sent a note to the government. The government accepted these, provided viable restructuring programmes were drawn up by the three banks acceptable to the government as the owner and to the Reserve Bank as the regulator. The Financial Restructuring Authority would comprise experts and professionals and be given powers to supersede the Board of Directors on the recommendations of the Bank.[48]

The recommendation to sustain weak banks drew critical comment from the IMF Mission under Article IV Consultation, which said that 'the assumption that all banks are too big to fail is likely to exacerbate weaknesses in governance that have contributed to the problem'. In December 2000, the government constituted a committee to examine the restructuring plans of the three banks.[49] The committee's report concluded that the banks could not be restructured through merger, privatisation, management lease or narrow banking.[50] Capital infusion by the government was unavoidable.

In February 2001, Governor Jalan desired that the memoranda of understanding and the quarterly monitoring reports of the three banks should be made public 'so that there is some pressure on the management/government to act'. The Bill to amend the relevant Act to establish a Financial Restructuring Authority, among other things, lapsed with the dissolution of the Lok Sabha in 2004. By then, the performance of weak banks had begun to improve. The turnaround was achieved primarily through large doses of recapitalisation or infusion of funds. The CRAR improved proportionately, in turn, providing additional room for asset growth. The banks acquired safe and interest-earning government bonds on the asset side. While these measures contributed to increased growth and profitability, the banks also improved their operations.

They closed unviable branches. The changed leadership instilled confidence. By 2003–04, the three banks had achieved the turnaround and were no longer considered weak.

Non-Performing Assets

The gross NPAs of scheduled commercial banks declined sharply from 15.7 per cent in March 1997 to 2.3 per cent in March 2008.[51] The improvement in asset quality of the Indian banking system was driven by improved credit risk management practices, favourable macroeconomic environment, and institutional measures that were taken to address loan recovery.[52] The Bank had an important role in facilitating this improvement.

For example, in 1998, a working group set up with representatives from large public sector banks and the Reserve Bank examined the issue of write-offs by banks. Based on the report and subsequent discussion, in May 1999, guidelines on a Settlement Advisory Committee was issued to public sector banks. At that time, the public sector banks had 0.53 million pending court cases amounting to ₹239.15 billion for loan defaults. Some of the banks had constituted Settlement Advisory Committees to review all cases of NPAs, processed compromise proposals speedily, and recommended to the competent authority for settlement and write off. A later circular, however, mentioned that 'a review of compromise settlements of NPAs through SACs made by us has revealed that the progress of recovery of NPAs through this mechanism has not been encouraging'.

In July 2000, the Bank issued revised guidelines to public sector banks on 'one-time settlement' for recovery of NPAs relating to all sectors except in cases of fraud and wilful default. The circular provided a simple settlement formula for cases with outstanding balance up to ₹50 million. The scheme evoked a moderate response. Only 19 per cent of the eligible borrowers applied for settlement.[53]

In November 2001, the Finance Minister in a meeting with the heads of public sector banks suggested a scheme for recovery of dues pertaining to small loans. Accordingly, the Bank advised public sector banks to formulate a policy and encouraged banks to adopt one-time settlement for such loans. In January 2003, the Bank issued revised guidelines to public sector banks to adopt compromise or one-time settlement in chronic NPA cases with outstanding up to ₹100 million. In December 2006, there was a significant change in approach as the Bank withdrew all the guidelines issued in the past. Banks were given the freedom to design and implement their own policies for recovery and write-offs. Wilful defaulters posed a different set of issues, which are examined in Chapter 11.

Why were NPAs such a persistent problem for the banks? Since the share of NPAs in priority sector and non-priority sector advances was almost equal, priority sector lending requirements would not have been the main reason for NPA. From the Bank's documents, the immediate reason for the accumulation of NPAs seemed to be the way projects were implemented. There was an allegation of diversion of funds; frequent time and cost overrun; business, product, marketing failure; inefficient management; strained labour relations; and choice of inappropriate technology. Recessions and changes in government policy contributed to the problem.

The Bank carried out another study through an in-house group in August 2002 on NPA management, following which, in September 2002, further guidelines were issued.[54] To contain the problem, the Reserve Bank advised banks to design loan policy and loan recovery policy, undertake periodic review of NPA accounts, make staff accountable, review top 300 NPA accounts by the Management Committee of the board, and strengthen risk management systems. In May 2007, the IBA was advised that banks might enter compromise settlement even with wilful defaulters or fraudulent borrowers without prejudice to the ongoing criminal cases. In March 2001, the Reserve Bank allowed banks to restructure or reschedule credit facilities extended to industrial units which were fully secured by tangible assets. Later that year, a Corporate Debt Restructuring system was put in place (see Part II of this chapter). In September 2005, the Bank issued guidelines for the restructuring of debts of small and medium enterprises and rationalised the prudential norms applicable to such accounts.

In view of a large number of pending court cases, and the slow process of the courts, a Lok Adalat had been created in 1987 as an alternative dispute redressal mechanism.[55] In June 2000, the Ministry of Finance asked the Governor to formulate guidelines to enable banks to settle disputes of smaller amounts by this mechanism. In August 2000, the Bank sent these guidelines. Between 2000 and 2004, negotiations continued on the appropriate ceiling amount for cases eligible to be brought to the Lok Adalat. While the government was in favour of a low ceiling, the Bank favoured a higher one. Eventually, the Bank's position prevailed. As of May 2003, all twenty-seven public sector banks were making use of Lok Adalats with the filing of 232,000 cases involving ₹10.49 billion. However, only fourteen private sector banks out of the twenty-nine were using this mechanism.

A working group formed to examine debt recovery tribunals (1998) recommended legislative amendments to strengthen the tribunals and overcome legal hurdles in their functioning.[56] All public sector banks were advised to set up special Debt Recovery Tribunal Cells and to keep a close liaison with the standing counsel who appeared before the tribunals. By March 2008, of 79,169 cases involving ₹1,263.78 billion filed with the tribunals by banks, 45,088 cases (involving ₹587.19 billion) had been adjudicated and ₹215.41 billion recovered from adjudicated cases.

In 2002, the government set up a committee to formulate guidelines for securitisation, asset reconstruction and enforcement of security interest by banks and financial institutions.[57] The Bank later issued guidelines for the setting up of asset reconstruction companies regulated by the Bank (see Part II).[58]

Amalgamation and Mergers

In June 1997, there were eighty-eight banks in various stages of liquidation.[59] The procedure was that the Bank made an application for winding up a banking company under Section 38 of the BR Act, and on a High Court passing orders for the winding up, the bank was placed under liquidation. The government appointed an official liquidator attached to the High Court to oversee the realisation of assets. The liquidation process was time-consuming. Although the Bank had the powers to be an official liquidator under Section 39 of the Act, it did not take up the role, since it did not have the appropriate machinery or staff to handle the process. Instead, the Bank monitored the process.

Excluding cooperative banks, the last commercial bank to be placed under liquidation in India (in reference to the period under review) was Bank of Karad Ltd, at the instance of the Reserve Bank in 1992, following a securities scam. After the process was completed, Bank of India took over the forty-eight branches of the bank in 1994. Since 1993, the Bank preferred voluntary mergers with strong banks for the closure of weak banks.

The procedure for amalgamation was the following: Under Section 45 of the BR Act, the Reserve Bank made an application to the government to issue a moratorium on a bank for a period up to six months. During the moratorium, the Bank would prepare a scheme for amalgamation of the bank with another one. The draft scheme, after discussion with both banks, would go to the government for approval. Whereas most cases of such mergers involved weak banks and an element of compulsion, the discussions in the Reserve Bank recognised the prospect of voluntary mergers led by business interests.[60]

Small banks posed a particular problem. The Reserve Bank was not comfortable with the existence of several very small and under-capitalised banks. There were seven private sector banks with net-owned funds of less than ₹0.25 billion in 1997. These banks were reluctant to raise further capital by public issue of shares fearing takeovers. A BFS meeting held in February 1998 decided that of the fifteen small old private sector banks, seven banks should be allowed to continue on standalone basis provided they increased their capital to ₹1.0 billion within three to five years. The others should merge. The banks were informed of the decision, but the matter was not pursued vigorously.

Between 2002 and 2004, further guidelines were prepared on mergers. Draft guidelines on mergers between NBFCs and commercial banks were prepared when the proposal for merger of Ashok Leyland Finance Ltd, an NBFC, with the new private sector IndusInd Bank was placed before the BFS in January 2004.

During the reference period, several notable cases of mergers occurred. In the case of Benares State Bank, the promoters defaulted to other banks, and the income tax department attached their shareholding. When the Mumbai police took the chief promoter into custody for alleged dishonour of cheques, the Bank had to remove him from the board in July 1998, exercising its powers under the BR Act. The Reserve Bank appointed two more additional directors, raising the number of the Bank nominees to four in December 1998. Its accumulated losses of ₹0.55 billion had eroded the entire net-owned funds. The Sahara Group showed interest in acquiring a major portion of the shareholding but no agreement could be reached on share pricing. In March 2000, the government was approached for winding up of Benares State Bank. The Cabinet Committee approved the proposal. To avoid a run on the bank, the Reserve Bank issued a directive in September 2001 placing restrictions on withdrawals. After further consultation, in June 2002, the bank merged with Bank of Baroda.[61]

A proposal to merge the Bareilly Corporation Bank Ltd with its parent bank, Bank of Baroda, was not received kindly by the Government of Uttar

Pradesh. Bareilly Bank was one of the few banks headquartered in that state. Despite this misgiving, the merger went through and was completed in June 1999. The Nainital Bank Ltd was a good candidate for a merger because of its small size, and the fact that 98 per cent of its shares were held by Bank of Baroda. But local residents of the state of Uttarakhand wanted the bank to continue as an independent entity as it was founded by the noted nationalist Pandit Govind Ballabh Pant. The Reserve Bank asked Bank of Baroda (in April 2007) to infuse additional capital into the bank, whereas the parent was inclined to disinvest its holding. The status quo continued until the end of the reference period.

Sikkim Bank Ltd commenced business in 1987 and applied for a licence in 1988. The application was kept pending because the bank did not satisfy the conditions stipulated in the BR Act. By 1997, its NPAs stood at 95 per cent, and 56 per cent of the deposits had been eroded. Finally, a moratorium was imposed in March 1999 for three months. Notwithstanding court cases, its merger with Union Bank of India was completed in September 1999.

Ganesh Bank of Kurundwad Ltd (GBK) did not want to raise its paid-up capital fearing takeover. The Reserve Bank wanted a merger but the government was not initially in favour because the bank had no major supervisory concern. In the early years of the new millennium, its NPAs increased to 26 per cent and the bank was placed under monthly monitoring. It was placed under a moratorium in January 2006 and amalgamated with the old private sector Federal Bank. There was considerable interest from several other private banks. Some of these rivals challenged the merger with Federal Bank in court, and the Bombay High Court issued a stay order. The Reserve Bank and Federal Bank then went to the Supreme Court against the stay order, and the Supreme Court asked the Bombay High Court to take a final decision. In April 2006, the High Court dismissed all writ petitions, maintaining that the amalgamation was in order, though it expressed some reservations on the process.[62] The merger was effected in September 2006.

Nedungadi Bank Ltd, a private bank in Kerala, ran a scheme from September 1999 involving purchase and sale of shares to take advantage of the price differential between the National Stock Exchange, the Bombay Stock Exchange and other exchanges. All transactions were routed through three firms controlled by stockbrokers who had been co-opted as directors to the board of the bank. The bank financed the brokers and they took investment decisions on behalf of the bank. In the process, the bank incurred losses that eroded its entire net worth. In view of this incident, in May 2001, the Bank cautioned all banks against conducting arbitrage operations of this sort and initiated steps to restructure the board. The bank was placed under moratorium in November 2002, and in January 2003 amalgamated with the public sector Punjab National Bank.

The Dutch ING Group acquired substantial equity in the old private sector Vysya Bank Ltd in 2002 and, consequently, the name was changed to ING Vysya Bank Ltd. There were several cases of voluntary mergers. The Bharat Overseas Bank Ltd, a private sector bank promoted by public sector Indian Overseas Bank and owned by six other banks was embroiled in an IPO scam in 2005–06. The board of the bank asked the Chairman to go on leave. In March 2007, a proposal to merge with the promoter bank materialised. A newly licensed bank in the private sector, Times Bank Ltd, voluntarily merged with HDFC Bank in February 2000. An old private bank, Bank of Madura Ltd, merged with ICICI Bank in February 2001. Sangli Bank Ltd, another small private sector bank, voluntarily merged with ICICI Bank in April 2007.

The case of Centurion Bank was more complex. Twentieth Century Finance Corporation Ltd, an NBFC, proposed to merge with the private sector Centurion Bank Ltd in 1999. The NBFC was the promoter of the bank with 45 per cent shareholding. In April 1999, the scheme was approved by shareholders, and the merger became effective from May 1999. The step, however, failed to strengthen the bank. Its asset quality deteriorated; the bank made heavy losses and the CRAR slipped to 1.95 per cent in March 2003. In April 2003, the bank received a proposal from a group of investors for the restructuring of capital through a rights issue and additional investment from Bank of Muscat, which was leaving Indian operations. The restructuring went through, and the bank achieved a CRAR of 9 per cent by September 2004. Later, Centurion Bank merged with another new private sector bank, Bank of Punjab Ltd, in October 2005 to become Centurion Bank of Punjab (CBP).

In September 2006, the two boards of Lord Krishna Bank Ltd (LKB), which was under the directions of the Reserve Bank, and CBP, approved a voluntary merger plan, but a shareholder challenged the plan in the Kerala High Court. The employees of LKB in Kerala went on strike, and political leaders from Kerala represented to the Reserve Bank their dissatisfaction with the plan and preference for a merger of LKB with a public sector bank. The petition, however, was dismissed by the High Court, and the merger went through in 2007. Subsequently, in 2008, CBP merged with HDFC Bank.

The development finance institutions (DFIs) were keen to reverse merge with the banks that they had set up. The DFI model was becoming obsolete for several reasons. The ICICI Bank approached the Reserve Bank in October 2001 with an application for the reverse merger of ICICI Ltd. The merger was approved on 26 April 2002. IDBI was converted into a commercial bank through a Parliamentary Act and without the issue of Reserve Bank licence. In terms of the provisions of the IDBI (Transfer of Undertaking and Repeal) Act, 2003, a new company in the name of Industrial Development Bank of India Limited (IDBI Ltd) was incorporated as a government company under the Companies Act on 27 September 2004. Thereafter, the undertaking of IDBI was transferred to and vested in IDBI Ltd from 1 October 2004 (see Part II). In the following year, the scheme of the merger of IDBI Bank Ltd with IDBI Ltd came into effect. In 2006, loss-making United Western Bank merged with IDBI Ltd. The name was changed to IDBI Bank in May 2008.

The board of SBI approved the proposal for merger of State Bank of Saurashtra (SBS) with SBI in August 2007, and the board of SBS also approved the merger. The Reserve Bank suggested a few changes to the draft scheme, which were incorporated. The acquisition was officially notified by the government in August 2008.

The failure of GTB and its merger with Oriental Bank of Commerce is of a different order and discussed in Chapter 11.

Branch Authorisation and ATMs

Branch Authorisation

The BR Act restricts banks from opening branches without the Reserve Bank's permission. Though the word 'licensing' is not present in Section 23 of the Act, the Bank had been using the term 'branch licensing' until 2005. Its branch licensing policy in the immediate post-nationalisation period emphasised the extension of banking services to rural centres. In the 1980s and 1990s, the policy was restrictive on the opening of branches in cities and was still in favour of rural and semi-urban areas. The policy during the reference period changed and gave banks more freedom to use their commercial judgement in opening new branches. The Reserve Bank considered proposals on merits, taking into account the overall financial position of the bank, quality of its management, its internal control system, profitability, and availability of other banks in the area. The Narasimham Committee I had recommended the abolition of 'branch licensing', and banks wanted this, too, but the policy did not go that far.[63]

With the spread of ATMs, this piece of regulation had outlived its utility. In 1994, banks were given freedom to install off-site ATMs except that they were required to obtain from the Bank an *ex post facto* licence after installation, to comply with the Act. In 1995, freedom to open branches was given to banks, which met a set of criteria relating to CRAR, NPA and profitability. Only three nationalised banks met the criteria. However, those three banks opened as many as 536 branches in three to four years and risked their profitability and internal controls. Since such speed of branch expansion was not safe, the freedom given to the three banks was withdrawn. Similar cautionary observations were made also about branch expansion in private banks.[64] The permissible number of new branches, however, was to depend on the rating of the bank.

On 14 November 2002, the IBA in a letter sought more flexibility to banks to rationalise their branch networks. The Reserve Bank responded that the present system was flexible enough, but the IBA insisted on a review. When suggestions were sought from banks before the Annual Monetary Policy Statement for 2004–05, they wanted 'the entire issue of opening branches could be left to the banks'. The Reserve Bank tended to be conservative not only on branch licensing but also on ATM licensing. Internal discussions showed that banks opened ATMs driven by competition alone and without due regard to cost–benefit considerations.

The case was put up before Deputy Governor Udeshi, who convened a meeting of STACFR to review the branch licensing policy. In the meeting, in October 2004, bankers favoured more freedom to open ATMs and branches, whereas the Reserve Bank executives favoured a more cautious policy. P. J. Nayak, member, and Chairman of UTI Bank, observed, '[T]he definition of place of business needs to be re-examined. Physical branch presence is not the only channel today for customer interface, door-step banking, call centres, and internet banking should be considered as a relationship/distribution function in the modern context.' Another member suggested that the BR Act should be amended to expand the scope of banking. The response from the Bank was the issuance of a new branch licensing policy in 2005.

Several other related issues were also considered during these years, and on several of these the Bank took a cautionary stance.[65] The Bank's caution reflected the fact that a new policy was on its way after a new Governor took office in

September 2003. The Revised Branch Authorisation Policy was announced in September 2005. For the first time, the word 'licensing' was not used in the circular. By the new rules, banks were required to send their detailed plans for opening branches to the Reserve Bank to obtain aggregate approvals on an annual basis. A 'branch' would include a satellite office, an extension counter, off-site ATM, service branch or an administrative office. Soon after the revised policy was announced, the Reserve Bank began to receive Annual Branch Expansion Plans from banks. The Reserve Bank held discussions on the banks' Basel preparedness, the status of a compilation of know-your-customer (KYC) and anti-money-laundering norms (see later), financial parameters, quality of customer service and measures to promote financial inclusion.

Banks were still not happy. The promised freedom was seen, by one nationalised bank, as 'illusory'. In response to views like these, in December 2005, the Governor approved certain operational flexibility, and this was followed in January 2006 by revised guidelines. According to the revised policy, instead of individual licences, a consolidated letter of authorisation or permission would be issued to meet the requirements of the BR Act. More freedom was given to banks for shifting of branches, subject to conditions, and conversion of specialised branches and extension counters to full-fledged branches.

The Bank adopted a more liberal approach to branch licences in under-banked areas. However, a letter from the Ministry of Finance of 26 May 2006 stated that 'some visiting foreign dignitaries have indicated to the senior officials in government that in some cases the applications of foreign banks for opening of branches in under-banked areas are not being approved by RBI'. After further reminders, the Bank responded that the applications concerned happened to be for opening branches in under-banked areas in close proximity to a big city.

ATMs

The media commented on the Bank's role with ATMs in a generally negative light.[66] On 29 September 2006, the Finance Minister had an unusual meeting with the Governor to discuss pending applications for opening branches and ATMs. In a follow-up, the Secretary to the Ministry of Finance wrote to the Deputy Governor (17 October 2006) specifying the dates for disposal of all applications by the Bank (see Appendix 10A.1.2) The Bank did not adhere to the prescribed deadlines.

The controversy boiled down to the definition of a branch. The IBA in a letter to the Bank requested that 'offsite ATMs, extension counters, satellite offices, service branches, credit card centres, and administrative offices to be excluded from prior authorization and might be allowed by way of *post-facto* reporting to RBI'. But the Bank would not agree with this proposal because, in the interpretation of its Legal Department on Section 23 of the BR Act, all outlets and offices were counted as branches.

The Annual Branch Expansion Plans submitted by banks for 2007–08 were not taken up for approval 'as the progress in opening of branches/ ATMs in respect of authorizations issued against the previous year's plans was not satisfactory'. Banks were advised to complete the actual opening of branches for which approvals had already been given. When the case was put up to the Governor, he noted that annual plans need not be kept in abeyance for this reason.

The ATM controversy continued into 2007–08. Already, banks had been trying to use ATMs for a range of marketing services. For example, there was keen interest among banks that had incurred sizable capital expenditure in installing ATMs to use them as a kiosk to provide services such as mail facility to banks, utility payments such as power and phone bills, and product information to their customers. But the Reserve Bank, when approached, was not willing to give permission. A new generation private sector bank and a foreign bank, which had set up a large number of ATMs, approached the Reserve Bank in 2001 to allow flashing of third-party advertisements in ATMs, while the customers' transactions were being processed. The Reserve Bank did not agree and issued a circular to banks in January 2002 that advertising was not a permitted activity. In October 2004, a new generation bank wanted to arrange for cricket scores, horoscope and movies to be shown on ATMs. The Reserve Bank turned down the suggestion. Some public sector banks, partnering with Indian Railways, wanted to install ATMs in major railway stations, which could also issue railway tickets. The Reserve Bank's Legal Department came back (April 2001) stating that 'banks cannot engage in selling railway tickets'. The BR Act expressly forbid banks from selling goods. The Department of Information Technology pushed the scheme. In 2005, the Legal Department offered the modified view 'that railway tickets cannot be classified as goods/movable property as envisaged under Section 8 and therefore the prohibition provided under said Section is not attracted in issuing railway tickets by the banks'.

Policy on Cross-Border Branch Authorisation

Since 1972, it had been a convention (not legally binding) that opening of overseas branches by Indian banks would be referred to the government, as it had geopolitical implications. The interdepartmental committee referred to earlier in this chapter investigated applications from public sector banks for opening of branches abroad, apart from dealing with applications of foreign banks to open branches in India. The Reserve Bank prepared guidelines for the opening of branches by foreign banks in India and also Indian banks abroad and sent them to the government in February 2005. It sought to simplify the procedures and speed up the clearance. The policy for the opening of branches abroad was further rationalised in 2006–07.

A Comprehensive Economic Cooperation Agreement was signed between the Governments of Singapore and India in June 2005. In terms of the agreement, India would allow three Singapore-based banks to open fifteen branches in India over four years. In turn, Singapore would grant Qualifying Full Bank licence to two Indian banks in Singapore. The Agreement did not mention the conditions set by the Reserve Bank and the Monetary Authority of Singapore, and therefore correspondence and negotiations began, which continued until the end of the reference period.

Know-Your-Customer Norms and Anti-Money-Laundering Standards

To discuss steps to prevent criminals from utilising banks and financial institutions, in 1999, the Bank formed a working group.[67] The report recommended setting up an agency that would collect information from banks and store in a database. In September 2000, the Bank suggested to the government that a technical group should design an institutional framework for inter-agency cooperation in this field. However, this was not done. The 9/11 incident in 2001 prioritised the issue for the government and the Bank. Until then, anyone could open an account with a bank in India on the strength of an 'introduction' by another customer of the bank or the bank staff. There was no need to produce any document to the bank to establish one's identity. This practice now came into question.

In December 2001, the Bank forwarded a list of suspected organisations (received from the government) and advised commercial banks to keep a watch on the transactions of the listed organisations and report to appropriate authorities. In March 2002, an Internal Coordination Committee on Prevention of Money Laundering and Financing of Terrorism was constituted. The Governor had an internal meeting in June 2002 to discuss the role and responsibility of the Bank in dealing with money laundering and financing of terrorism. Thereafter, the Reserve Bank issued guidelines to banks in August 2002 on the customer identification procedure for opening accounts, monitoring transactions of a suspicious nature and reporting them to the government. As part of the process, the Bank conducted trial runs of the system and formed an illustrative list of suspicious transactions. Banks were advised to upgrade their computer software to enable automatic reporting of transactions above a certain limit and to make cheque transactions mandatory for large remittances and transfers. In January 2003, the Prevention of Money Laundering Act (PMLA), 2002, was enacted. On the Reserve Bank's insistence, a new set of rules were framed for the banks to follow, in view of the provisions of the Act.[68]

The introduction of KYC norms was a major element of the new rules. KYC consisted of a set of identity documents every bank account holder needed to furnish. The norms led to complaints from bank customers of harassment, in view of which banks were advised (in 2003–04) to 'exercise care', not to insist on unnecessary information, respect the privacy of the customer and maintain confidentiality. A further set of guidelines was issued in November 2004 based on international standards and domestic legislation.

In November 2004, the government set up the Financial Intelligence Unit–India as an independent body and as the central national agency for receiving and processing data on suspicious financial transactions. Banks were to report suspicious transactions to this agency. The KYC and other guidelines and standards were extended to the NBFCs and financial institutions regulated by the Bank in January 2004 and May 2006. Provisions, however, were made of a simplified procedure for small-value accounts.

Deregulation of Credit Regime

In line with the Reserve Bank's policy to give operational freedom to banks in the matter of credit management, between April and December 1997, the Reserve Bank withdrew the numerous instructions relating to maximum permissible bank finance (MPBF), guidelines on the mandatory formation of a consortium of lenders, and Credit Monitoring Arrangement.[69] Quantitative ceilings on bank credit to NBFCs were also withdrawn in May 1999. The Reserve Bank began to focus instead on macro-level policies on credit to industries, exports and housing. Among new areas of focus, infrastructure, bill discounting, mortgage guarantee, forward markets and derivatives assumed special importance.

Infrastructure

In September 1997, the ceiling of ₹5 billion for term loans by banks for a single infrastructure project and ₹10 billion for power generation projects was dispensed with. During the meetings that the Governor had with the chairmen of select banks and financial institutions in 1999 and 2000, financing infrastructure and coordination between banks and financial institutions in this field were discussed. In 2002, a group of officials from different departments attempted to define the term 'infrastructure' and frame prudential norms for infrastructure financing. In February 2003, new guidelines on infrastructure lending by banks covered the definition, financing criteria and risk weight for securitised paper, among other issues. Banks could (from June 2004) raise long-term bonds with a minimum maturity of five years, to the extent of their lending to the infrastructure sector.

The definition of 'infrastructure lending' was expanded in November 2007 to include projects involving oil and gas pipelines and their maintenance. The asset classification norms were rationalised in March 2007 and, in response to representations made in respect of delayed completion of projects, the asset classification norms were further modified in March 2008.

Mortgage Guarantee Companies

Banks and housing finance companies that lent against mortgages would benefit if the mortgage was guaranteed by a three-way contract among borrower, lender and guarantor. A working group was set up in December 2003 jointly by the Bank and the National Housing Bank (NHB) to suggest a regulatory framework to enable such guarantee. The NHB proposed to promote an India Mortgage Guarantee Company in 2006. But who should regulate mortgage guarantee companies? There was a case for the Bank to regulate them since mortgage guarantee was linked to credit expansion and credit quality. Accordingly, in 2007–08, mortgage guarantee companies were included as a separate category of NBFC under Section 45 of the Reserve Bank of India (RBI) Act. Towards the end of the reference period, the Bank was evolving a separate regulatory framework for these companies taking into account the lessons of the subprime crisis.

The government wanted the NHB to examine the possibility of introducing reverse mortgage loans – one in which the owner relinquishes equity in the property in exchange for regular payments. The scheme would provide for refinancing and guarantee to banks and housing finance companies for reverse mortgage loans to be extended by them. A few major banks came up with schemes to grant such loans to the targeted group. There was, however, a legal obstacle to this. As IDBI Bank pointed out, the BR Act did not encourage banks to acquire property except for administrative purposes. As expected, the response from banks was lukewarm.

Derivatives

To hedge interest rate risks, in July 1999, the Reserve Bank allowed banks and financial institutions to undertake forward rate agreements and interest rate swaps. Exchange-traded interest rate derivatives were permitted from June 2003. Final guidelines on derivatives (other than forex derivatives) were issued in April 2007.

In 2002, the Forward Markets Commission (FMC), set up under the Ministry of Consumer Affairs, Food and Public Distribution, asked the Bank to permit banks to participate in commodity derivative markets. Trading in equity-based or commodity derivatives by banks was not permitted under Section 6(1) of the BR Act. While banks in India offered hedging products to corporates in foreign exchange and money markets, products to hedge commodity price risk were not offered. Some private banks had approached the FMC to take up the matter and push for necessary amendments to the BR Act. An informal group in the Bank deliberated on the proposal. Pending amendment to the BR Act, in 2003, the Coffee Board under the Ministry of Commerce was permitted to hedge price risk on behalf of coffee growers through a price insurance scheme. A public sector bank acted as a facilitator to the arrangement. A major shipping company was also allowed to cover freight risk in a similar manner. A public sector bank sought permission in February 2004 to participate in commodity trading transactions of Multi Commodity Exchange of India Ltd by becoming an institutional trading-cum-clearing member. The National Commodity and Derivatives Exchange Limited wanted a regulatory framework that allowed banks to become members of commodity exchanges.

In the backdrop of these developments, the mid-term review of the Annual Monetary Policy 2004–05 announced setting up of a working group to examine the role of banks in providing loans and advances against warehouse receipts and evolving a framework for the participation of banks in the commodity futures market.[70] While the draft report recommended participation, a notification under the BR Act was required to make it effective. At the end of the reference period, the Bank was in correspondence with the Ministry of Finance on the matter.

The Annual Policy Statement for 2007–08 mentioned that as a part of the process of financial sector liberalisation, it would be appropriate to introduce credit derivatives in a calibrated manner. Despite some progress in discussions, after the financial crisis of 2007–08, the matter was shelved.

Mortgage Debt and the Global Crisis

In November 2003, the NHB sent a proposal for securitisation of residential mortgage debts. Securitisation is a process by which assets are sold to a special purpose vehicle (SPV) in return for an immediate cash payment. Recognising the need to provide Indian banks the option to securitise their assets such as housing loans, the Bank set up a group in May 2004 to create the draft rules on asset securitisation.[71] The report observed that unregulated securitisation activity was already taking place. Asset-backed securities and mortgage-backed securities were being issued by trusts.[72] These securities did not come under the scope of SEBI or the Reserve Bank. The banks were active in the market both as originators and as investors. The move by Governor Reddy to frame regulatory measures drew an adverse response from the press.[73] But the attempt to frame appropriate rules on securitisation continued.

The final guidelines were issued in February 2006, which covered the true sale of assets by the originator, criteria to be met by the SPV, credit enhancement facilities to be provided to the SPV, provision of liquidity support, and underwriting facilities. The Bank was again criticised by market players for its conservative approach, specifically for the restriction on immediate profit recognition. It was only later, after the global financial crisis of 2007–08, that the Bank's caution in the matter was appreciated.

By insisting on adequate risk assessment and provisioning, the Bank had slowly but steadily built up firewalls against the financial crisis. Hindsight revealed that the Indian financial system was less susceptible to the global credit market crisis due to the relatively small exposure to non-transparent and structured financial products. A study undertaken by the Bank on the impact of the subprime crisis on Indian banks revealed that the limited overseas exposure of Indian banks comprised credit default swaps, credit-linked notes, collateralised debt obligations, commercial papers, and asset- or mortgage-backed securities. Fourteen banks had reported exposures to Lehman Brothers and its related entities either in India or abroad. Only one private sector bank had a mark-to-market loss of ₹3.60 billion. Other banks had negligible losses. Of the two Lehman group entities operating in India, Lehman Brothers Fixed Income Securities, operating as a primary dealer, had settled all outstanding interest-rate swap transactions with the counter-parties in India. Further, its entire assets were found to be sourced out of its equity with no borrowings from the market. The other one, Lehman Brothers Capital, registered as an NBFC, had not raised funds in India.

Miscellaneous Regulatory Issues

Para-Banking Activities/Bank Subsidiaries

Para-banking activities would include bank participation in mutual funds including money market mutual funds, merchant banking, insurance, credit cards, factoring, derivative trading and funds management. Early in the reference period, banks showed keen interest to enter these areas. In July 1999, the Reserve Bank reminded them that they should not do so without 'specific approval'. As Governor Jalan observed, with public sector banks, the Bank had a special responsibility to ensure prudence before approving any risk-based new business.

Commercial banks were free to undertake activities like equipment leasing, hire purchase business, factoring services, money market mutual funds, and underwriting shares and debentures without the Reserve Bank's prior approval. In other words, banks were free to undertake these activities departmentally (that is, by the bank itself and not through another entity established by the bank). But if they were to set up a separate subsidiary or invest in the equity of a joint venture to undertake the same para-banking activity, then banks had to obtain permission from the Reserve Bank.

In 2000, the government at the instance of the Bank notified 'insurance' as a form of business which a bank could engage in. In August 2000, the Bank issued guidelines to banks to act as agents of insurance companies with prior approval for distribution of insurance products without risk participation. Later, the restriction was withdrawn but banks were still prohibited from undertaking insurance business departmentally.

According to the Bank guidelines, the maximum equity contribution a bank can hold in a joint venture with a foreign company would 'normally be 50 percent of the paid-up capital of the insurance company', allowing for flexibility on a selective basis. The government considered the limit too high, in view of prescribed limits in the BR Act, and the provision to relax norms on selective basis inappropriate. The matter was subject to discussion during the next three years.

Meanwhile, the Bank received applications from thirty banks for entry into the insurance business through joint ventures, on a risk participation basis, as a strategic investment, or as an agency business. Except for a few cases, approvals were granted, subject to certain criteria being met. In 2002–03, the Reserve Bank allowed banks to undertake referral business, through their network of branches. That is, insurance companies could sell their products to banks' customers, and banks would earn referral fees on the basis of the premia collected.[74] The department came out with a proposal to grant general permission with stringent conditions. On further intervention from Deputy Governor Udeshi, the conditions were relaxed.

It transpired later that some banks were disclosing customer profile information to insurance companies with whom they had referral arrangement without the consent of the customers. In 2004, a group went into the question of customer confidentiality, and in May 2004, fresh instructions were issued to banks in this matter.

All mutual funds were regulated and supervised by SEBI. The money market mutual funds, which were initially governed solely by the Reserve Bank, were also brought under the purview of SEBI regulations in April 1998. Thereafter, on a few issues where the mutual funds wanted reform of regulation – such as removal of the restriction on lending in call and term money market, participation in repo auctions, and third-party cheque writing – the Bank and SEBI needed to discuss matters jointly. These discussions did not always end in agreement.

Many public sector banks launched mutual funds through subsidiaries. Some of them promised 'assured returns'. Most had been launched before 1993.

Thereafter, regulatory control shifted from the Reserve Bank to SEBI, and the subsidiaries did not need to seek the Reserve Bank's approval to sponsor schemes with assured returns. As the boom in the stock market ended, they were unable to pay up the assured return. SEBI insisted on payment, forcing the parent banks to step in and undertake a heavy financial burden as a result. Reviewing this disaster, the Standing Committee on Finance (SCF) on Demands for Grants (Ministry of Finance) in its sixth report recommended that bank-sponsored mutual funds should not be allowed to float assured return schemes. SEBI has since disallowed assured return schemes.

Credit card was another business the banks were keen to enter. In June 1998, banks were permitted to issue credit and debit cards either independently or in tie-up arrangements with other card-issuing banks without the Reserve Bank's prior approval. Banks needed prior approval of the Reserve Bank only for setting up a subsidiary to issue cards. In 1999, prudential norms were announced for the card issuer. Meanwhile, business boomed. By March 2000, public sector banks had issued 1.06 million credit cards, and foreign banks had issued 2.38 million cards. Clearly, the Reserve Bank needed to step in with safeguards. In October 2000, it became necessary for banks to have a minimum net worth of ₹1 billion to be eligible for the business. Later, the Reserve Bank waived this condition for debit cards. In 2001, following a review and discussion with stakeholders, additional safeguards were announced. Following receipt of complaints from card users about levy of unconscionably high rates of interest and charges, a meeting of card-issuing banks was convened in December 2004. Subsequently, some progress was made towards prioritising customer complaints and evolving a code of conduct.

In the aftermath of the securities scam of the early 1990s, no bank was permitted to offer portfolio management services to its constituents. However, ten banks were permitted, on application, to offer non-discretionary investment advisory services without acceptance of funds and without guaranteeing customers any return on their funds. In the non-discretionary type, the decision to invest the funds remained with the client. Actual investing was done by the bank along with the provision of transaction support, besides custodial services for the securities. Banks designated these services as 'private banking' and 'wealth management services'. In the case of portfolio management services, banks accepted funds from customers and parked them in a nominal account, the client's account, whereas, in the case of investment advisory services, the funds remained in the customer's account.

In 2005, when a foreign bank's proposal to offer private banking services was put up to the Governor, he ordered a review of all such services and regulatory provisions. An internal group on Investment Advisory Services studied the issues and concluded that there were no regulatory concerns and, therefore, the existing practice might continue. The proposal was passed in May 2005.

After opening up the insurance sector, the government wanted to open up the pension market as well. It asked the Insurance Regulatory and Development Authority of India (IRDAI) to suggest a scheme especially suitable for those in the unorganised sector. Pension business was so far treated as part of the life insurance business in India, and Life Insurance Corporation of India was the sole provider of pensions. While discussions with banks and the IRDAI continued, the government of India issued the Pension Ordinance in December 2004 and the Pension Fund Regulatory and Development Authority (PFRDA) was set up in January 2005 to regulate the new system. The PFRDA was authorised to grant a licence to pension fund managers, subject to eligibility criteria. When this was discussed in the Bank, the Legal Department said that pension fund management was not a permissible form of business for banks to undertake in terms of the BR Act. However, opinion within the Bank was in favour of entry of banks into this low-risk business. In March 2005, the Bank conveyed to the government its decision to allow banks to act as pension fund managers and requested the government to notify it as a permissible activity under the BR Act. The eligibility conditions, however, were subject to further discussion until draft guidelines were finally issued in May 2007. Later, three banks were accorded permission to set up subsidiaries for undertaking pension fund management.

In August 2006, the Reserve Bank issued prudential norms on banks' investment in venture capital funds (VCFs). Banks needed to obtain prior approval for making a strategic investment in VCFs, that is, in excess of 10 per cent of the equity or unit capital. As a matter of policy, the Bank granted approvals to banks to invest in VCFs, subject to the ceiling of 10 per cent of the bank's capital and reserves. All exposures to VCFs would be deemed to be on par with equity and, hence, would be within the ceiling fixed for capital market exposure. The exposure to VCFs had to be assigned a risk weight of 150 per cent.

In February 2002, Deputy Governor Kamesam wrote to the Ministry of Finance with a proposal for setting up offshore banking units (OBUs) by banks in SEZs. The Bank wanted to treat OBUs on a par with the overseas branches of Indian banks in the matter of reserve requirements. The government accepted the proposal. These units would be exempt from maintaining CRR and SLR and were expected to provide finance to units in SEZs at global rates. The sources of foreign currency funds would be external and the balance sheet would be in foreign currency. The Bank would be the sole regulator. It accorded 'in principle' approval to ten banks (eight public sector and two private sector) for setting up fourteen OBUs, of which 90 per cent were to be located in Mumbai. In due course, only six banks (five public sector and one private sector) operated seven units in three SEZs. They were not doing good business. Banks felt that the Reserve Bank norms were too restrictive, but the Reserve Bank did not relax the norms.

Amendments to the BR Act and RBI Act

Finance Minister Yashwant Sinha in his Budget speech for 2000–01 announced a plan to amend the BR Act to give the Bank more operational flexibility in the regulation of the financial system. The Bank submitted a draft of these amendments to the Ministry in May 2001. The amendments addressed avoidance of connected lending by banks, licensing of bank acquisitions, the power to supersede the board of a bank when potentially dangerous decisions had been taken, consolidation of accounts and inspection of subsidiaries, among others. The RBI (Amendment) Bill, 2001, was also drafted, following the recommendations of the Narasimham Committee II, but it was not presented to Parliament and was later replaced by the Amendment Bill, 2005.

In a draft Cabinet Note (August 2001) on the proposed amendments to the BR Act, the government mentioned specifically the need to address the problem of dual control over cooperative banks, by state governments as well as by the Bank. On 28 January 2003, the Bank wrote to the Ministry of Finance recalling the recommendations of the Joint Parliamentary Committee for more powers to the Bank to remedy the problem (also see Chapter 11).

A revised draft Amendment Bill sent to the government in March 2003 became the basis for the Banking Regulation (Amendment) and Miscellaneous Provisions Bill, 2003, tabled in Parliament in August 2003. During the discussions, the Bank submitted a note on the rationale for amendments to have uniform application of the provisions of the BR Act to both commercial and cooperative banks. State governments were up in arms against the proposal. The convention of State Ministers for Cooperation, held in Kolkata on 17

December 2003, passed a resolution demanding the withdrawal of the Bill. The Chief Minister of Odisha wrote to Finance Minister P. Chidambaram in June 2004 expressing concerns about the impact of the proposed amendments on cooperative banking in his state, in particular, the introduction of higher entry-level norms for cooperative banks and provision of powers to the Reserve Bank to remove the management of cooperative banks. The Chief Ministers of West Bengal and Bihar wrote similar letters.

In July 2004, the Ministry wrote to the Bank urging a rethink on the controversial provisions. In April 2005, the Bank forwarded to the Ministry revised drafts of the Banking Regulation (Amendment) Bill, 2005, and the RBI (Amendment) Bill, 2005. They were introduced in the Lok Sabha in May 2005 and were referred to the Standing Committee on Finance (SCF). The first Bill contained new provisions for the Bank to enforce measures ensuring the prudent functioning of banks and financial institutions, among other interventions. The second Bill provided for removing the ambiguity in the legality of over-the-counter derivatives and covered repo transactions, money market and CRR. The SCF gave its reports on both Bills in December 2005. However, the BR (Amendment) Bill, 2005, was allowed to lapse, and only the RBI (Amendment) Act, 2006, was passed by Parliament in May 2006.

The subsequent Banking Regulation (Amendment) Ordinance, 2007, had only two amendments. One of the changes was that the prescriptions of minimum SLR of 25 per cent and the type of assets to be held were dispensed with, giving flexibility and freedom to the Bank to specify such assets. The other significant change enabled the setting up of banking units within SEZs. The Ordinance was later replaced by the BR (Amendment) Act, 2007.

Statutory Reserve, Accounting Standards, Data Sharing, Tax Issues and Regulatory Overlap

In several specific areas, the Reserve Bank exercised its regulatory powers to improve the health and capability of banks. One of these occurred in respect of the statutory reserves banks maintained to meet contingencies. With effect from March 2001, the Reserve Bank stipulated that not less than 25 per cent (as against the statutory minimum of 20 per cent) of net profits should be transferred to reserves every year. Between 1997 and 2003, certain banks were allowed to draw down part of such reserves to meet provisioning requirements and, thereby, avoid posting net losses in their profit and loss accounts.

The BR Act allowed banks to appropriate sums from the statutory reserve fund with only *ex post facto* reporting to the Bank. It was observed that some banks appropriated and utilised these funds for purposes like writing off of NPAs and for making fresh provisions for NPAs. Banks were, therefore, advised in September 2006 to take prior approval from the Reserve Bank before any appropriation was made.[75]

To facilitate the adoption of international financial standards, the Reserve Bank, in consultation with the government, formed a standing committee.[76] The committee identified action points and disseminated the information and the proposed actions widely. India was one of the countries requested to help the Financial Stability Forum in the Task Force on the Implementation of Standards. The Bank was also represented in the follow-up Group on Incentives for Implementation of Standards instituted by the Forum following the submission of the task force report.

During the reference period, the Bank set up several committees to study accounting norms.[77] The process of convergence between Indian practice and international best practices, however, was slow, and subject to continuous dialogue between the Bank, the FEDAI, the Financial Stability Forum, the Institute of Chartered Accountants of India (ICAI), the IBA and of course, the banks themselves.

The Income Tax Department and the government investigating agencies sometimes needed information from commercial banks on specific clients. Sharing of information was, however, bound by a secrecy clause. The Reserve Bank advised banks in February 1998, outlining their obligation to maintain secrecy as part of the contractual relationship with their customers while furnishing such information under different statutes. Banks were advised not to respond to 'fishing and roving enquiries' from the Income Tax Department and enforcement agencies. In March 1999, Deputy Governor Talwar wrote to the Finance Secretary suggesting that a technical group should look into the principles of data sharing. The Ministry at first did not respond. On pursuing the matter, in 1999, the government advised that the Reserve Bank should ask banks not to disclose information in response to general enquiries.

In 2000–02, income tax authorities complained that bank customers split and transferred their deposits to different branches to avoid tax deduction at source (TDS). The Reserve Bank observed that the practice did not violate any law, nor were the banks actually assisting the practice, effectively refusing to intervene.

In May 1998, Governor Jalan wrote to the Finance Secretary suggesting that, in line with the recommendations of the Narasimham Committee II, the government might increase the ceiling of deduction of general provision against NPAs from the taxable income of banks. An amendment to the Income Tax Act was accepted by the government in this regard.

Some other areas that saw reform and discussions between the banks and the Reserve Bank were the declaration of dividends, voluntary retirement scheme of banks, outsourcing of services, rationalisation of regulations and gold-related issues. Of these, gold and regulatory overlap issues deserve longer treatment.

Under the Gold Import Authorisation Scheme, the Reserve Bank had been authorising banks (called 'nominated banks') to import gold for sale to jewellery manufacturers, exporters and domestic users. The nominated banks were advised in December 1998 that gold loans should be given only to jewellery exporters. Traders opened long-period usance letter of credit for import of gold. The sale proceeds, realised within a short period, were kept in fixed deposits with banks for opening further letters of credit. Therefore, in July 2004, the Reserve Bank reduced the maximum usance period for import of gold to ninety days.

In September 2005, banks authorised to import gold were allowed to extend gold metal loans to domestic jewellery manufacturers who were not exporters, subject to the tenor of the loan not exceeding ninety days and compliance with KYC requirements. In 2006, there were seventeen banks authorised (nominated) to import gold. The authorisations had to be renewed annually. In March 2006, with a view to enhancing competition, the Reserve Bank invited applications from banks with unimpaired total capital of ₹3 billion or more, and complying with certain other parameters, for being considered for authorisation to import gold.

Banks reportedly imposed excessive interest and charges, particularly in respect of credit card dues. In 2007, the Monopolies and Restrictive Trade Practices Commission (MRTPC), an organ of the Ministry of Corporate Affairs, advised the Ministry of Finance that several banks had violated the Reserve Bank's guidelines on credit cards and action was taken against them by the MRTPC. The MRTPC had also released to the media the findings of its preliminary investigations without giving an opportunity to the banks to explain. The banks complained to the IBA, which reminded the Reserve Bank in August 2007 that 'it is for RBI to decide whether there is a need for regulatory intervention'. When the Reserve Bank wrote to the Ministry of Finance in January 2008 on the overlap of regulatory powers between the MRTPC and itself, the Ministry replied that the MRTPC, being a judicial body, had the powers to investigate and adjudicate in such matters and that the banks should deal with the MRTPC. Clearly, this was not to the Bank's liking, nor consistent with its interpretation of the law.[78]

In October 2003, the Competition Commission of India was set up, and banking and financial sectors were covered under the Competition Act, 2002. In a presentation before senior officers of the Reserve Bank in January 2007, the MRTPC members questioned the appropriateness of a range of restrictions, such as administered interest rates in a few sectors, branch licensing, SLR and priority credit, and uneven treatment of public, private and foreign banks, among others. The Reserve Bank responded that these restrictions reflected the Bank's obligations under the BR Act to the depositors and in the public interest. The MRTPC did not pursue the matter.

Box 10.1.2 Reflections on Regulation and Deregulation

… RBI was much more control-oriented in my view than is consistent with giving a lead for an emerging, a growing capital market in the modern financial structure.

Montek Singh Ahluwalia, economist

We have lost a lot of opportunities in developing our capital markets and I guess I would hold the RBI responsible for that; we have been very very conservative.

Surjit Bhalla, economist

It is better not to move forward at all rather than step forward and then step back. In pursuing deregulation or liberalization policies, it is important therefore for the Governor to be sure, in the 99 percent confidence interval, that the policy will not be reversed. That I think contributes to conservatism.

D. Subbarao, former Finance Secretary, and former Governor of RBI

... the Reserve Bank has badly failed in looking at the requirements of long-term finance for industry, or for manufacturing in particular. They allowed the development financial institutions (DFIs) to collapse. The policy of universal banking in this respect was a disastrous step. The RBI did not think in terms of providing an alternate source of finance for the industry. The bond market has not developed nor was it capable of closely evaluating large projects for their healthy promotion.

S. L. Shetty, economist

Conclusion

The history of banking regulation in India brings out the fact that even though the Reserve Bank was the regulator of banks, in practice, regulatory reform involved a carefully calibrated negotiation with the government. After all, the government owned by far the largest segment in the banking system. As the Competition Commission noted, public sector banks were advantaged in many ways, and both the government and the Reserve Bank were trying to level the field of competition between public and private banks. The general preference among people and public agencies for government-owned banks due to the implicit sovereign guarantee enabled them to out-price other banks in the market. On the other hand, these banks faced political interference, loan waivers, low staff productivity and active trade unionism.

Despite this skewed playing field, private sector banks raised their share of deposits fast. Starting with a clean state, and with full computerisation of all branches from the start, these banks were better placed to introduce state-of-the-art technology, deliver better customer service and offer innovative products to meet the changing needs of bank customers. Their staff had a younger age profile and were more customer-friendly and less bureaucratic as decision-making was faster in these banks.

Because of the need to coordinate steps with the government, the Bank's stance may appear to be overly conservative and cautious at times (see Box 10.1.2). And yet regulations and wide-ranging reforms were undertaken during the reference period, and these did produce significantly positive results. One indication of this was the limited impact that the 2007–08 subprime crisis had on India. More substantially, by all performance indicators, commercial banks improved their performance during the period.[79]

Notwithstanding this improvement, intervention could do more to encourage financial innovation and competition. The reforms delivered but left scope for further improvement.

Notes

1. Such as payment of travelling and halting allowances and sitting fees to board members of banks, acquiring and disposing of immovable property by banks, rent and rent advance payable to the landlords of bank premises, induction of members to local advisory boards by foreign banks, remittance of profit by foreign banks, issue of bonds eligible to be reckoned as Tier II capital,

and donation by banks for social and charitable purposes up to 1 per cent of previous year's profits.

2. Chairman: T. R. Andhyarujina, former Solicitor General of India.
3. At 10 per cent of banks' net demand and time liabilities in March 1997, and stood at 7.50 per cent by March 2008 (see Chapter 3). Refers to essentially public deposits.
4. To 25 per cent in October 1997 (from 31.5 per cent fixed in October 1994), which was the floor rate as per the statute and remained at 25 per cent until March 2008. In practice, banks maintained a much higher level of SLR (except between 2004 and 2007). The ceiling and floor rates for the CRR and the floor rate for SLR were removed (retaining the SLR ceiling rate at 40 per cent) by carrying out amendments to the Reserve Bank of India (RBI) Act and the Banking Regulation (BR) Act in 2006–07.
5. Chairman: H. N. Sinor, Chief Executive of the Indian Banks' Association (IBA).
6. Bimal Jalan, Inaugural speech at the Conference of Bank Chairmen, National Institute of Bank Management, Pune, 6 January 2000.
7. In February 1999, the Bank assessed the capital requirement of public sector banks for the next six years (1999–2004), based on the trend in the growth of risk-weighted assets and retained earnings, and sent it to the Ministry of Finance.
8. Basel norms refer to norms for managing risks, issued by the Basel Committee on Banking Supervision (BCBS), a body established by leading central banks. Basel I refers to a set of norms announced in 2004.
9. In February 2000, a working group (Chairman: A. Ghosh) set up to examine the proposals of the Basel Committee on Banking Supervision (BCBS) on the New Capital Adequacy Framework (NCAF) submitted its report recommending the modalities for implementing the Framework.
10. In the same year, the Bank wrote to the government suggesting amendments to the statutes, to enable banks to issue perpetual non-cumulative preference shares (Tier I) and perpetual redeemable cumulative preference shares (Tier II).
11. Banks were later required to provide capital for market risks for investments, held in HFT category from March 2005 and in AFS category from March 2006.
12. The group relied mainly on International Accounting Standard (IAS) 39 (which sets out the principles for recognising and measuring financial assets and financial liabilities). In October 2005, its report was sent to the Institute of Chartered Accountants of India (ICAI) for comments. In July 2006, the draft guidelines, modified after taking into account the views expressed in the STACFR meeting, was sent to all banks for feedback. Another internal group developed guidelines for derivatives accounting. The group submitted

its proposals in June 2006, which were largely based on the principles of IAS 39. Subsequent to the subprime crisis in the USA, IAS 39 came in for criticism and, therefore, this matter remained unresolved until the end of the reference period.

13. The group found that the offer documents for private placement had varying disclosure levels, limited company information and no auditors' comments.
14. These covered regulatory requirements, rating and listing requirements, prudential limits, internal assessments, role of boards, disclosure, and trading and settlement in debt securities.
15. Including equity-oriented mutual funds, venture capital funds, CP, certificates of deposit (CDs) and investments in security receipts of asset reconstruction companies (ARCs).
16. Such lending on a fortnightly average basis should not exceed 50 per cent of owned funds (paid-up capital plus reserves) as at the end of the previous financial year. The ceiling was reduced to 25 per cent in December 2002. Further, call borrowings by scheduled commercial banks were not to exceed 100 per cent of their owned funds or 2 per cent of aggregate deposits, whichever was higher.
17. Chairman: S. Gurumurthy.
18. The relationship between asset–liability management and the credit–deposit ratio may need a clarification. The mismatch in assets and liabilities in banks was more often due to an abnormal credit–deposit ratio. After taking into account CRR and SLR requirements, the credit to deposit ratio should be around 65 to 70 per cent. If it is higher, there is a possibility of loans (long term assets) being funded by short-term borrowings (liabilities). Therefore, the credit–deposit ratio is an important variable in asset–liability management.
19. Banks were advised in 1999 to set up an Asset Liability Management Committee. Statements of Interest Rate Sensitivity were to be sent to the Reserve Bank initially on a quarterly basis, and later on a monthly basis. Banks were allowed to undertake forward rate agreement and interest rate swap transactions to hedge their interest rate risk in their balance sheets. Further, in January 2001, Executive Director G. P. Muniappan met the heads of the old private sector banks to discuss areas of improvement in risk management. Based on the recommendations of two internal groups, guidance notes on risk management covering credit and market risks were issued (2001–02). Subsequently, a questionnaire-based survey to review the progress in the implementation of risk management systems by banks was carried out and the responses analysed.
20. A joint technical committee reviewed bank financing of equity in May 2001 and revised instructions issued redefining aggregate exposure.
21. Internal office noting put up to the top management of the Bank in May 2004. Roughly 85 per cent of the equity market was in the hands of day

traders and speculators who did not take possession of the stocks, traded on margins, and squared up the positions by end of the day.

22. On individual and consolidated basis as on 31 March of the previous year.
23. The definition of capital market exposure was widened by including advances for any other purpose for which shares and convertible debentures/bonds and units of equity-oriented mutual funds were taken as security.
24. Subsequently the guidelines were slightly modified to include funds in the nature of capital which had accrued to banks after the last balance sheet date for arriving at exposure limits.
25. Effectively, the new limits were 20 per cent and 45 per cent for single and group borrowers, respectively, and 25 per cent and 55 per cent for advances to infrastructure. With delegation of powers to banks' boards, the number of references to the Bank for approval declined substantially.
26. Of ₹1.40 billion and ₹2.40 billion and ₹2.50 billion for group exposure to infrastructure projects until March 2003 when the bank could achieve minimum capital adequacy norms.
27. Some foreign banks had activities concentrated only on OBS business such as issue of guarantees, letters of credit and hedging products. Such banks were required to lend 40 per cent of credit equivalent amount of their OBS exposure to the priority sector.
28. Chairman: S. Gurumurthy.
29. The in-principle approval was given on the strength and reputation of Rabobank, Netherlands, which had expertise in agricultural lending.
30. Since the Indian promoters' equity in new private banks was restricted to 40 per cent, there was a concern that the liberal norms for foreign investment created an uneven playing field. In 2003, the Finance Ministry agreed to the Bank's position, and capped foreign investment from all sources at 74 per cent.
31. The Narasimham Committee II held a similar view.
32. In May 2004, Deputy Governor Udeshi wrote to the Ministry that

    > our internal review of the functioning of private sector banks, both old and new, reveals that when bank's ownership is diversified either directly or indirectly, the supervisory concerns have been less. In this background, we are of the view that there would be no need for removal of the ceiling on voting rights as originally envisaged, at this stage.

33. Soon after issue of the guidelines, the Reserve Bank entered into dialogue with individual banks to ensure compliance. By May 2005, dialogues with nineteen private banks had been completed. In August 2005, private sector banks were further advised that they should report to the Reserve Bank the details of share transfers that had resulted in change of shareholding to the extent of 0.5 per cent or more of the bank's paid-up capital whenever such transfers took place. The Bank did not like to be taken by surprise and wanted

to monitor the position so that pre-emptive action could be taken as soon as necessary. This advice to banks became necessary after the two depositories and SEBI expressed their inability to provide information on share transfers. Banks, however, found it difficult to report change in shareholdings as there were shares in both demat and scrip form. There were many queries from banks for clarification and guidance on the matter.

34. The Reserve Bank's policy was that the pricing of public issue of shares should not be less than the one determined according to the Controller of Capital Issues (CCI) formula and that preferential allotment of shares at preferential prices would be discouraged. Bonus issues could be decided by banks, provided they were issued along with public/rights issues.
35. Two other old private banks proposed to allot preferentially 4.99 per cent and 4.80 per cent to the IFC in 2006 and approached the Reserve Bank for its acknowledgement of the allotment.
36. The meeting was called by SEBI; other participants included the two depository companies and stock exchanges.
37. The BFS directed in October 1999 that a group be set up with representatives from SEBI, the Reserve Bank, NSDL and Deutsche Bank.
38. The depositories were Deutsche Bank Trust Company Americas and J. P. Morgan Chase Bank.
39. Provided in Section 36 AB of the BR Act.
40. Nominee directors were to be appointed only in cases of banks making losses for more than one year, having CRAR below 8 per cent, gross NPAs exceeding 20 per cent, and where there were disputes in management. In other words, the presence of a nominee director became an indication of some supervisory concern. It was further decided in September 2005 that barring one private sector bank, which had certain management issues, nominee directors from all private sector banks would be withdrawn and appointment of 'observer' in the status of a 'permanent invitee' to board meetings would be considered.
41. On the boards of public sector banks, the Reserve Bank, the National Bank for Agriculture and Rural Development (NABARD) and the National Housing Bank (NHB). Its guidelines issued in September 2004 did not refer to a draft document sent earlier by the Reserve Bank.
42. The Bank requested the government to refer to its draft and made procedural suggestions on appointment of directors. In August 2005, the Bank suggested to the government that the criteria relating to 'fit and proper' status might be made applicable to the nominated directors on the boards of nationalised banks as in the case of private sector banks. In September 2005, the Bank advised the government that the elected directors of public sector banks also should satisfy the criteria applicable to nominated directors. The Bank cited two examples to show why having a formal procedure mattered so much

to the Bank. 'Recently,' the letter stated, 'we had come across a complaint from the Investors' Grievance Forum regarding a film director contesting the election for director's post in a public sector bank and eventually being elected as a director.' In another case, one of the directors of another bank was found to be associated with two companies figuring in the defaulters' list. The government advised the said bank to persuade him to relinquish his directorship. But the director disputed the contentions raised and declined to resign. Pending legislative changes, only moral suasion could be resorted to in such cases.

43. In November 2006, the Bank set up a committee (Chairman: Janki Ballabh) to finalise the modalities and frame the guidelines for such appointments, which submitted its report in January 2007. It held that in view of the legal requirements of the nominee directors having necessary experience and expertise, they had to be from the pool of the Bank's retired officials. Accordingly, in February 2007, the Bank replaced the serving officers by nominating retired officials to various public sector banks.
44. 'In view of the performance of PE [private equity] funds during the last two years internationally, the fact that these are generally unregulated entities and also the issues regarding the investment by foreign PE funds in India, SBI should consider structuring such investments as VCFs [Venture Capital Funds] which should be registered with SEBI.'
45. In June 2002, an internal working group was formed to draw guidelines for the setting up of banking subsidiaries by foreign banks. The guidelines took into account cross-country experiences and provisions of the General Agreement on Trade in Services (GATS). The draft guidelines were sent to the government, proposing that the Bank would process the applications for setting up subsidiaries without separate clearance from the Foreign Investment Promotion Board. The government's stand on these issues was not quite clear and, therefore, the guidelines were not issued.
46. An issue of concern with foreign banks in India was that several of them operated in niche services, did not offer full banking services for all types of clients, were not required to conduct priority sector lending and, therefore, did not meet one of the objectives of banking regulation, that banks should foster financial inclusion. Reviewing the situation, an in-house Technical Paper on Differentiated Banking Licences concluded in October 2007 that 'it is necessary that all banks offer certain minimum service to all customers' and 'it will be prudent to continue the existing system for the time being. The situation may be reviewed after a certain degree of success in financial inclusion is achieved'.
47. A committee of outside experts was formed under the Chairmanship of M. S. Verma, who had just retired as SBI Chairman.

48. A draft amendment to the Banking Companies (Acquisition & Transfer of Undertakings) Acts of 1970 and 1980 was sent to the government by the Bank in April 2000.
49. High-level group headed by Deputy Governor S. P. Talwar, with Deepak Parekh and two Joint Secretaries from the Ministry of Finance as members.
50. 'Narrow banking' is a term used to describe a very restricted form of banking, where the institution is not allowed to take risks. Funds are placed only in risk-free and liquid assets like government securities and asset–liability duration mismatch is also avoided.
51. RBI, Basic Statistical Returns.
52. Such as setting up of Debt Recovery Tribunals, Lok Adalats, ARCs, corporate debt restructuring mechanism, and the Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interest (SARFAESI) Act, 2002, among other measures.
53. In 2001, a study carried out for putting in place an early warning system in banks concluded that a software could be developed for the purpose. The Reserve Bank advised the IBA to arrange for and develop such a software. No definite progress in this field was reported, presumably because banks ran different IT platforms for their operations.
54. Covering early recognition of the problem, introduction of special mention accounts (as a category between standard and substandard to serve as an early alert system), identification of borrowers with genuine intent, timeliness and adequacy of response, consortium/multiple financing, legal issues, and auditors' responsibility.
55. This was a forum where disputes pending in the court of law or at the pre-litigation stage were settled amicably without payment of court fees.
56. Chairman: N. V. Deshpande, to examine the working of Debt Recovery Tribunals, which submitted its report in August 1998.
57. Chairman: M. R. Umarji.
58. This was a major step in addressing the issue of NPAs in the banking sector. In April 2003, another set of guidelines was sent to banks on sale of financial assets to ARCs, and in 2005, guidelines were issued on purchase and sale of NPAs among banks, financial institutions and NBFCs to develop a secondary market for NPAs where ARCs were not involved. The boards were required to lay down policies on valuation procedure. In October 2007, banks selling NPAs were advised to work out the net present value of the estimated cash flows associated with the realisable value of the available securities, and net expenses. The sale price should generally not be lower than the net present value so derived. By March 2008, commercial banks had issued 279,796 notices under the SARFAESI Act, involving NPA cases with outstanding amount of ₹560.60 billion and had recovered an amount of ₹154.15 billion from 172,809 cases.

59. RBI, *Report on Trend and Progress of Banking in India 1996–97* (1997), p. 57.
60. The Narasimham Committee II, for example, considered that all public sector banks should be brought under the Companies Act so that mergers driven by business interests would become easier and a routine matter. The government, however, was not keen on the idea.
61. When informally approached by Bank of Baroda expressing interest in taking over the bank, the Reserve Bank made an application to the government in October 2001 for a moratorium.
62. The court was referring to the amount mentioned in Section 22 of the BR Act, which was ₹0.50 million, as against the Reserve Bank's administrative fiats to private sector banks enhancing the minimum net-owned funds to first ₹0.50 billion and then to ₹3 billion. The Reserve Bank, however, resorted to issuing directions in public interest, deriving powers from the enabling provisions of the Act, as frequent amendments to the statutes was time consuming.
63. There was no restriction on opening of extension counters, satellite offices, and so on. Specialised branches and service branches could also be opened without prior permission from the Bank except that its formal 'licence' had to be obtained to comply with the law.
64. Nevertheless, in July 2000, Deputy Governor Talwar recommended that private sector banks meeting the criteria of CRAR of over 10 per cent, net NPA below 3 per cent, return on assets above 1 per cent and the Reserve Bank's inspection rating of 'A' be allowed to open twenty-five to thirty branches in a year and others eight to ten branches in a year. Governor Jalan broadly agreed and added that 'it would be desirable to promote greater competition among good private sector banks'.
65. SBI sought the Bank's approval in May 2000 for opening 'sub-branches', or small offices offering specialised services, in cities covering remittance, deposits and loan products, setting up of full-fledged branches being expensive. The Bank rejected the proposal. Private and foreign banks outsourced some of their activities and appointed franchisees for marketing of loan products. The Bank held that in keeping with the spirit of the BR Act, banking needed to be done in the branches. In July 2002, the Exchange Control Department took up with the regulatory department, the Department of Banking Operations and Development, the question of allowing 'cash back' by merchant establishments against credit cards, which would potentially help foreign tourists. After some discussion, the Bank disallowed the move. A proposal from foreign banks to open Financial Service Centres or Limited Service Branches in 2003–04 was similarly turned down. A nationalised bank wanted to open 100 Retail Boutiques (kiosks) in May 2004, but the plan was rejected by the Bank. In September 2004, at a Federation of Indian Chambers of Commerce and Industry conference, there was a suggestion that the Bank should permit the South African microfinance institution TEBA Bank model (see Chapter

13 for more details on this institution). The Reserve Bank's negative stand in this regard drew critical comments from the United States Agency for International Development, in a review of the Indian financial sector in 2005.

66. On 6 September 2006, *Financial Express* ran a four-column headline, 'Banks ATM Plans Go Awry as RBI Sits on Applications', and three days later ran an editorial captioned 'Control Mania: Let a Thousand ATMs Sprout'. The editorial said that by including ATMs in the definition of bank branch, the Reserve Bank had merely extended its control over banks.
67. The group was to prepare a framework for a reporting system on transactions connected to economic crime.
68. In performing this task, the Bank made use of recommendations made by the Financial Action Task Force (FATF) on Anti-Money-Laundering (AML) standards and on Combating Financing of Terrorism. The FATF was conceived by the G-7 countries.
69. See Reserve Bank of India, *The Reserve Bank of India, Vol. 4: 1981–1997* (New Delhi: Academic Foundation, 2013).
70. Chairman: P. Saran. It had members from IBA, NABARD, three major banks, FMC, and different departments of the Reserve Bank.
71. Chairman: V. S. N. Murthy.
72. Guidelines were given to banks for investment in mortgage-backed securities in May 2002.
73. For example, *Business Today*, April 2004.
74. In August 2003, Deputy Governor Udeshi suggested that 'in the present liberalised scenario, it would now be appropriate for RBI to prescribe standard norms on agency/referral arrangement and grant general permission to banks'.
75. From statutory reserve or any other reserve. Banks were also advised that such draw-down was to be effected only after arriving at the year's profit or loss and also to report the draw-down in the 'Notes on Accounts' on the balance sheet.
76. On International Financial Standards and Codes under the chairmanship of Deputy Governor Reddy, and the Secretary in the Ministry of Finance as alternate Chairman. The standing committee constituted advisory groups in ten core subject areas, which broadly encompassed the key areas prescribed by the Group of Seven (G7) body the Financial Stability Forum. These advisory groups would study the relevance of standards and codes, review the feasibility of compliance and compare the levels of adherence in India in comparison with other countries. Consistent with the spirit of an independent enquiry, the advisory groups were chaired by experts not generally holding official positions.
77. One of these was a working group with members from the ICAI, the Reserve Bank and banks formed by the Reserve Bank to study accounting standards

in relation to the international best practice. The Advisory Group on International Accounting and Auditing (Chairman: Y. H. Malegam), subject to some exceptions, endorsed the Institute's practices. Banks, however, did not necessarily follow these standards. Therefore, a working group (Chairman: N. D. Gupta, former President of the ICAI) was formed to recommend better compliance by banks. Based on the group's recommendations, a set of guidelines was issued in March 2003.

78. The Reserve Bank sent a letter to the Ministry in December 2008 stating that

> the stand taken by the Commission does not appear to have complete statutory backing. It would not be in the best interest of the banking system or in public interest for the MRTPC to release reports in the media. MoF may like to suitably take up the matter with MRTPC.

79. The Committee on Financial Sector Assessment (2009) concluded that

> commercial banks have shown a healthy growth rate and an improvement in performance as is evident from capital adequacy, asset quality, earnings, and efficiency indicators. In spite of some reversals during 2008–09, the key financial indicators of the banking system do not throw up any major concern or vulnerability and the system remains resilient. (Para 3.2.49, Volume III)