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Regulation of the Financial System

Part II: Other Financial Institutions

Introduction

In the decades after Independence, a set of financial institutions other than commercial banks were established under the government's encouragement.[1] The three most important types, which will form the subject of this chapter, were those known as all-India financial institutions or development financial institutions (FIs), non-banking financial companies (NBFCs) and urban cooperative banks (UCBs). The cooperative banking institutions in rural areas are covered later in the chapter on rural credit. These served specific types of clients, some of whom had inadequate access to commercial banks.

The relative share of assets of scheduled commercial banks (SCBs), FIs, NBFCs and UCBs as of March 1998 (comparable figures are not available for March 1997) and 2008 are shown in Table 10.2.1. Though the assets of these three categories had increased in absolute terms during the reference period, there was a fall in their market share and a rise in the market share of commercial banks. The commercial banks accounted for 94.3 per cent of public deposits in March 2008.

During the reference period, the regulatory framework applicable to these institutions underwent fundamental changes. Some FIs converted into banks, and the others tried to reinvent themselves. NBFCs and UCBs were subjected to regulations aimed at improving governance. The Bank, despite limited jurisdiction on these institutions, played a pivotal role in the transition. This chapter outlines the transition. The three main sections of the chapter deal with FIs, NBFCs and UCBs. The next section gives a brief overview of the three types of institutions and their relationship with the Reserve Bank.

Table 10.2.1 Share of Assets

(₹ billion)

Sector	*31 March 1998*	*31 March 2008*
SCBs	7,955.06 (75.8)	43,261.66 (90.4)
FIs[a]	1,612.16 (15.4)	1,799.12 (3.7)
NBFCs	455.08 (4.3)	990.14 (2.1)
UCBs	475.63[b] (4.5)	1,794.21 (3.8)
Total	10,497.93 (100)	47,845.13 (100)

Source: Compiled from Reserve Bank of India (RBI), *Report on Trend and Progress of Banking in India*, various years.

Notes: a. Data for 1998 pertains to seven FIs and for 2008 to four FIs (SIDBI, NABARD, NHB and EXIM Bank). See text for the full forms of these abbreviations. Figures in brackets indicate percentage share. b. Total of owned funds, deposits and borrowings.

Financial Institutions, Non-Banking Financial Companies and Urban Cooperative Banks

Financial Institutions (FIs)

The FIs were set up to extend long-term loans directly, and indirectly through banks and other agencies to meet the financial needs of industrialisation. Banks, on the other hand, supplied mostly working capital loans. Of these, the Industrial Development Bank of India (IDBI), Industrial Finance Corporation of India (IFCI) and Industrial Investment Bank of India (IIBI) were set up by the government primarily for industrial finance; EXIM Bank for exports; National Bank for Agriculture and Rural Development (NABARD) for agricultural and rural development, Infrastructure Development Finance Company (IDFC) for infrastructure finance, Tourism Finance Corporation of India (TFCI) to promote the tourism industry, National Housing Bank (NHB) to promote the housing sector, Small Industries Development Bank of India (SIDBI) for finance to small industries, and Industrial Credit and Investment Corporation of India (ICICI, a joint private–public company) for providing industrial finance. Of the ten, five (ICICI, IFCI, TFCI, IIBI and IDFC) were registered under the Companies Act, and the other five were incorporated under the respective statutes. These were governed by the relevant statutes and by the government as owners. But the Reserve Bank had been entrusted with the responsibility of 'regulating' them under Sections 45L and 45N of the Reserve Bank of India (RBI) Act, though the powers were not specific and sweeping as in the case of banks under the BR Act. There was no statutory mandate for protecting the interests of depositors or investors. Public deposits held by them were not covered by the Deposit Insurance and Credit Guarantee Corporation. NABARD, SIDBI and NHB were essentially refinance institutions with some direct lending activities.

The FIs grew rapidly in the 1990s as there was good demand for their term lending and refinancing operations. The Industrial Credit and Investment Corporation of India was renamed ICICI Ltd in 1991. The Shipping Credit and Investment Corporation of India merged with ICICI Ltd in 1997, and ICICI Ltd effected a reverse merger with ICICI Bank Ltd in 2002. The merger of IDBI Ltd with IDBI Bank Ltd was completed in 2005.

Non-Banking Financial Companies (NBFCs)

An NBFC is essentially a financial company without a 'banking' licence from the Reserve Bank. This is a negative definition, which has served well because it appears to caution the consumer that an NBFC is potentially less secure than a bank. For example, deposit insurance is available to banks but not to NBFCs. Unlike banks, which can open chequable demand deposit accounts, NBFCs can open only term deposits. A deposit-taking NBFC is relatively more closely regulated and supervised. If a non-deposit taking NBFC is big in size (in terms of assets), it is considered 'systemically important' because ultimately all funds other than the share capital are public funds (bank borrowings and other debts), and such companies are, therefore, brought under closer scrutiny. In short, there are three main categories of NBFCs, with the regulatory order being different in each case – these are deposit-taking, non-deposit-taking and systemically important. Somewhat distinct is the residuary non-banking company (RNBC), which only takes deposits and does not engage in investment or asset financing. The asset reconstruction companies (ARCs) specialize in enforcing or encashing mortgaged securities of bankrupt firms. They are regulated under the Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interest Act, 2002 (SARFAESI Act), and the RBI Act as a class of NBFCs.

Urban Cooperative Banks (UCBs)

UCBs are member driven and community based. However, they are permitted to accept deposits from non-members. There is much heterogeneity among them in terms of size, geographical distribution, performance, financial strength and human resource endowment. At one end, there are small neighbourhood unit banks and, at the other end, there are several large UCBs with a wide network of branches and a large number of depositors and borrowers. For the latter, while the cooperative structure exists as an organisational arrangement, the business model is like that of commercial banks. Though a highly differentiated group, the UCBs were largely subjected to uniform regulation.

In March 1997, there were 1,653 UCBs with aggregate deposits of ₹307.14 billion. At the end of the reference period, there were 1,770 UCBs with deposits of ₹1,384.96 billion.[2] Maharashtra and Gujarat had the major share of UCBs in the country, followed by Karnataka and Andhra Pradesh. Tamil Nadu and Kerala also had a sizable share of UCBs. Twenty UCBs had a presence in more than one state in 1997, which increased to twenty-five by 2008. In 1997, 250 UCBs were categorised as 'weak banks' that had suffered erosion of owned funds to the extent of 25 per cent. In March 2008, there were 496 weak UCBs.

Financial Institutions

In 1998, the Reserve Bank was monitoring the operations of ten FIs (IDBI, ICICI, IFCI, EXIM Bank, IIBI, TFCI, NABARD, SIDBI, NHB and IDFC).

In 1997, the Bank formed a working group to suggest measures to harmonise the roles of FIs and commercial banks.[3] The group recommended a gradual move towards universal banking through mergers between banks and FIs. This would allow for one regulator to oversee both types of institutions. The Narasimham Committee II (1998) made a similar recommendation. In January 1999, the Bank brought out a discussion paper containing draft proposals based on these recommendations. It did not envisage any specific time frame or compulsion for the conversion of FIs into banks or NBFCs. The decision would be left to their own strategic planning, commercial prudence and business synergies, and the complementarities that could be derived from such conversion.

The Bank issued a circular in April 2001 to the FIs, highlighting the issues that would need to be addressed in the process. The Confederation of Indian Industry (CII) brought out the practical problems in the process of FIs converting into banks. In the pre-reform era, the FIs had access to certain concessional sources of funds that had been withdrawn. This increased their cost of funds. The enactment of the Fiscal Responsibility and Budget Management Act, 2003, constrained the government from subsidising these institutions. A commercial bank, the CII pointed out, had to keep aside 32.5 per cent (cash reserve ratio [CRR] plus statutory liquidity ratio [SLR] applicable at that time) of its non-equity liabilities as CRR–SLR, which was a costly option. They would have to borrow funds at 9 per cent to achieve this and earn an average of 7 per cent. The CII suggested that CRR–SLR should apply only for public deposits and not for other liabilities of the FIs. Pending such conversion, the Bank concentrated on governance.

In early 1999, the Bank, in consultation with the government, constituted an informal advisory group,[4] with members from industry, to examine the regulation and supervision of FIs. The advisory group recommended prudential norms on income recognition, asset classification, provisioning and capital adequacy, and revised guidelines for export credit, bridge loans and exposure norms. Though the Bank had prescribed a minimum capital to risk-weighted assets ratio, or CRAR, of 9 per cent for the FIs, no specific guidelines were issued for the adoption of Basel I or II norms for those FIs that were primarily refinancing institutions.

Efforts were also made to improve the quality of asset and liability management, to address such chronic problems as non-performing assets (NPAs), state guaranteed advances and connected lending.

Asset Management

From June 1997, these institutions were subjected to credit exposure norms. The exposure limit – defined to include both funded and non-funded credit limit, underwriting and other commitments – was linked to the institution's capital funds (paid-up capital and reserves as per published accounts).[5]

As for asset classification, they were required to classify an asset as NPA if the interest was overdue for 180 days and principal for 365 days from November 2000. In April 2001, this became 180 days for both interest and principal. It was reduced to 90 days from March 2006 (applied to commercial banks from March 2004). The Reserve Bank sent out the guidelines issued to banks on compromise and one-time settlements of chronic NPAs (see Part I) to FIs as well.[6] In July 2003, the Bank advised the FIs on prevention of the slippage of accounts from standard to substandard and from substandard to doubtful category based on a study by an in-house group. Between standard and substandard, a new category – 'special mention' – was introduced, which could serve as an early alert. The Bank also issued guidelines for sale of financial assets to ARCs. The guidelines addressed a few other subjects as well, such as investment in SLR, categories of investment, and connected lending.[7]

In December 1997, it was clarified that although government-guaranteed advances need not be classified as NPAs for provisioning, such advances were to be treated as NPAs if the concerned state government repudiated its guarantee. In November 2006, in line with the instructions issued to commercial banks, FIs were advised that government-guaranteed advances should be treated as any other advance from March 2007. The impact of this decision was significant, for 41 per cent of the advances of FIs were guaranteed by state governments. Since the change would impact NABARD severely due to its high exposure to state-guaranteed advances, it was permitted at their request to make additional provisioning over a period of three years from 2007, with a minimum of 25 per cent each year.

Liability Management

Until 1997, the Reserve Bank set instrument-wise annual limits for each financial institution for raising resources from the market. The instruments were term deposits (1 to 5 years), term money borrowings (3 to 6 months), CP (15 days to 1 year), CD (1 to 3 years), and inter-corporate deposits. In May 1997, an overall or umbrella limit was introduced, equivalent to 100 per cent of net-owned-funds. The choice of instruments was left to the institution. These institutions were prohibited from issuing SLR bonds and from accessing long-term funds from the Bank on concessional terms. On the asset side, they faced competition from banks and were exposed to asset–liability mismatch, interest rate risk and adverse selection risk.[8]

In July 2007, a master circular was issued on prudential guidelines for bonds and debentures, whereby the outstanding of total resources mobilised by an FI, including funds mobilised under the umbrella limit, should not exceed ten times its net-owned funds. The FIs were also subject to capital adequacy norms, which indirectly restricted the total quantum of resources to be mobilised for a given level of regulatory capital. Since the capital adequacy norms, as well as the resource raising norms for the FIs, sought to address the same prudential concern relating to the extent of leverage deployed by them, there was an element of regulatory overlap.

In 2004–05, the three refinancing institutions (NABARD, SIDBI and NHB) raised substantial amounts as capital gains bonds.[9] In September 2005, the Reserve Bank wrote to the government urging a review of the bond issued by FIs, and suggesting a cap on total funds during a year in tranches and duration of the tap (at that time, the FIs were issuing the bonds on tap at fixed rates and unlimited amounts). The facility of issuing capital gains bonds was discontinued following the withdrawal of tax benefits in the Union Budget in 2006–07.

In December 2000, FIs were advised to introduce asset liability management systems from April 2001. Based on feedback received from ICICI Ltd, the guidelines were fine-tuned in August 2001.[10]

In June 1999, the Chairman of ICICI Ltd wrote to the Governor seeking permission from the Bank for lending and issuing guarantees to joint ventures and wholly owned subsidiaries of Indian companies abroad. The CII also wanted FIs to lend to overseas Indian entities. Whereas banks had a diverse resource base for foreign exchange, borrowing was the only recourse for FIs to mobilise foreign exchange. On this ground, in October 2000, the Bank rejected the proposal. The government convened a meeting in February 2001, following which the Finance Secretary wanted the Bank to reconsider the decision. On 22 February 2001, the government asked the Bank for a proposal with necessary safeguards. In June 2001, the Bank reiterated its reservations but suggested that 'if the government is keen', loans up to 50 per cent of external commercial borrowings and not exceeding 5 per cent of Tier I capital could be allowed to overseas entities if the net NPA of FIs was below 5 per cent. In a meeting convened by the government in July 2001, the Finance Secretary wanted the net NPA to be fixed at 7–10 per cent. But the Bank stuck to its position on this point and there was no further communication from the government.

The jurisdiction of the Bank over FIs was partly a legislative matter, and the law was a subject of frequent deliberations.

Review of Regulatory Framework

The Reserve Bank initially considered amendments to the RBI Act to vest powers of regulation of FIs to itself. In May 2001, however, the Bank sent proposals for extending certain provisions of the BR Act to FIs. Correspondingly, the supervisory powers over FIs in the RBI Act could be deleted. In 2003, Governor Reddy, who had taken charge in September that year, observed that in the emerging architecture of the Indian financial system, there could be only two intermediaries, banks and NBFCs, and hence it was not necessary to provide for specific statutory provisions in the BR Act for regulation and supervision of FIs.

Another issue that figured in discussions on regulatory reform was the debenture redemption reserve (DRR). Under the Companies Act, 1956, any company that issued debentures needed to create a reserve to protect investors against the possibility of default. In 2001, the Bank and the Ministry of Finance requested the Department of Company Affairs (Ministry of Law) to exempt public financial institutions, which were within the regulatory domain of the Bank, from this condition. The advantage for these institutions was that the bonds issued by them and certain other liabilities were treated as eligible investments for insurance companies, provident funds and mutual funds. The NBFCs also represented to the Bank seeking a similar exemption. The subsequent meetings showed that the Department of Company Affairs was convinced and exempted FIs fully, and NBFCs partly (50 per cent DRR) from this condition.[11]

In 2002, the Bank sent a proposal to the government to transfer the loans and investments out of the National Industrial Credit (Long Term Operations), or NIC(LTO), funds to the government, to enable the Bank to focus on its core functions.[12] A revised scheme envisaged the transfer of ₹37.92 billion of NIC(LTO) loans and advances to IDBI, IIBI, SIDBI and EXIM Bank from the Bank's books to the Government of India in exchange for 10.25 per cent securities of twenty years' maturity. The Finance Minister in his Budget speech for 2002–03 announced the strengthening IDBI's capital by converting NIC(LTO) loans into appropriate long-term instruments.[13]

In 2006, an internal working group reviewed the future role of refinancing institutions, which regulated and supervised cooperative banks and regional rural banks (RRBs), and found that the four refinancing institutions, NABARD, NHB, SIDBI and EXIM Bank, had faced little competition until the end of the 1990s since they had a captive clientele, but thereafter, while access to concessional funds was withdrawn, demand for refinance fell with the availability of alternative sources of funding.[14]

Other Regulatory Issues: Corporate Debt Restructuring and Reserve Bank's Ownership of FIs

The need for better coordination between financiers in large-value projects jointly financed by banks and FIs was stressed from time to time both within the Reserve Bank and the government. In 1999, a standing coordination committee was formed. Further, the Bank issued guidelines in March 2001 allowing banks and FIs to restructure or reschedule credit facilities extended to industrial units that were fully secured by tangible assets. An institutional mechanism for restructuring of corporate assets in the form of a corporate debt restructuring (CDR) system was proposed. There were, however, impediments to its efficient functioning. These problems were discussed in 2001 and 2005, based on which the guidelines were revised.

The Reserve Bank had shareholdings in various proportions in NHB (100 per cent), NABARD (72.5 per cent), Discount and Finance House of India (10.59 per cent), Securities Trading Corporation of India (14.4 per cent), IDFC Ltd (15 per cent), and State Bank of India (SBI) (59.73 per cent).[15] In May 1999, the Reserve Bank wrote to the government with a proposal to transfer the Bank's shareholding in SBI and proposed the method of transfer of the Bank's shares in NHB and NABARD. The government replied in April 2000 that these transfers would be considered later. Between 2005 and 2007, the Bank did transfer its shares in IDFC Ltd and SBI to the government.

The transfer of the shares in NABARD and NHB would require legislative amendments. The Reserve Bank had to be empowered to regulate and supervise housing finance companies, rural cooperative banks and RRBs, and limit the two FIs to developmental and refinancing activities because regulation and supervision of the financial system was essentially the Bank's responsibility. That the financing agency should not also regulate was obvious. The issue became more critical when the divestment of the Bank's ownership of NHB and NABARD was under consideration. The Bank wanted these issues to be resolved before effecting the transfer of ownership or at least to be synchronous with the changes in the regulatory set-up. But these issues were not resolved and the transfer of shareholding not effected until the end of the reference period.

Although all FIs were subject to similar pressures, and a need to adapt to market competition, their situation differed considerably depending on their own histories and the nature of the business. The next section describes the circumstances of the major FIs.

Notes on Individual FIs

IFCI was the first development finance institution promoted by the government. Originally the Industrial Finance Corporation of India, it was renamed and corporatised as IFCI Ltd in 1993. At the start of the reference period, IFCI was beset with a high level of NPAs and approached the Reserve Bank for permission to set up an ARC in 2002. This was not granted, ARC being as yet an untried concept in India. Instead, the government extended several financial packages and concessions. Despite this, the financial position of IFCI deteriorated. Gross NPAs of IFCI stood at ₹86.21 billion. In 2004, there was a proposal to merge Punjab National Bank with IFCI. The Bank conducted an impact study on the proposal and found that the gross NPA of the merged entity would be 30 per cent, net loss for the year ended March 2004 was ₹17.92 billion and CRAR was 4.51 per cent, which would attract prompt corrective action (PCA). Therefore, the proposal did not go forward. IFCI managed to declare a net profit in 2006–07 by the sale of shares in FIs it held. It was classified as an NBFC but exempted from NBFC directions until August 2007.

Banks and other FIs that had exposure to IFCI were, in turn, a cause for concern. The Reserve Bank gave permission to IDBI Ltd (which had become a bank) for retention of its investment in IFCI in 'standard' category despite IFCI having a negative net worth of ₹47.73 billion in March 2005 and incurring a net loss of ₹3.24 billion in 2004–05. Several banks were exempted from prudential norms in respect of restructured IFCI liabilities in 2002–03, 2003–04 and 2005–06. The aggregate exposure of banks and FIs to IFCI by way of investments and loans stood at ₹69.51 billion in March 2006. The Reserve Bank advised banks that the regulatory forbearance would be withdrawn from March 2007, and they should value the investment in bonds of IFCI Ltd at market rates from June 2007. However, on a representation from the IBA, banks were given time until 31 March 2008 to do this. In 2007, the government's stake in IFCI fell to less than 51 per cent. All facilities to IFCI as an FI ceased and it was reclassified as a systemically important non-deposit taking NBFC (NBFC-ND-SI, see section later on NBFCs) governed by relevant directions of the Reserve Bank.

As mentioned earlier, in 2001, the government offered a package to augment the capital of IDBI using the NIC(LTO) fund. In the same year, IDBI submitted a proposal to the government for its restructuring, through a merger with a bank, to convert itself into a universal bank. The government favoured the proposal and intended to issue an ordinance to effect the transformation. Before doing so, the government sought the Reserve Bank's views. The Bank had already placed in the public domain the operational and regulatory issues that needed to be addressed in the process of conversion of an FI into a universal bank. Full compliance with prudential norms was a condition. Subsequently, the Finance Minister in his Budget speech for 2002–03 proposed to make legislative changes to corporatise IDBI.

In March 2002, Deputy Governor G. P. Muniappan wrote to the Finance Secretary stating that the Board for Financial Supervision (BFS) had 'taken specific note of the inactivity of the Board of IDBI'. In October that year, the Ministry of Finance convened a meeting with the Bank and the Law Ministry to discuss proposals for conversion of IDBI into a bank. Several options were considered. The Union Cabinet decided in November 2002 that the IDBI Act would be repealed and the undertaking of IDBI be vested in, and transferred to, a company to be incorporated under the Companies Act, which could be deemed to be a banking company under Section 5C of the BR Act. Thus, IDBI would be converted into a universal bank but not be required to obtain a licence.[16] IDBI was converted into a bank through an Act from October 2004 (see Part I) after the transfer of NPAs of ₹90 billion to a stressed asset stabilisation fund.[17]

The Industrial Reconstruction Corporation of India Ltd was set up in 1971 for rehabilitation of sick industrial companies and was reconstituted as the Industrial Reconstruction Bank of India (IRBI) in 1985 under the IRBI Act, 1984. To convert the institution into a full-fledged FI, IRBI was incorporated under the Companies Act, 1956, as Industrial Investment Bank of India Ltd (IIBI) in March 1997. The new entity had a high level of NPAs and did not comply with prudential norms. It was facing default on payment obligations, including on SLR bonds. The government subscribed to ₹1 billion in 2001–02 towards preference shares of IIBI, and the latter invested a similar amount in government securities. The government and IIBI wanted the amount to be treated as Tier I capital but the Reserve Bank did not agree, stating that there could be 'perverse implications if the fiscal neutral injection of funds by the government is treated as Tier I capital'. In July 2003, the Bank advised the government to either rehabilitate or close IIBI.[18] The company's CRAR stood at -46.2 per cent in March 2006. In May 2007, IIBI informed the Bank that the government had agreed to wind up IIBI.

The Tourism Finance Corporation of India, or TFCI, was set up in 1989 to contribute to the growth of tourism infrastructure by providing a dedicated line of credit on a long-term basis to tourism-related projects. The public had 39 per cent shareholding besides substantial shareholdings by SBI, Life Insurance Corporation of India (LIC) and General Insurance Corporation of India. The company was beset with increasing NPAs. Though registered as a non-deposit-taking NBFC, it was granted exemption from the provisions of directions and prudential norms up to June 2005, and the company sought an extension of the exemption. The exemption was withdrawn in November 2007 as TFCI came under NBFC directions. The Reserve Bank had no regulatory concern with TFCI.

SIDBI was set up in 1990 through an Act of Parliament. It was incorporated initially as a wholly owned subsidiary of IDBI. Later, the ownership was transferred to government-owned/controlled institutions. Beginning as a refinancing agency to banks and state-level FIs for their financial assistance to small industries, it expanded its activities with direct lending through its 100 branches across India. The erstwhile IDBI transferred its supervisory functions over the State Finance Corporation (SFC) to SIDBI. The ad hoc borrowing facilities to SFCs provided in the RBI Act were discontinued from 2004–05. They were permitted to raise public deposits, subject to the approval of the Bank, on a case-to-case basis and these permissions were routed through SIDBI, the monitoring agency for SFCs.

In the context of the SFCs' precarious financial condition and the need to protect the integrity of public deposits, the Bank advised SIDBI in July 2003 that only well-managed SFCs be permitted to raise public deposits. Besides, the Bank decided in July 2003 that the bonds issued by SFCs should not be given the SLR status. SFCs ceased to be part of the market borrowing programme since 2003–04. The Bank was not directly involved in the regulation and supervision of SFCs. From the systemic angle, there was no cause for concern as they were not part of the payment system. However, the Bank was concerned about the possible impact on the stability of the financial system since a large component of their liabilities was accounted for by SLR bonds issued in the past. As the regulator and supervisor of SIDBI, the Bank was also concerned about SIDBI's huge exposure to SFCs. The exposure to SFCs amounted to ₹46 billion by 2006, when thirteen of the eighteen SFCs were making losses. The government announced a package to be implemented by SIDBI. The Bank prepared a draft model memorandum of understanding, or MoU, between SIDBI, SFC and the state government concerned. SIDBI signed eleven such MoUs with SFCs by September 2007.

At the time of transfer of the erstwhile IDBI's investments in SFCs to SIDBI in March 2007, the Bank insisted on booking the loss to absorb the diminution in value while taking them on to SIDBI's balance sheet. In January 2008, the revaluation of investments in SFCs was a drain on SIDBI's resources. SIDBI's exposure to SFCs formed 25 per cent of its total assets. The NPAs of SFCs averaged around 60 per cent.

The deeper problem with the SFCs was that they functioned with little regulation, and the SFC Acts did not mention regulation by SIDBI. State governments had the powers to direct the SFCs. The powers exercised by SIDBI over the SFCs were contractual arrangements between a lender and a borrower. To instill better management in the SFCs, the Bank needed to work with SIDBI.

In January 2007, the Bank sought confirmation from SIDBI that prudential norms on asset classification and income recognition, and accounting standards issued by SIDBI to SFCs were in line with guidelines issued by the Reserve Bank to banks. SIDBI sought certain regulatory relaxations for SFCs on provisioning norms, which were allowed only up to March 2007. Since SIDBI was being regulated and supervised by the Reserve Bank, prescription of prudential norms for SFCs was considered necessary, as the Reserve Bank did not want SIDBI to be financing insolvent SFCs that had no possibility of turning solvent in the near future. Further, the Bank tightened its regulation of SIDBI in June 2007, and advised that 'for all direct exposures, prudential norms, accounting standards and risk management guidelines as applicable for banks will henceforth be applicable to SIDBI'. The Bank increased the risk weight from 100 to 125 per cent for SIDBI's exposure to SFCs and advised SIDBI to make full provision in respect of SFCs that had defaulted.

In June 2007, a committee constituted by the Ministry of Finance made a presentation on the restructuring of SIDBI to the Reserve Bank. There were two proposals: SIDBI to register as a new public sector bank or SIDBI to acquire an unlisted public sector bank that would function as a 100 per cent subsidiary. The Bank responded that it could not give licence for the formation of a weak bank and that, SIDBI being the regulator, supervisor and stakeholder in SFCs, the issue of conflict of interest needed to be resolved.

When SIDBI stopped refinancing SFCs with negative net worth, many SFCs and other affected bodies approached the Reserve Bank requesting restoration of refinancing. Their ground was that the small manufacturing firms, which many SFCs had as main clients, faced difficulties. In July 2007, the Ministry of Finance wrote to state Chief Secretaries to extend necessary support to SFCs. The government also repeatedly asked the Reserve Bank to restore SIDBI refinance to SFCs. The Bank held its ground and did not relent. In January 2008, the Bank expressed its inability to review the direction issued to SIDBI. In February 2008, the Ministry of Finance informed the Bank that four state governments had taken steps and committed to providing funds to the respective SFCs. The Bank agreed to change its position and advised SIDBI to extend refinance to four states, Haryana, Himachal Pradesh, Karnataka, and Tamil Nadu, if the state governments kept their commitments.[19]

In January 2008, the government permitted SIDBI to issue Deferred Payment Guarantee in foreign currency to individual concerns. The Reserve Bank advised the government to keep this on hold until the true financial position of SIDBI was revealed. In February 2008, the government wanted to channel Rural Infrastructure Development Fund (RIDF) funds to SIDBI but the Bank did not agree and, in turn, suggested to the government to grant SIDBI exemption from payment of income tax.

The NHB was set up in 1987 by an Act of Parliament and was wholly owned by the Bank. The entry of banks in housing finance without dependence on NHB refinance required the NHB to redefine its functions. In 2006, the NHB sought a general line of credit for ₹10 billion from the Bank for rural housing. This was not approved, but the NHB was allowed to borrow eleven times (instead of the stipulated ten times) from the market for one year. In 2007, the BFS considered a Technical Paper on the future framework of the NHB. The paper recognised that the NHB had multiple roles, and proposed to transfer the regulatory and supervisory functions of the NHB to the Bank and convert the former into an NBFC. But despite much correspondence with the government, the proposals had not materialised until 2008.

The EXIM Bank was established in 1982 to help institutions engaged in the financing of foreign trade. In January 2001, the government sent a proposal to the Reserve Bank to convert it into a bank. The Reserve Bank did not think it was a good idea and suggested other options.

NABARD came into existence in July 1982 by taking over the agricultural credit functions of the Reserve Bank and the refinance functions of the then Agricultural Refinance and Development Corporation. The Reserve Bank was the majority shareholder. NABARD refinanced, regulated and supervised rural cooperative banks and RRBs. To avoid conflict of interest, the Reserve

Bank proposed to take over the regulatory and supervisory functions and to transfer its shareholding in NABARD to the government.

IDFC, in which the government had 23 per cent shareholding and the Reserve Bank, IDBI and other banks also held shares, was set up as a company in January 1997 to provide infrastructure loans. In July 1998, IDFC was brought under the regulatory framework of the Reserve Bank after its notification as a public FI. It was also registered as a non-deposit-taking NBFC in April 2002. The Reserve Bank as the regulator decided to treat it as a non-deposit-taking NBFC rather than as a development FI.

When the Bank introduced the New Capital Adequacy Framework in April 2007, the company faced a problem. The risk weights for corporate borrowers with a credit rating of 'AAA', 'AA', 'A', and BBB and unrated corporate debt obligations were fixed at 20 per cent, 30 per cent, 50 per cent and 100 per cent, respectively. IDFC pointed out to the Bank in October 2007 that an exception to this principle had been made in respect of systemically important non-deposit-taking NBFCs. These attracted a risk weight of 125 per cent regardless of the credit ratings. IDFC actually had the highest ratings from all rating agencies for its debt instruments. The Bank, however, did not make any change during the reference period.

Non-Banking Financial Companies

Pitfalls of Limited Regulation

The Reserve Bank exercised limited regulation of the NBFCs until the 1990s. The NBFCs were not permitted to accept demand deposits and were not part of the payment system and the CRR was not prescribed for them. The regulations in force until 1997 mainly dealt with rules concerning deposits and the protection of depositors. However, the NBFC sector had grown in size and diversity in the 1990s. In March 1997, the aggregate public deposits with the NBFCs stood at 12.3 per cent of bank deposits.[20] There were also certain disquieting developments. Some companies offered exorbitant interest rates on deposits and were unable to service such funds. Clearly, the regulatory framework needed to be strengthened.

The concept of registration of NBFCs by the Bank was introduced in 1993 for companies with net-owned funds in excess of ₹5 million. Until 1997, the system of registration was without statutory support, and registration was optional. Prior to 1997, the Bank could prohibit a company from accepting fresh public deposits, but could not ensure repayment of existing deposits. Since NBFCs did not need a licence from the Bank for opening branches, they had an incentive to open many branches. They used the services of agents and brokers who could mobilise deposits. The Bank did not have powers to evaluate the assets side of the balance sheet, that is, loans and advances, which left open a major loophole.

The case of the CRB Capital Markets Ltd (CRB) served as a reminder of the weakness of the system. In 1994, the company had made an application to set up a commercial bank, and the Reserve Bank made a reference to the Securities and Exchange Board of India (SEBI). Although there were some issues in the past, SEBI had closed enquiry proceedings against CRB in December 1995. In May 1996, SEBI allowed CRB to launch its mutual fund, and on 4 July 1996, the Reserve Bank granted a conditional 'in-principle' approval to CRB to set up a banking company.

With owned funds of ₹4 billion and public deposits of ₹1.86 billion, CRB had also applied to the Bank for registration as an NBFC, which could not be processed because of inadequate information. After two years, the company again applied in October 1996 for registration but in view of the adverse findings of a Reserve Bank inspection, and other complaints, the company was issued a show-cause notice on 24 February 1997. The Bank's scrutiny revealed that the major segment of the company's shares was held by its group companies. The group companies were accommodated by CRB through loans and advances. Also, CRB held a major segment of its group companies' equity and, in turn, received loans and advances from them. The paid-up capital of ₹4 billion was created in this manner. Since their reply of 31 March 1997 to the show-cause notice was not satisfactory, orders were issued on 9 April 1997 prohibiting the company from accepting deposits. In line with these developments, the in-principle approval given to the company to set up a commercial bank was withdrawn on 9 April 1997.

New Regulatory Framework

Designing an appropriate institutional set-up for the regulation of NBFCs was a key area of concern for the Bank for a long time. This received new emphasis in 1996, when the Supreme Court in its judgment in the case of *RBI vs Peerless General Finance and Investment Company* observed that the Bank being engaged in multiple activities, the government could create 'a separate instrumentality' entrusted with the task of supervision and enforcement of NBFCs. The Bank, in consultation with the government, set up a working group[21] in September 1996 to examine the proposal. The group concluded that the Bank should continue to monitor the NBFCs as before.

To avoid situations like the CRB episode, the RBI Act was amended by an Ordinance on 9 January 1997 and eventually replaced by an Act, effecting major changes in the regulation of NBFCs. The new provisions had cast certain obligations on the NBFCs and certain responsibilities on the Bank. The amendments empowered the Bank to determine policy and issue directions to NBFCs on entry point norms, minimum net-owned funds, compulsory registration, prudential norms and disclosure practices. The Bank was vested with powers to act against NBFCs that did not comply with the provisions of the Act. However, the Bank did not have the power to order a company to repay deposits as this power was given to the Company Law Board of the government. The Bank could lodge a criminal complaint in the case of non-compliance with the Board's orders, cancel certificate of registration and, in worst cases, cause the winding up of the company.

All existing NBFCs were now required to obtain a certificate of registration from the Bank to continue in business.[22] Existing companies were required to raise their owned funds to the new limit by January 2000, which was later extended. Interest rate ceiling was fixed for deposits. The ceiling was not applicable to well-rated companies. For others, it was fixed at 15 per cent in 1997 and gradually reduced in line with market trends.

The revised regulatory framework for NBFCs was announced on 2 January 1998. The regulations set an upper limit on public deposits that an NBFC could accept. This limit was linked to the credit rating by an approved rating agency. The requirements of minimum investment-grade credit rating, and/or higher capital adequacy ratio, were prescribed for deposit-taking companies. The NBFCs with a rating of less than 'A' or equivalent thereof would not be entitled to receive public deposits. Companies were permitted to regularise their excess deposits by December 1998. Within this period, NBFCs were expected to shore up their net-owned funds, or improve their credit rating, or substitute public deposits by borrowings. Deposit-accepting NBFCs were required to maintain a capital adequacy ratio of 10 per cent effective from March 1998, and 12 per cent from March 1999. This was higher than the 9 per cent CRAR fixed for commercial banks because the Bank wanted only financially sound NBFCs to accept public deposits. Deposit insurance did not apply in this case.[23]

Disclosure requirements were strengthened and responsibilities cast on the Board of Directors and auditors of the companies to ensure that the operations of NBFCs conformed to deposit regulations and prudential norms prescribed by the Bank. The disclosure requirements were widened. The requirement of transferring 20 per cent of net profit to a statutory reserve fund every year applied to both deposit-taking and non-deposit-taking companies.

Although the focus of regulations was deposit acceptance activities, the non-deposit-taking companies were subjected to prudential norms of income recognition, accounting standards, asset classification, and provisioning for bad and doubtful debts. But they were exempt from capital adequacy and exposure norms. The compliance with the regulatory framework by these companies was watched on the basis of exception reports. The stipulation of maintenance of liquid assets, credit rating, and credit and investment concentration norms were not applicable to NBFCs not accepting public deposits.

With the amendments, stock-broking companies were brought under the Bank's directions. But with a view to avoiding dual control on them by both the Bank and SEBI, the Bank granted an exemption to these companies from its directions. It was suggested to SEBI in June 1997 to place some restrictions on their capacity to raise public deposits under SEBI regulations. Insurance companies, merchant banking companies and chit funds were given exemption.

With the comprehensive changes taking place in the statutory provisions governing NBFCs, including their compulsory registration, the Department of Non-Banking Supervision (DNBS) was created in July 1997 by carving out the Financial Companies Division from the erstwhile Department of Supervision.

Response

Subsequent to the regulation, some NBFCs substituted public deposits by debentures and attempted to escape the Bank's regulation. They repaid the deposits but the debentures were outstanding. SEBI was empowered to regulate the issue of debentures, both public and private issues, secured and unsecured. There was regular consultation between the Bank and SEBI in this regard. NBFCs were advised that debentures that were partly secured or secured by third-party assets and matured for redemption or were overdue would be treated as public deposits. A similar approach was taken with preference shares.

In August 1997, bank trade unions struck work for two days, seeking 'immediate ban on deposit acceptance by NBFCs from the public', and the government sought the Reserve Bank's comments. The Bank explained that since the deposits mobilised by them was just 5 per cent of bank deposits (annually), it did not support the ban.

It was expected that more than 8,000 companies would seek registration with the Bank. In fact, the Bank received 37,478 applications from financial companies seeking a certificate of registration. Of these applicants, companies with net-owned funds of ₹2.5 million and above, fulfilling the primary eligibility criteria, numbered 8,938. The method of computation of net-owned funds sought to ensure that there was no diversion of funds by an NBFC to other companies within the group (as was the case with CRB).[24]

A committee was formed to issue certificates of registration.[25] The committee's mission was to maintain fairness.[26] The government set up an Appellate Authority to consider appeals against the Bank's rejection orders. The Authority held hearings and could order the Bank to reconsider an application. The process was fair, but not a smooth one. In a letter dated 24 November 1997, the President of the Hire Purchase and Lease Association complained to the Bank of delay in deciding the applications for certificates of registration. Bankers to NBFCs, the letter said, were not willing to sanction credit facilities without the certificate. Media, too, complained of the tight regulatory norms by the Bank. The Bank, however, remained committed to the screening process that it had designed.

Industry's reaction to the new regulations was very critical. In view of the criticisms, consultations with NBFCs were held, and certain provisions relaxed.[27] Notwithstanding the relaxations, the requirement of minimum credit rating and linking of the quantum of deposits to the level of credit rating had hit the leasing and hire purchase companies. They were generally small in size, neither rated nor considered for rating by rating agencies. The representatives from the industry met the Governor in New Delhi in February 1998. In a seminar in March 1998, speakers protested mandatory credit rating and linking the quantum of public deposits to the rating. Two associations of NBFCs filed writ petitions in the High Courts of Chennai and Hyderabad for setting aside the relevant Reserve Bank directions. The government also wanted the Bank to review the stipulation of compulsory credit rating for acceptance of public deposits. The Bank replied in June 1998 stating that such de-linking was neither prudent nor in public interest.

In April 1998, the Bank initiated a review of the regulations.[28] Representations from industry stated that the provisioning norms were too harsh. The Institute of Chartered Accountants of India (ICAI) pointed out inconsistencies between accounting for investments prescribed by the Bank on the valuation of unquoted shares and the accounting standards issued by ICAI. Accordingly, directions issued in May 1998 sought to bring the prudential norms in alignment with the accounting standards of ICAI. New prudential norms were issued.[29]

One of the issues raised by NBFCs with the Bank in several forums was the discrimination by commercial banks in lending to NBFCs. When the matter was taken up with the banks, they responded that with the entry of banks in the retail business, NBFCs were their competitors and they would not fund competitors.

In 1998, the Ministry of Finance had set up a Task Force on NBFCs to review the legislative framework and to suggest improvements in the procedures relating to customer complaints.[30] The government accepted the recommendations of the Task Force, but some of the recommendations required amendments to the RBI Act. The Reserve Bank had given effect to the recommendations relating to deposit acceptance norms for NBFCs by issuing a notification in December 1998. The requirement of credit rating for acceptance of public deposits up to ₹100 million or 1.5 times of their net-owned funds, whichever was less, was done away with, provided CRAR of the NBFC was 15 per cent or above. Later, the linking of the quantum of public deposits with the level of credit rating was removed.[31]

There were thousands of court cases. NBFCs or their associations or the investor groups filed petitions against the Bank, challenging the new provisions of the RBI Act or the directions issued. Besides, the prohibition on unincorporated bodies from accepting deposits was challenged in various High Courts. In the Karnataka High Court alone, the Bank faced 2,300 petitions. The Court upheld the Constitutional validity of the provisions. The Bank appealed to Supreme Court to bunch the cases from all High Courts and hear them out together. The matter was heard in the Supreme Court in March 2000 and a decision pronounced in May 2000, upholding the Constitutional validity and reasonableness of the provisions.

Though the Bank claimed that it had 'never been our intention to stifle the operations of the NBFC sector', a few companies opted out of the NBFC business subsequent to the regulations. Some offered to repay the public deposits and decided to downsize their balance sheets. But those companies that had asset–liability mismatch because of excessive short-term deposits faced liquidity shortage. Some companies migrated from deposit-taking to non-deposit-taking category. They were allowed to park an amount equivalent to the outstanding public deposits together with the present value of future interest differentials in an escrow account by investing in government securities or in term deposits with commercial banks.

Through a process of negotiations and consultations with the financial industry and other stakeholders, the NBFC regulations/directions were amended from time to time.

Further Interventions

Subsequent to the 1997–98 reform, several specific areas saw further intervention by the Bank. As the minimum net-owned fund for new companies had been raised, some entities or individuals were expected to take over existing companies. Such sale or transfer of financial stake could be done only with the prior permission of the Bank, and with three months' notice. Further amendments to NBFC regulations allowed exemption of deposits from relatives of the director of an NBFC from the definition of public deposits and introduced mechanisms to protect the interests of depositors of companies whose applications had been rejected to avoid asset stripping.

To protect depositors' interest, the Bank advised the NBFCs accepting public deposits (February 2005) to ensure that full asset cover was available for public deposits accepted by them. The assets for this purpose should be valued at book or market value, whichever was lower. They were further directed to create a floating charge on SLR investments in favour of depositors and be registered in accordance with the requirements of the Companies Act. In view of the practical difficulties in creating such a charge in favour of a large number of depositors, it was decided that companies could do it through a trust deed.

Companies found it difficult and uneconomical to enter into trust deed arrangements with banks or their trusteeship associates for the creation of charge on their liquid assets. In Kerala, no company could create a floating charge on its assets due to the non-availability of a bank or institution engaged in trustee business. Most small companies in Kerala had to repay their deposits since they could not make any progress in this regard. The Kanpur office reported that twenty-six of the thirty-six deposit-taking NBFCs were not able to create a floating charge because no commercial bank was willing.

Microfinance institutions (MFIs) that did not accept deposits and provided credit not exceeding ₹50,000 per borrower were exempted from certain provisions of the RBI Act, including the requirement of registration as NBFCs. There were demands from some quarters to permit exempted MFIs to accept public deposits. This was not accepted. There was a suggestion from the Prime Minister's Office for reducing the entry capital norm in respect of new microfinance companies. The Bank's Rural Planning and Credit Department also wanted relaxations in entry-level norms for microfinance companies as they served the rural poor on a 'not-for-profit' basis. This was not acceded to either, as it would not be possible for the Bank to regulate or supervise a large number of small microfinance companies. However, in 2005, a new class of NBFCs undertaking microfinance activities was recognised and subjected to relaxed regulatory norms. Though the minimum net-owned fund was kept unchanged at ₹20 million, they were allowed to issue preference shares. In framing these proposals, international standards laid out by the Consultative Group to Assist the Poor (CGAP), a global organisation working to promote financial inclusion, as well as other country experiences were taken into account.

Even in 2007, there were a large number of deposit-taking NBFCs that had not attained the minimum net-owned fund. They were given two more years to meet the condition, after which any NBFC still not able to fulfill the condition would be automatically converted to non-deposit category and the deposits held by them were to be repaid within three years. The NBFC federations represented that the policy was harsh and could lead to a liquidity crisis. The proposal was modified to extend the time to three years.[32]

A separate set of updated prudential norms in supersession of the previous Non-Banking Financial Companies Prudential Norms (Reserve Bank) Directions of 1998 were issued for deposit-taking NBFCs (including RNBCs) and non-deposit-taking NBFCs in February 2007. These directions covered income recognition, investments, accounting standards, capital adequacy, asset classification, provisioning requirements, disclosure requirements and auditors' certificate.[33]

All non-deposit-taking NBFCs with an asset size of ₹1 billion (reduced from ₹5 billion under the earlier framework) and above would be considered as systemically important NBFCs, and subject to different rules.

Systemically Important NBFCs

The non-deposit taking NBFCs as a category expanded sharply with the advent of foreign direct investment (FDI). In April 2001, the government placed FDI in NBFC under the automatic route, subject to minimum capitalisation norms. Several foreign firms showed interest in acquiring stakes in NBFCs.[34] The interest was due to the arbitrage opportunities available in the sector vis-à-vis the banking sector, and the light regulatory framework for non-deposit-taking NBFCs. The inflow of money also gave an opportunity to the companies to diversify into activities like real estate through subsidiaries where FDI was prohibited. Because of the restrictions imposed on the opening of branches by foreign banks, some foreign banks were using the NBFCs to operate as their branches. Domestic funds by way of debentures and bonds, which the foreign banks were disallowed from tapping, were accessible to their NBFC arms. By September 2005, there were twenty-seven foreign-owned NBFCs (of these, nineteen were from the United States) operating in India.[35]

This development worried the Bank. Taking into consideration an internal group's recommendations and feedback thereon, a revised framework pertaining to systemically important non-deposit taking NBFCs (NBFC-ND-SI) was announced in the Mid-Term Review of the Annual Monetary Policy for 2006–07.[36] One option on the table was the introduction of capital adequacy ratio requirements for such NBFCs to limit the leverage of capital funds. The final guidelines issued in December 2006 created a tighter regulatory regime for systemically important non-deposit-taking NBFCs.[37]

Two other important subcategories of NBFCs were the RNBCs and the ARCs.

Residuary Non-banking Companies (RNBCs)

During the reference period, there was a sharp growth in public deposits with RNBCs and a steep decline of deposits with other NBFCs. The absence of any ceiling on the quantum of deposits that could be accepted by the RNBCs and the absence of linkage with a credit rating or net-owned funds were the reasons behind this trend. As of January 1999, 100 RNBCs had applied for certificate of registration but only one company, India Financial Corporation Limited, Lucknow, was issued the certificate. A discussion paper was prepared in 1999 containing proposals to ensure that their financial position was sound, and there was a substantial improvement in accountability and transparency of their operations.

In a speech delivered at a seminar in the RBI Staff College, Chennai, on 4 March 1999, former Deputy Governor Tarapore said, 'What totally hamstrings RBI is that those NBFCs which cannot adhere to the regulatory framework can take cover under the RNBCs framework which has inherent weaknesses.'[38] Deputy Governor Talwar wrote to the Ministry of Corporate Affairs in 2000 to work out a mechanism so that no new company took up the business of RNBC in the country.

In 2000, Peerless General Finance and Investment Company Ltd (Peerless) and Sahara India Financial Corporation Ltd (Sahara) were the two major RNBCs with deposits comparable to those of medium-sized banks. These two companies were distinct in that no other category of NBFCs had ever held deposits of the magnitude that these two had raised. The fact that there was a regulatory vacuum of sorts in this case, therefore, was particularly disturbing. The RNBCs were required to invest 80 per cent of their deposit liabilities in government-guaranteed securities, term deposits with commercial banks, and bonds and debentures of companies and mutual funds.[39]

In view of the supervisory concerns, it had become necessary to improve their capital structure on par with commercial banks. In stages, the level of investment in government securities was enhanced, and rating and listing requirements of the approved instruments made mandatory. The RNBCs' investment in bonds, debentures and certificates of deposit (under 'directed investments') needed a rating not less than AA+ grade or its equivalent by an approved rating agency. Besides, they were restricted from investing in equity-oriented mutual funds and allowed to invest only in debt funds. The 'discretionary investments' of an RNBC was limited to 20 per cent. The percentage of discretionary investment was to be reduced to 10 per cent by April 2005 and 0 per cent by April 2006. The RNBCs represented against the revised prudential norm on directed investments and the chief executive officers (CEOs) met the Governor. Both the RNBCs made several representations to the Bank for relaxations in 'discretionary/directed investments'. The Bank, therefore, deferred implementation by a year to April 2007.

The Bank also issued instructions to improve the transparency of operations, connected lending, corporate governance and minimum rate of interest. However, inspection of these companies revealed continued non-compliance with the core provisions of the directions, forfeiture of the depositors' money on one pretext or the other, diversion of money to sister and associate concerns, investment in illiquid assets, and violations of investment requirements jeopardising the interests of depositors (see Chapter 11). An internal working group in December 2006 examined the viability of RNBCs, and suggested strategies for a smooth transition out of the current business model. Both Peerless and Sahara were advised to exit the business model. The matter was under correspondence at the close of the reference period.

Asset Reconstruction Companies (ARCs)

In 2000, the Bank, in consultation with the government, formulated a scheme for setting up ARCs to take over the NPAs of weak banks. The draft scheme was sent to the government in April 2000. The Finance Minister had a meeting with the CEOs of public sector banks for resolution of NPAs. The Minister desired that the participants could explore the possibility of setting up ARCs without waiting for specific legislation. To facilitate this, the Ministry of Finance formed a committee to explore the possibility of setting up ARCs within the existing legal framework.[40] Based on its report, the Finance Minister decided that an ARC would be formed in the public sector as a company and registered with the Bank as an NBFC. IDBI would be the main promoter and the capital would be contributed by banks and FIs.

Since the regulations applicable to non-deposit-taking NBFCs would not be relevant to an ARC, the Governor wrote to the Finance Secretary in January 2002 that it was 'neither feasible nor legally appropriate for RBI to "regulate" or to lay down prudential norms for the ARC'. The Ministry replied that the 'regulatory framework for the ARC will be decided in consultation with RBI'. The pilot ARC, the Asset Reconstruction Company of India Limited (ARCIL), was incorporated in February 2002. The central government later asked the same committee to finalise the draft legislation, combining the provisions of the draft Bill for Enforcement of Securities Interest by Banks and Financial Institutions, the draft Securitisation Bill and the legal framework concerning ARCs. In 2002, the draft SARFAESI Bill became law. The Act would enable banks and FIs to securitise long-term assets, manage problems of liquidity and asset–liability mismatches, and improve recovery by exercising powers to take possession of securities, sell them without going through the judicial process and reduce NPAs by adopting measures for recovery or reconstruction. The Act also created a framework for licensing companies that would undertake activities of securitisation and asset reconstruction.

The Act did not give any direct power to the Bank to inspect or supervise ARCs. However, the Act did cast responsibility on the Bank to frame guidelines on registration of ARCs and securitisation companies, prudential norms for these companies, and for the acquisition of assets and enforcement of security interest.[41] The Bank set up two working groups in July 2002 to fulfill this mandate.[42] Following these discussions, on 7 March 2003, the format of the application form for grant of certificate of registration was released by the Bank. By 24 March, six applications from existing companies and three from proposed companies were received.

The draft guidelines and guidance notes were sent to the Ministry of Finance on 10 March 2003. On receiving the government's approval, on 23 April, the Bank issued the circular. In August 2003, the Bank exempted ARCs registered with it under the SARFAESI Act from certain provisions of the RBI Act, concerning compulsory registration, maintenance of liquid assets, and compulsory transfer of a part of the profit to a reserve fund. Banks were not to invest in unrated non-SLR securities. Therefore, to make security receipts eligible for investment by banks, a rating of security receipts was made conditional. The guidelines for the takeover of management (of the NPA borrower) and sale or lease of the business concerned, though provided for by the Act, were still pending. Therefore, ARCs were advised to refrain from the takeover of management. The second working group[43] was reconvened in 2003 to discuss the two issues in detail. The group prepared draft guidelines for change or takeover of management, and sale or lease of the borrower's business. However, pending a decision in a case filed in the Supreme Court questioning the validity of the SARFAESI Act (*Mardia Chemicals vs Union of India*), further action was kept in abeyance until 2006.

The Bank set up an External Advisory Committee (EAC) to examine the applications received and make recommendations to the Bank on certificate of registration.[44] The first certificate was issued in August 2003 to ARCIL. For another four years, no other certificate for an ARC was issued.

In order to ensure that the size of capital had some relationship to the value of assets acquired by the ARC, the External Advisory Group recommended in a meeting in February 2004 that the minimum paid-up capital for ARCs should be (instead of ₹20 million fixed for generic NBFCs) fixed at 15 per cent of the assets acquired or to be acquired or ₹1 billion, whichever was lower. To ensure that the ARCs held stake in the asset acquired by them, that the mechanism of securitisation did not result in only parking of NPAs, and that they gave comfort to the qualified institutional investors, it was decided in September 2006 that the ARCs should invest in the security receipts an amount not less than 5 per cent issued by them under each scheme.

The government sought the Bank's views on foreign investment in ARCs and in security receipts issued by ARCs. The government convened a meeting in September 2004 and favoured a liberal approach to FDI in ARCs. The Bank and the government came to an understanding, and the government issued a notification in June 2005 permitting FDI up to 49 per cent in ARCs with the approval of the Foreign Investment Promotion Board and giving 'general permission' to foreign institutional investors to invest up to 49 per cent of each tranche of scheme of security receipts issued by ARCs.

The draft guidelines on calculation and declaration of the net asset value (NAV) of security receipts were ready in October 2006 and final guidelines were issued in May 2007. The ARCs were advised to declare NAVs of security receipts at periodic intervals so that qualified institutional buyers could value their investment in security receipts. A concept paper on the guidelines for a change in or takeover of the management of the business of the borrower under the provisions of the Act was put up to the EAC in May 2006. After prolonged deliberations in the EAC over a period of time, the draft guidelines were issued in September 2008.

Until March 2008, the Bank had received twenty-seven applications for grant of certificate and six had been granted.[45]

Government-Owned Institutions

The non-banking financial institutions sponsored by state governments did not have to obtain certificates of registration from the Bank. They were also exempted from provisions of NBFC prudential norms directions because these entities were governed by norms prescribed by their own government department or ministry or a nodal agency like IDBI for State Industrial Development Corporations (SIDCs). A letter from Deputy Governor Talwar raised the issue with the Government of India in September 1999 and urged a comprehensive review of the rules (see an extract of the letter in Appendix 10A.2.1). There was no further communication between the government and the Bank in this matter.

In 2006, the Bank proposed to bring all government-owned companies under the provisions of the prudential norms directions of the Bank for NBFCs. Such companies were advised to prepare a roadmap for compliance in consultation with the state government and submit to the Bank by March 2007. However, little progress was made in this area. The SFCs were governed under the provisions of SFC Acts. They were not companies as defined by the Companies Act, nor were they NBFCs. Instead of regulations relevant to either one of these categories, they were subject to prudential norms prescribed by IDBI and later by SIDBI. But the SIDCs were engaged in extending loans and this activity came within the purview of financial business defined in the the Bank Act. The SIDCs sought exemption from the Bank on the ground that they performed social functions and the objective of setting them up was distinct from NBFCs in the private sector. There was not much concern about depositors' interest as they were functioning under the respective state governments with an implicit guarantee for the repayment of deposits.

Financial Companies Regulation Bill, 2000

In 2000, the government was advised that the Bank was in the process of designing new legislation for the regulation of NBFCs. The Bill was later drafted by the government, in consultation with the Bank, to take care of the concerns of the Bank in regulating NBFCs.[46] Similar in spirit to the BR Act, the proposed Act was expected to provide for a comprehensive legal framework. The Bill was referred to the Standing Committee of Parliament. In the sitting on 29 January 2003, there was a divergence of views regarding the jurisdiction of the Bank. The standing committee, in its report of July 2003, observed that the Bank should concentrate on the regulation of those incorporated bodies that were accepting deposits. Non-deposit-taking financial companies, investment companies and special purpose vehicles should be excluded from the purview of the Bill. Five years after conceptualisation, the Bill did not take a final shape and lapsed with the dissolution of the Lok Sabha in 2004.[47]

Following the CRB episode, there were demands from several quarters that insurance protection should be extended to the depositors of NBFCs. This issue was examined in 1997 by a working group set up by the Bank.[48] While recognising the need for insurance cover to NBFCs, the group suggested that deposit insurance could be considered only for registered NBFCs complying with all regulatory and supervisory norms, that too only after a period of six years when the process of consolidation of the NBFC sector was expected to be completed. Opinion within and outside the Bank sided with the view against insurance.[49]

The Bank conducted many workshops and seminars to inform and engage stakeholders in NBFCs, provided training, and made publicity campaigns for creating awareness. State governments were requested to frame legislation on the lines of the Tamil Nadu Protection of Interest of Depositors Act, 1997. The Act provided for action against FIs that failed to return deposits, arrest of persons responsible and special courts for speedy trial, attachment and sale of properties, and distribution of the money to the depositors. Other areas where the Bank intervened included an extension of nomination facility, additional interest paid to senior citizens, foreign exchange operations by NBFCs, mutual funds operations and fraud prevention. The Bank also regulated and supervised primary dealers (PDs). The system of PDs was introduced in 1996. Their operations have been covered in Chapter 7.

The period witnessed a marked qualitative change in the sector, with a general decline in overall deposit acceptance by NBFCs (excluding the two RNBCs whose share rose) and the emergence of large systemically important NBFCs.[50] The overall approach of the Bank was to protect the depositors, prevent systemic risk, avoid regulatory arbitrage and, over a period of time, replace public deposits with other resources. The Bank had broadly succeeded in meeting these objectives. The bank borrowings of NBFCs were not significant and so the systemic risk was not much. The low NPA level, less dependence on deposits and bank borrowings, and stable business indicated a move towards consolidation of the sector but with a sharp decline in the sector's market share.

Urban Cooperative Banks

UCBs recorded substantial growth in the 1990s, thanks to deregulation of interest rates, a liberal licensing policy, focus on small depositors, and a shift in the focus from accepting deposits from members to actively soliciting deposits from the public.[51] The entry norms for UCBs were revised in April 1998. The low entry point norms facilitated the mushrooming of UCBs. The number of UCBs increased from 1,306 in 1991 to 2,050 by 2000.

At the same time, UCBs suffered from a lack of professionalism and lack of modern technology and technical support. The capital build-up was inadequate as they had low retained earnings, and raising additional capital from members was not easy. Corporate governance was an issue. When many shareholders/directors were also borrowers, the management had a conflict of interest. State governments and the Bank both had regulatory powers. State governments had jurisdiction over management and audit, and the Bank over banking operations. For the Bank, the major impediment to regulating UCBs was political involvement in their operations. The directors were often political figures. For instance, whenever a new political party came to power in Tamil Nadu, the state government would issue orders to supersede all elected boards of cooperative banks/societies and appoint administrators. The practice was not confined to Tamil Nadu alone. The dual jurisdiction did not work well.[52]

Another problem was the proliferation of unlicensed banks. Under Section 22 of the BR Act (As Applicable to Cooperative Societies), or BR Act (AACS), if a primary credit society's share capital and reserves reached a level of ₹0.1 million, it would get automatically converted into a UCB. They continued to transact banking business without a licence as no decision had been taken on their licence applications by the Bank for years – over thirty years in many cases. Subject to these constraints, a series of steps were taken during the reference period to improve the operations and transparency of UCBs.

Inclusion in the Second Schedule of the RBI Act

The inclusion of a bank in the second schedule of the RBI Act enabled the bank to have access to refinance facilities from the Reserve Bank, free remittance of funds from the Bank, and enhanced public confidence in it. There was also a greater acceptance of guarantees issued by a scheduled bank. Between 1997 and 2003, thirty-three UCBs were scheduled by the government at the recommendation of the Bank, taking the total number of scheduled UCBs to fifty-seven. An in-house working group recommended an increase of minimum share capital from ₹0.5 million to ₹200 million. The Reserve Bank made it a condition that the urban bank should have a licence from the Reserve Bank and have deposits of ₹1 billion or more and the affairs of the bank be conducted prudentially. Subsequently, the condition that gross NPAs should not exceed 15 per cent of the advances was also added. In August 2001, the Governor approved additional conditions for scheduling.[53]

In May 2002, there were seventy-two applications pending with the Bank for scheduling. A group was set up by the Bank to study the experiences in regard to the inclusion of UCBs in the second schedule and recommend revised criteria. Based on the recommendations of the group, the government issued a notification in October 2003 stating that only such UCBs which were licensed and whose deposits were not less than ₹2.50 billion would qualify for the purpose of inclusion in the second schedule. The high bar kept many UCBs out. In July 2004, UCBs were advised by the Reserve Bank that no bank would be included in the second schedule of the RBI Act until proper legislative framework was brought about. This policy continued until 2008.

In May 1999, a Reserve Bank committee had discussions with industry federations, the UCB sector and state government officials on the regulation of UCBs.[54] It made recommendations on revision of the licensing policy for new UCBs, with increase in entry point norms, rationalisation of branch licensing policy, extension of areas of operation, methodology for dealing with unlicensed and weak banks, application of capital adequacy norms, conversion of cooperative societies into UCBs, and measures to overcome the dual control by amending the relevant statutes. The Bank implemented the recommendations and revised them over a period.[55]

The committee had also suggested a dual criteria of strong start-up capital, professional background of promoters with proven track record, and licensing of the 181 unlicensed UCBs (as of June 1999), subject to compliance to the stipulated criteria, and to weed out other weak banks by initiating action through moratorium, reconstruction, amalgamation or rejection of application for banking licence by March 2002. Since unlicensed banks had been granted enough time to fulfil the norms, the Reserve Bank decided that they should either be granted a licence if they fulfilled the norms or their licences should be refused by March 2002.[56] Subsequently, CRAR norms were adopted for compliance by UCBs. Other recommendations relating to branch licensing, the opening of extension counters, an extension of the area of operations and the new definition of weak banks were also implemented. The bigger UCBs were advised to set up the audit committee of the board.

The issue of dual control would require legislative changes. The subject 'cooperative societies' came under both the union and state lists in the Constitution, and, therefore, the duality of control was inevitable. The committee had recommended an amendment to the BR Act 1949 (AACS) and the Cooperative Societies Acts of state governments to demarcate the banking related functions, to be regulated by the Bank, and other administrative areas regulated by the Registrar of Cooperative Societies (RCS) representing the state government. The recommendations were forwarded to the state governments in December 1999, for carrying out amendments to the State Cooperative Societies Acts.

This being a sensitive issue with a bearing on centre–state relations, the Bank also wrote to the union government in March 2000 requesting amendment of the relevant union law and pursuing the matter with the state governments. The Bank proposed that until amendments were carried out, licences for new UCBs and branch expansion should be on hold. In August 2000, the policy was revised to allow opening of new banks where revised entry norms were complied with. Preference was given to states that had carried out the recommended legislative changes.

However, the efforts to persuade state governments to amend laws did not succeed. The central government indicated that they could not force state governments to do this, and suggested that the Bank should assume more powers by amending the BR Act. The Legal Department of the Bank held that the Bank could not assume more powers unless amendments to the BR Act were carried out together with amendments in the State Cooperative Societies Acts. In the end, however, amendments to the BR Act were drafted and sent to the government in December 2003. The changes would bring regulatory and supervisory powers of the Bank over UCBs on a par with that over commercial banks. The state governments opposed the amendments in a concerted way (see Part I of Chapter 10) and the government allowed the Bill to lapse with the dissolution of Parliament in 2004.

The 2001 Crisis

The Madhavpura Mercantile Cooperative Bank, the largest UCB in Gujarat, was lending out money to stockbrokers in violation of the Bank's instructions. In March 2001, following rumours of it lending a large sum to a stockbroker who lost heavily in the stock market crash that year, depositors began to withdraw their deposits from the bank, which at that time held about ₹6.34 billion from 282 UCBs in Gujarat and from other states. The withdrawal of deposits within a short time resulted in severe liquidity problems for the bank. (The episode is discussed in detail in the next chapter.) While attending to the crisis, the Reserve Bank took further measures to strengthen the regulatory framework for UCBs. Such measures covered CRAR for scheduled and non-scheduled banks, investments in government and approved securities, restrictions on investment in other UCBs and institutions, restrictions on call market operations, management structure, access to uncollateralised funds, and lending against volatile assets like shares, among others. A series of steps and recommendations to improve the functioning of the UCBs followed this episode.[57]

In 2002, another major crisis broke out in Andhra Pradesh. One of the largest banks in the state, Charminar Cooperative Urban Bank Ltd, faced a run following a newspaper report of an inquiry into the affairs of the bank by the State Registrar of Cooperative Societies. The bank was in a weak position, and after attempts to revive it failed, its licence was cancelled by the Bank (also see next chapter). Following this episode, the Bank norms were again revised and some flexibility was introduced.[58]

Other Issues in Regulation

On several occasions, the Bank was dealing with regulatory and operational problems of UCBs, and sometimes its actions set a precedent. For example, the Gujarat government issued an order in 1997 under the State Societies Act to UCBs to invest in the non-convertible bonds of Gujarat Small Industries Corporation, a state government undertaking and not guaranteed by the state government. About forty banks invested substantial amounts and the corporation defaulted in repayment. The banks appealed to the Reserve Bank with a request to be allowed to make provisions for the non-performing investments in a phased manner, but the Reserve Bank did not accede to their request.

Under the provisions of Section 24 of the BR Act (AACS), both scheduled and non-scheduled UCBs could maintain their SLR funds in the form of deposits with central cooperative banks and SCBs. However, the aforementioned committee had commented that 'keeping SLR funds with cooperative/commercial banks in itself is an indefensible dispensation'. Therefore, the switch from bank deposits to government securities was initiated by the Bank in a phased manner and completed by March 2003 despite intense lobbying by the industry and federations against the move. Restriction on UCBs placing deposits with other UCBs continued.[59]

From 2002 to 2007, several banks defaulted in the maintenance of reserve requirements, mainly due to the heavy withdrawal of deposits. They sought a waiver of penalty.[60] A framework for examining the requests for waiver of penal interest was drawn up and implemented.

The Joint Parliamentary Committee (JPC) on the stock market scam of 2002 had recommended a ban on the grant of loans and advances to directors, their relatives and the firms in which they were interested. The Bank issued instructions in April 2003 to UCBs not to sanction any fresh loans, including 'loan against deposits', to the directors and their associates. There were representations in protest from the industry, including one from the National Federation of Urban Cooperative Banks. They questioned the ban on 'loans against deposits', which even commercial banks granted to its directors. The JPC did not specifically mention 'loan against deposits' in their recommendation. Some banks in Kerala, Karnataka and Gujarat filed writ petitions in High Courts against the Reserve Bank's decision. The Bank recognised the risk that the directors might withdraw their deposits if they were not allowed to take loans against the security of deposits. It approached the Ministry of Finance in February 2006 for relaxation of the ban on loans against deposits and LIC policies. In March 2007, after further consultation with the government, UCBs were allowed to lend against deposits to their directors. Despite the relaxation, of the twenty-five UCBs penalised for different reasons in 2007–08, ten were penalised for violating the Bank's directives on loans and advances to directors.

In 2001, four new UCBs were set up in Kozhikode district of Kerala without the Bank's licence. They were registered under the Kerala Cooperative Societies Act, 1969. Their entry in the banking business without a Reserve Bank licence was a violation of the BR Act. Since the Government of Kerala refused to take any action, the Bank issued a notice in leading newspapers cautioning the general public that the Bank had not granted licence and that the depositors were at their own risk. The RCS, Kerala, issued a rejoinder in the press stating that the banks did not require a licence from the Reserve Bank to conduct banking operations and the public should not be carried away by malicious propaganda by the Reserve Bank. The Reserve Bank initiated criminal proceedings against these banks and their directors and took up the matter with the Chief Secretary, Finance Secretary and the Registrar in December 2001. The existing UCBs filed writ petitions against the new banks and state government authorities. The High Court in its order dated 29 November 2002 observed that the process of registration and licensing, as far as cooperative banks were concerned, was complimentary to each other.

Though the registering authority was the RCS, the purpose of registration was the transaction of banking business, which was regulated under the provisions of the BR Act. The Reserve Bank was the authority with supervisory powers over banking institutions. The Court concluded that the Kerala Cooperative Societies Act and the associated rules did not permit registration of a cooperative society as an 'unlicensed urban bank' and directed the Registrar not to permit any unlicensed UCB to function.

Resolution of Weak Banks

The reasons for weakness in UCBs were poor credit management, connected lending, heavy reliance on high-cost deposits and adverse selection of borrowers, all resulting in a high level of NPAs. The BR Act (AACS) did not prohibit granting of secured loans to the directors, their relatives or the firms in which they were interested.

The procedure for dealing with weak banks involved advice to draw up a time-bound action plan. They were given reasonable time for a revival, and if revival was not found possible, then amalgamation with a strong bank would be considered. If even that was not possible, then the Reserve Bank would have to take the extreme step of cancelling their licences or rejecting applications in the case of unlicensed banks and take them to liquidation. The State Level Rehabilitation Review Committees convened by regional offices of the Reserve Bank at half-yearly intervals monitored the performance and progress of weak banks in the states. The committees were reconstituted in 1998. The CEOs of the weak banks had to be invited for discussing revival plans and to chalk out a time-bound plan, failing which merger or liquidation would be unavoidable. In 1999–2000 alone, twenty-one licences were cancelled and the banks taken to liquidation.

In February 2005, the Bank initiated measures for consolidation of UCBs and exit of weak and insolvent banks, and issued guidelines for merger and amalgamation. To smoothen the process of mergers in the sector, it was decided to permit the acquirer UCB to amortise the losses taken over from the acquired UCB over a period of five years. The federations of UCBs represented that the provisions relating to carry forward and set-off of accumulated losses, envisaged under Section 72AA of Income Tax Act, in case of amalgamation of a banking company should be made applicable in case of mergers among cooperative banks. This was taken up with the government in September 2006 and reminded in March 2007 and the government amended the Income Tax Act in the following year.

The Reserve Bank decided that banks with negative net worth or without minimum capital should wind up. This approach was followed in a staggered manner with some consideration for weak UCBs. The Deputy Governor had meetings with seven scheduled UCBs with negative net worth in August 2006. The banks were advised that if they did not attain positive net worth by March 2007, the Reserve Bank would be constrained to consider withdrawing their scheduled status and even cancelling their banking licence. The banks did not take these threats seriously, presuming that the Bank would avoid such steps to prevent panic withdrawal of deposits.

Multi-State Cooperative Societies Act

UCBs that had a presence in more than one state were governed by the Multi-State Cooperative Societies Act, 1984, under a Central Registrar of Cooperative Societies (CRCS). There were thirty-three multi-state cooperative banks (MSCBs) in 2002. The Reserve Bank suggested several amendments to the Act, or to replace it with a new Act, and forwarded draft proposals to the Ministry of Finance. In July 2002, the government notified a new Multi-State Cooperative Societies Act (MSCS), repealing the old Act of 1984. The new Act made several changes with implications for banking regulation without consulting the Reserve Bank. Section 17 of the new Act dispensed with the provision for sanction in writing from the Bank before the Central Registrar approved an amalgamation or reconstruction of an MSCB. The provision of the Central Registrar passing an order for supersession of a cooperative bank, if so required by the Reserve Bank, available in the earlier Act was omitted. Further, there were no provisions in the new Act empowering the Reserve Bank or the government to declare waiver or write-off and, hence, the CRCS did not consider it appropriate to issue guidelines to MSCBs as it was done by the State Registrars of Cooperative Societies.

The Bank proposed filling these gaps through amendments to the BR Act. Because of a Supreme Court ruling in the case of Apex UCB for Maharashtra that the provisions of the BR Act did not apply to MSCBs, the Reserve Bank had no authority under the BR Act to issue guidelines to these banks. An ordinance was issued by the government in September 2004 amending the BR Act as advised by the Reserve Bank. The ordinance removed ambiguities in the Bank's regulatory and supervisory powers over MSCBs.

Vision and Medium-Term Framework for UCBs

In 2004, Governor Reddy initiated steps to prepare a draft 'vision document' for the sector.[61] The document advocated a state-specific policy proposing an MoU to ensure convergence of approach between the Bank and state governments. It also suggested the constitution of the state-level Task Force on Cooperative Urban Banks (TAFCUB) in five states with a large presence of UCBs. Based on this, a draft 'medium-term framework' was designed. After revisions, the framework was placed on the website (March 2005) for comments and received thirty responses. A retired bank executive wrote to the Governor that the document contained 'the sad story of inability or disability or incompetence of RBI to supervise this small sector of the economy'. Stating that the MoU was pointless, the letter ended with the lament, 'Only God can save poor depositors.' The other responses were similarly cynical.

It was decided that after the signing of the MoU, a TAFCUB would be set up in each state with senior officers of the Bank and the state government as members. The TAFCUB would also have representatives from the industry and associations and chaired jointly by the Regional Director of the Reserve Bank and the RCS. The idea was to settle problems through dialogue. Deputy Governor Leeladhar wrote to the Chief Ministers of Gujarat, Andhra Pradesh and Maharashtra, the three states that had the largest share of UCBs in the country, to impress upon them the need for signing the MoU. He also personally met the Chief Ministers and held a discussion with them. After the Deputy Governor's presentation in Gujarat, the then Chief Minister, Narendra Modi, appreciating the initiative of the Bank, observed that the draft MoU needed to be reformulated to make it more acceptable to both signatories without losing its main thrust. Taking these and other feedback into consideration, a revised draft of the MoU was placed before the Settlement Advisory Committee (SAC) on 31 May 2005. The Andhra Pradesh and Gujarat governments signed the MoU on 27–28 June 2005, followed by Karnataka and Maharashtra. The Ministry of Agriculture in the Government of India signed the MoU with the Bank with regard to MSCBs in January 2007.

The TAFCUBs were operationalised soon after the MoUs were signed. The TAFCUBs identified potentially viable and non-viable weak UCBs in the state and suggested a revival path for the former and a non-disruptive exit route for non-viable banks. Being a consultative process, such decisions received greater acceptability. The positive impact of a consultative platform was seen in the decline in the number of weak and sick banks in the three states that were the first to sign the MoU. The process eliminated the pitfalls of dual control and facilitated decision-making. In the TAFCUB meetings, the Bank members impressed upon the RCS to appoint only professional chartered accountants and law firms as liquidators of failed cooperative banks.

By January 2008, MoUs had been signed with fourteen state governments and with the central government for multi-state UCBs. This had effectively covered 83 per cent (1,514) of the total UCBs and 92 per cent of the deposits of the sector. Public confidence in the UCB sector in Gujarat was restored to a large extent after the formation of TAFCUB. Many UCBs in the state recovered and stabilised quickly. Overall, in March 2005, 725 of the 1,872 UCBs were in Grades III and IV. The number came down to 496 in March 2008 and the number of banks in Grades I and II had gone up correspondingly.

Arising out of the comfort of coordinated regulation in states that had signed the MoU with the Bank, certain additional business opportunities were extended to eligible UCBs in such states. These included the permission to set up currency chests, sell mutual fund products, open ATMs and granting of a licence to deal in foreign exchange, sell insurance products and convert extension counters into branches, subject to conditions.

TAFCUBs enabled more informed decision-making and better implementation, expeditious approvals for revival plans, and consolidation of the sector through mergers with local-level inputs. Since TAFCUB was taking a view on UCBs in Grades III and IV in states that had signed the MoU, the Bank acted on the basis of its recommendations. Unlicensed banks were accorded preferred treatment in the MoU states on the basis of TAFCUB's recommendations, as entry point norms were not applied for the grant of licences to these banks.

The functioning of TAFCUBs was not without problems. In one case in 2007, the Bank took a course of action in respect of a weak bank that was contrary to TAFCUB's recommendation. The Bank justified its action arguing that it was 'not only based on inputs from TAFCUB but also from other sources based on regulatory and supervisory experience, knowledge of domestic and international best practices and the socio-economic objectives'. However, the Urban Banks Department happened to retrieve an earlier paper in which Governor Reddy had noted, 'It is not a good signal for Central Office to reject any recommendation of TAFCUB.... I have no issue with the conclusion, either way … but the process?' Subsequently, all such cases where the Bank held a different view were sent back to TAFCUB for review.

Prudential Norms

The mid-term review of monetary and credit policy for 2001–02 observed that 'the prudential norms and the regulatory system prescribed for UCBs have traditionally been relatively soft, in comparison with those for commercial banks. This is partly on account of historical reasons, and partly due to their size being generally small and the preferential treatment of co-operative structure in general'.[62] In April 1999, UCBs were advised to make a general provision of 0.25 per cent on standard assets from March 2000, which was raised to 0.40 per cent in November 2005. The guidelines for the valuation of investments were issued in February 2000. UCBs were advised to bifurcate their investments into 'current' and 'permanent' and to make provision for the depreciation in 'current' investments.

In October 2001, a meeting with the Governor was convened by the Union Finance Minister at the request of the Urban Cooperative Banking sector in Maharashtra. The industry representatives wanted more time for compliance with prudential norms. Governor Jalan said in that meeting that as long as the responsibility of protecting depositors' interest was cast upon the Bank, the sector should learn to live within a prudential regulatory framework. By June 2004, the prudential norms as applicable to commercial banks in respect of NPA classification were extended to UCBs.[63] UCBs were granted time to meet the provisioning requirements progressively over a five-year period commencing from March 2005. UCBs operating on a small scale within a district were allowed to classify NPAs based on 180-day norm until March 2007, whereas, for other banks, the norm was 90 days. The federations asked the Bank why 'global norms' had to be applied to cooperative banks and pointed out drought conditions in many states. There were several representations from Members of Parliament, and other public representatives demanding that the government and the Bank should reduce the rigours of prudential norms.[64] Generally, the Bank set norms for UCBs in line with those for other regulated entities. Late in the reference period, a working group was set up to examine the applicability of Basel II norms to Reserve Bank regulated entities other than commercial banks (2007).[65]

In 2001, a working group discussed asset–liability management guidelines for UCBs. The group's report was circulated among select UCBs. The Deputy Governor desired further simplification of the guidelines. The College of Agricultural Banking (CAB) in Pune conducted workshops for officials of UCBs in January 2002. The recommendations were then modified and final guidelines made applicable to scheduled UCBs from July 2002.

NPAs were a potentially serious concern in the case of the UCBs. We now turn to this topic.

Non-Performing Assets

The level of NPAs with UCBs was higher than that of commercial banks because of inadequate credit appraisal and follow-up skills, concentration risk due to their limited geographical areas, and connected lending, among other problems. In May 2000, the Ministry of Finance advised the Bank to examine whether SAC guidelines could be extended to the cooperative banks. The RCS, Maharashtra, also requested the Bank in June 2000 to formulate guidelines for the write-off of NPAs. The Bank prepared draft guidelines and proposals for recovery of dues in NPA accounts of UCBs. Governor Jalan noted that 'in view of differing powers for RCS in different states, [we] leave to RCS to decide rather than a uniform guideline from RBI which in any case does not have adequate powers'. In February 2001, therefore, the Bank sent the draft proposals on guidelines for recovery of dues in NPA accounts to all the RCSs for suggestions. Since the Bank did not have the powers to directly advise UCBs, state governments were advised to issue notification or administrative orders in the respective states under the state laws.

Following the issue of revised guidelines to commercial banks for compromise settlement of chronic NPAs up to ₹100 million in January 2003, draft guidelines on the same lines were issued to all RCSs' and Chief Secretaries for consideration and implementation in respective states. The guidelines were issued to ensure non-discretionary and non-discriminatory treatment of NPA borrowers. The guidelines on 'one time settlement' for small and medium-sized enterprises, distressed farmers and small borrowers with less than ₹25,000 principal outstanding were sent to state governments in 2006 for necessary action. The guidelines on the debt restructuring mechanism for such enterprises were issued to UCBs in August 2006. A few larger banks participated in the CDR mechanism.

Conclusion

The Bank's overall approach towards the non-bank institutions was driven by a desire to improve governance and transparency to make them more efficient as market players and more responsive to the users of their services. Despite occasional frictions and differences with the Bank, the government too shared that broad aim. It was still a complicated transition, because of differences in the circumstances of individual institutions, regional economic conditions and local political pressure, dual control over state-level banks, and limited jurisdiction of the Bank over these entities. The legislative reform in this sphere was a story of modest success at best. Whenever there were a consultative approach and negotiated decision-making, the efforts delivered good results.

Notes

1. 'Commercial banks' refer to scheduled commercial banks, excluding regional rural banks.
2. Until 1997, twenty-four UCBs were included in the second schedule of RBI Act, which increased to fifty-three by March 2008. They were relatively larger and more like commercial banks.
3. Chairman S. H. Khan.
4. Chairman: Y. H. Malegam.
5. The exposure limit was not to exceed 20 per cent of capital funds in the case of individual borrowers and 50 per cent for group borrowers. For lending to infrastructure, 10 per cent additional limit for group borrower was fixed. The exposure norms were fine-tuned in June 2001 and fixed at 15 per cent, 40 per cent and 50 per cent of Tiers I and II capital for individual, group and 'infrastructure-group' borrowers, respectively. From April 2002, capital fund was defined under capital adequacy standards and non-fund-based limit was to be reckoned at 100 per cent value (not 50 per cent as before). Later, the boards of FIs were authorised to allow an additional 5 per cent, subject to instances of such exposures being disclosed in the annual financial statements. The 'refinance' extended by FIs was not subject to exposure norms.
6. For uniform implementation in July 2000, and again in February 2003, as desired by the Ministry of Finance.
7. An informal group in the Bank reviewed these instructions on the classification and valuation of the investment portfolio for FIs and submitted a report in October 1999. The guidelines (November 2000) contained instructions to have three categories of investments (held to maturity, available for sale and held for trading), as in the case of commercial banks. Subsequently, in response to suggestions from IDBI and ICICI, the guidelines were fine-tuned in 2001 and 2002. The final guidelines on investments in non-SLR debt securities were issued in January 2004 and enforced from 1 April 2004. In July 1999 and in June 2002, the Bank wrote to the Ministry of Finance seeking the government's approval for restrictions to avoid connected lending. Connected

lending by an institution is lending to its own directors, including whole-time directors, and companies, firms and individuals associated with them. Usually, directors would also be directors of other group companies. After some delay, the government approved the proposal in November 2002. The restrictions imposed were on the lines of prohibition contained in Section 20 of the BR Act for banks.

8. Adverse selection refers to the case when, competing with banks in lending, the FIs do not get prime borrowers and end up lending to subprime borrowers.
9. Capital gains on sale of assets are taxable unless reinvested in another similar asset or invested in capital gains bonds. These bonds have a minimum lock-in period (say, five or seven years) and carry interest rates lower than that for bank deposits. It is a source of low-cost funds to the issuing government-owned FIs.
10. They had to prepare statements on liquidity gap and interest rate sensitivity at fortnightly/monthly intervals, respectively, for being placed before their asset–liability management committees. In July 2003, FIs were advised to submit these two statements at quarterly intervals to facilitate monitoring of their compliance to prudential norms.
11. Among other issues, the government wanted FIs to be part of the scheme of collection of information on defaulters, which was implemented and progressively extended. The treatment of restructured accounts for the purpose of asset classification was discussed during an informal meeting the Governor had with select FIs, banks and the IBA in 2001. In 2001 and 2002, discussions were also held on delays in project implementation.
12. The NIC(LTO) fund was created out of the profits of the Bank; it is a source of low-cost funds for the development financial institutions. The proposal envisaged the transfer of NIC(LTO) loans aggregating ₹37.92 billion granted by the Bank to IDBI, EXIM Bank, IIBI and SIDBI, and the subordinated debt of IDFC Ltd for ₹3.50 billion subscribed to by the Bank to the government.
13. These four FIs were allowed to issue twenty-year redeemable, convertible bonds, which could be reckoned as Tier I capital, subject to the conditions laid down. The Governor agreed to relax certain conditions for deeming it as Tier I capital because of the special circumstances of the case.
14. There was a consequent portfolio shift in favour of treasury operations.
15. The Narasimham Committee II was of the view that the Reserve Bank should not own the institutions it regulated. This was also the view expressed in the International Monetary Fund Article IV Consultation Discussions in November 1999.
16. The suggestions not considered were: (*a*) exemption from SLR should be available only in respect of the inherited liabilities, and not incremental liabilities of the new banking company, (*b*) the SLR exemption should be available so long as the government remained the majority shareholder of the

new banking company and (*c*) resultant amendments to the Companies Act and BR Act should be provided in the Bill. The sources do not explain why the government did not include these suggestions.

17. The cash-neutral assistance would flow from the government to an asset management trust, which would manage the stressed assets stabilisation fund (SASF). The assistance of the government was in the form of twenty-year non-interest bearing bonds. The IDBI transferred stressed assets with a net value of ₹90 billion to the SASF and received in exchange bonds that had been received by the SASF from the government so that IDBI could commence its banking operations with a clean slate. In 2005, the merger of IDBI Bank Ltd with IDBI Ltd was completed.
18. In April 2004, various options for restructuring were analysed and the results conveyed to the government. The government informed that it proposed to merge IIBI with another FI or bank.
19. The A. S. Ganguly Working Group on Flow of Credit to SSI Sector, 2004, had recommended that some of the more active SFCs might be converted into state-level NBFCs. The Working Group on Development Financial Institutions (Chairman: N. Sadasivan) recommended in May 2004 that SFCs had outlived their utility and should be phased out within a definite timeframe. SIDBI had communicated these views to all state governments and SFCs in October 2004, advising them to arrange for recapitalisation of SFCs to raise the level of capital adequacy to a minimum of 9 per cent.
20. RBI, *Annual Report 1997–98*. Data on deposits with NBFCs from subsequent years in the Reserve Bank's publications show a drastic decline.
21. Chairperson: K. S. Shere.
22. The Narasimham Committee II had recommended that the minimum net worth of NBFCs for registration be increased from ₹2.5 million to ₹20 million progressively. The ordinance of January 1997 specified the limit at ₹5 million, but Parliament reduced the limit to ₹2.5 million at the time of passing the Bill in March 1997, with the provision that the entry barrier could be raised to ₹20 million. It was left to the Bank to prescribe higher limits for new companies. The Bank fixed the minimum paid-up capital at ₹20 million for new companies.
23. It was also announced that the liquid asset requirement would be uniform for all NBFCs at 12.5 per cent of public deposits from April 1998. This was further raised to 15 per cent in 2008.
24. The net-owned fund was arrived at only after deducting the investments made in subsidiaries and group companies.
25. With an Executive Director as chairman and three other senior officers as members.
26. In respect of applications from ineligible companies, a transparent procedure of rejection was followed through issue of public notice in a newspaper,

followed by a show-cause notice served on the company. After the expiry of the notice period, applications of NBFCs that did not respond and those that were not traceable were rejected by issue of a speaking order.

27. For example, the limits on public deposits were raised, and the time to regularise the excess deposits was extended.
28. Informal Advisory Group on NBFCs, with members from industry, NBFC associations and ICAI.
29. Fixed at 15 per cent of net-owned funds for single borrower and 25 per cent for groups. Investment in real estate was not to exceed 10 per cent of net-owned funds of the NBFC. Investment in unquoted shares was also not to exceed 10 per cent of net-owned funds.
30. Chairman: C. M. Vasudev, Special Secretary, Banking. A Deputy Governor was a member of the Task Force.
31. The Task Force had recommended that the Bank should have a separate Executive Director for this purpose. In compliance, the Bank appointed M. R. Umarji in September 1999 as Executive Director in charge of the Department of Non-Banking Supervision.
32. The stipulated period for attaining the minimum net-owned fund was extended up to 2010 instead of 2009.
33. Several other measures were taken to regulate NBFCs and make their business practices more efficient and transparent. The Governor announced in the Annual Monetary and Credit Policy for 2001–02 that a system of asset liability management for NBFCs would be put in place. The draft guidelines were circulated among the members of the informal advisory group in July 2000. In June 2001, Asset Liability Management Guidelines for NBFCs with assets above ₹1 billion was issued. The Bank was aware that there were registered NBFCs that had ceased to undertake NBFC business since long. But they continued to hold the certificate of registration. The certificate had an intrinsic value insofar as companies not engaged in financial business could still use the certificate as a mark of credibility in non-financial business activities. The regional offices were advised to identify such companies and follow due procedure for cancellation. A circular was issued in September 2006 to effect this. In January 2004, the Bank issued know-your-customer guidelines to NBFCs akin to those issued to commercial banks. It included customer identification, ceiling and monitoring of cash transactions, internal control system, internal audit and inspection, and record-keeping. The boards of NBFCs were advised to adopt the Customer Due Diligence Guidelines issued by the Basel Committee on Banking Supervision with suitable modifications. The industry demanded parity with banks on deposit insurance, liquidity support, lender of last resort, and entry to call money market. The Reserve Bank could not offer complete parity with banks, which were more tightly regulated, but did allow some flexibility. For example, guidelines for entry of

NBFCs into insurance business as agents of insurance companies was issued in June 2000. NBFCs were also permitted to set up joint ventures for insurance business with risk participation. The industry sought separate status for asset financing companies (leasing and hire purchase), which were different from investment companies. The Mid-Term Review of the Annual Monetary Policy for 2006–07 announced a separate segment for asset financing companies. From then onwards, there were three NBFC categories – asset financing, investment companies and loan companies.

34. The inflows into the NBFC sector in the next three years amounted to $223 million, $206 million and $363 million, respectively.
35. The total assets of eighteen of these NBFCs, with an asset size of ₹1 billion and above, was ₹214.21 billion.
36. An internal group of Chief General Managers of regulatory departments examined the 'Issues relating to Level Playing Field, Regulatory Convergence and Regulatory Arbitrage in the Financial Sector' and recommended a policy framework. The group submitted its report in March 2006.
37. The regulatory framework for these companies included leverage ratio (borrowings up to ten times their net-owned funds), CRAR of 10 per cent and single/group borrower exposure limits for lending and investment at 15 per cent and 25 per cent of owned funds. Reporting formats of monthly returns were prescribed for these companies for the purpose of comprehensive monitoring. There were 147 NBFC-ND-SIs in December 2006. These companies were further advised to attain a minimum CRAR of 12 per cent by March 2009, and 15 per cent by March 2010. Certain disclosure requirements relating to CRAR, exposure to real estate sector, and maturity pattern of assets and liabilities, along with reporting requirements on short-term dynamic liquidity, structural liquidity and interest rate sensitivity in specified formats for monitoring asset–liability management, were also prescribed.
38. 'In any mature system,' Tarapore continued, 'we cannot countenance a situation wherein an RNBC in its very constitution is allowed to take on unlimited liabilities without any reference to its owned funds. The system of RNBC is dangerous for the financial system and frustrating for the regulators/supervisors.'
39. A sub-limit of 10 per cent, and later 15 per cent, was prescribed for government securities within the limit of 80 per cent. A major portion could be invested in papers of public sector undertakings and corporates with a rating of AA+ or above. The limit of 15 per cent fixed for liquid assets in the form of government-guaranteed securities was low as even commercial banks with deposit insurance cover kept 25 per cent of deposits in SLR securities.
40. High-level committee (Chairman: M. R. Umarji), with participation of the government, banks, FIs and Reserve Bank officials.

41. Security interest refers to the interest of the creditor on the security taken from a borrower for the loan extended. The SARFAESI Act was passed to make enforcement of this security interest speedy and less cumbersome, without the intervention of the courts. However, banks did not have the core competence to enforce security in respect of NPAs, which activity could, therefore, be outsourced. ARCs were specialised in reconstructing a stressed asset and in enforcing the security and, hence, banks found it expedient to sell NPAs to ARCs, which would either facilitate turnaround of the asset or encashment of securities (that is, enforcement of security interest).
42. Both groups had members from outside the Bank and the government. The first group (Chairman: C. S. Murthy) examined issues relating to registration, prudential norms and accounting, and disclosure standards; and the second group (Chairman: N. Sadasivan) framed guidelines for acquisition of assets by ARCs and enforcement of security interest. The ARCs raised money by issue of 'security receipts' to qualified institutional buyers, or QIBs (banks and FIs). The group consulted SEBI on issues relating to security receipts as these would be issued on private placement basis by the ARCs. Both groups submitted their reports in October 2002. Before framing the draft rules under the Act, the Bank consulted select bankers and financial institutions and obtained their views in a meeting. The draft guidelines were sent to the Ministry of Finance on 17 December 2002, and placed on the website the following day for feedback.
43. Chairman: N. Sadasivan.
44. With three outside experts, the Economic Adviser for the government, and a nominee from the Bank.
45. Several other miscellaneous issues concerning NBFCs engaged the Bank. These bear a brief mention. The Bank's discomfort with non-bank entities accepting and holding public deposits was no secret and made known to all concerned including the government. In the Mid-Term Review of the Annual Monetary Policy for 2004–05, it was announced by the Governor that NBFCs would be encouraged to move out of public deposits in line with international practices. The Bank even discussed this with NBFC industry bodies. However, there had not been much progress in this regard until the end of the reference period. The public deposits with NBFCs, including RNBCs, increased from ₹196.44 billion in March 2004 to ₹243.95 billion in March 2008. From 2000 onwards, the Bank had been recommending to the government to extend the benefits of debt recovery tribunals (DRTs) to NBFCs. In June 2005, the Bank's view was communicated to the Ministry of Finance that the Bank 'does not have objection to extending benefits of DRT Act to NBFCs'. But Deputy Governor Leeladhar observed in September 2005 that 'it is true in the past we have supported the case of NBFCs getting the benefits of DRTs.

However, the operations/experience with DRT had not been satisfactory.... Without strengthening the DRT infrastructure giving them additional work of NBFCs also will be counterproductive'. Subsequently, there was a meeting with the government to discuss the issue and a working group was set up by the government to examine it. The working group did not favour bringing NBFCs under the purview of DRT.

46. The draft Bill was sent back to the Ministry of Finance in March 2000 with the Bank's comments.
47. In March 2007, the Bank's views were conveyed to the government in these words:

    > NBFC sector has stabilised during the period and the sector as a whole has undergone change with deposit taking NBFCs on decline and wherever there is a need for enhanced legislative powers the same can be incorporated in the existing legislation through amendment to RBI Act. Therefore, ... a separate legislation for regulating deposit taking NBFCs may not be necessary at this stage.

48. Chairman: K. S. Shere.
49. The Narasimham Committee II had also advised against insurance of NBFC deposits. The Bank constituted in April 1999 an advisory group (Chairman: Jagdish Capoor) to look into this issue. The group concluded that deposit insurance 'could be considered after the regulatory and supervisory system is stabilised'. Another internal working group (Chairman: N. Sadasivan) was of the same view. Since the group was internal with all members from the Bank and the Deposit Insurance and Credit Guarantee Corporation, a second working group with external members was set up to offer its views, with the Chairman and Managing Director of the New India Assurance Company chairing the group. This group also agreed that there was no case for providing insurance cover to depositors of NBFCs.
50. In March 2008, there were 376 registered deposit-taking NBFCs with aggregate deposits of ₹243.95 billion, which included the two RNBCs with total deposits of ₹223.58 billion. There were 11,642 non-deposit-accepting NBFCs, including systemically important NBFCs with total assets of ₹990.14 billion.
51. Following the Marathe Committee recommendations (1992), a liberal policy was adopted regarding new UCBs.
52. The Joint Parliamentary Committee (2002) observed that it did not work well because 'the State Registrars of Cooperative Societies do not always act expeditiously on directions received from RBI with the result that the management of these banks are enabled to take advantage of existing loopholes to commit irregularities'.
53. Such as the maintenance of good track record of continuous net profit, net NPA of less than 10 per cent, and conditions relating to management,

prudential requirements, methods of operation, and liquid assets. A letter stated that these conditions 'should be complied with by the bank on a continuous basis and failure on the part of the bank to do so will result in de-scheduling'. Despite the monitoring, three UCBs in Maharashtra that were included in the second schedule turned weak within a short time, and placed the Bank in an embarrassing position.

54. High Power Committee (Chairman: K. Madhava Rao) was formed by the Bank to review the regulatory framework for UCBs.
55. The licensing policy for new banks was revised in August 2000. Entry point norms were reset for four categories of banks depending on the population size as recommended by the high power committee. The Bank set up in May 2001 a committee to look into licence applications from proposed UCBs. The independent external Screening Committee (Chairman: G. Ramachandran) had member-representatives from banking, finance and cooperation fields.
56. Many of these unlicensed banks held large public deposits. Placing a large number of banks under moratorium or liquidation could have a contagion effect, and the Bank decided to follow a gradualist approach in this regard. The cut-off date was, therefore, extended in phases up to March 2006.
57. In March 2001, the Bank wrote to the Chief Secretaries of states to prioritise professionalism in the management of UCBs and tone up the audit system. In April 2001, placement of deposits by UCBs with other cooperative institutions and other UCBs, except for maintaining current accounts for clearing and remittance purposes, was banned on account of contagion risk in a reaction to the crisis. For scheduled UCBs, the SLR was raised to 20 per cent from 15 per cent in April 2001. For non-scheduled banks with deposits over ₹250 million, it was raised to 15 per cent from 10 per cent and for non-scheduled UCBs with deposits less than ₹250 million, the SLR was introduced for the first time and fixed at 10 per cent. Later in April 2003, it was raised to 25 per cent for scheduled UCBs. In March 2002, the norms of classifying weak and sick banks were modified.
58. Soon after, another high power committee was formed by the government under the chairmanship of the Minister of State for Finance, Anant G. Geete. In line with the committee's recommendations, the Bank made relaxations on placement of funds by smaller banks with scheduled UCBs, in granting unsecured advances, and in NPA norms for small loans. The federations of UCBs and the Geete Committee informed the Bank that the new norms for identifying weak or sick banks were too stringent and needed to be reviewed. It was also suggested that the negative terms ('weak', 'sick') affected the reputation of banks. The negative classification continued for some more time, but was eventually replaced by a new categorisation of all UCBs as Grades I, II, III and IV in 2003–04. The restrictions on 'weak' banks would by and large apply to UCBs classified as Grade III and restrictions on 'sick'

banks would apply to UCBs classified as Grade IV. In March 2004, there were 900, 318, 511 and 191 banks categorised under Grades I, II, III and IV banks, respectively.

59. UCBs were permitted in May 2003 to place deposits with strong (Grade I) scheduled banks. However, scheduled UCBs were advised not to place deposits with another UCB. The UCBs were advised in July 2004 to obtain a certificate from statutory auditors certifying that the bank had not placed any deposit with any ineligible bank during the year and to forward the auditor's certificate to the Reserve Bank.
60. Interest as the amount of penal interest levied but not recovered aggregated ₹1.60 billion by March 2004. It was reduced to ₹1.12 billion by March 2006, mainly on account of liquidation and mergers.
61. The committee preparing the draft submitted its report in December 2004. The vision was that UCBs must emerge as a sound and healthy network of jointly owned, democratically controlled and ethically managed banking institutions providing need-based quality banking services, essentially to the middle and lower middle classes and marginalised sections of society. The vision document recognised the heterogeneity of the UCB sector in terms of size, geographical distribution, financial soundness and technology absorption, and prescribed a multi-layered regulatory regime.
62. Prudential norms on income recognition, asset classification and provisioning were made applicable with some relaxations to UCBs from 1992–93 in a phased manner. CRAR was not made applicable to UCBs as these banks could not raise equity by public issue since only members could contribute to share capital. These norms were in different stages of implementation by 1997.
63. Minimum level of CRAR, exposure norms, restrictions on unsecured advances and call money operations, and disclosure requirements were made applicable to UCBs with some relaxations as compared to commercial banks.
64. Prudential exposure limits were fixed at 15 per cent and 40 per cent of the capital funds for single and group borrowers, respectively, as in the case of commercial banks. Since there were many UCBs with negative net worth or accumulated losses, these banks had to approach the Bank for relaxation. The risk weights for commercial real estate and capital market exposure were raised to 125 per cent from 100 per cent in July 2005, following the direction to commercial banks. The risk weight for commercial real estate was further raised to 150 per cent, again in line with commercial banks. The federations sought lower risk weight and relaxation in provisioning norms for gold loans. Twice in 2006, the Bank rejected the demand. According to the State Cooperative Societies Acts, UCBs were required to transfer 20 per cent of their net profits for appropriation to reserve fund. However, UCBs were advised by the Bank to appropriate not less than 50 per cent of their net profits to reserve

fund or general reserve, if the prescribed CRAR had not been attained. Until 2002, the Bank was fixing the floor rate for interest charged on advances by UCBs. In April 2002, UCBs were permitted to determine their lending rates, taking into account cost of funds and transaction cost. Later in May 2007, UCBs were advised to lay down appropriate internal principle and procedure so that usurious interest rates were not levied on loans and advances.

65. As per the group's recommendations, scheduled UCBs undertaking foreign exchange business were required to comply with Basel I norms by March 2009 and Basel II norms by 2010. A working group was set up to examine the methods of capital augmentation of UCBs. The recommendations for alternate instruments/avenues for augmenting capital funds of UCBs were considered, and in 2008, UCBs were allowed to issue preference shares and long-term deposits with a minimum maturity of fifteen years, subordinate to the claims of depositors.