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Reforms in Banking and Financial Institutions

INTRODUCTION

The banking and financial policy during the 1970s aimed at aligning the financial sector, in particular, banking operations, with the Plan priorities and social goals. This policy thrust continued during the early 1980s with the pursuit of target-oriented lending and a plethora of interest rate and credit controls. In the process, especially among public sector banks (PSBs), commercial considerations became secondary, which resulted in weakening the soundness and operational efficiency in banking. To reverse this tendency, efforts towards consolidation began in the mid-1980s through various regulatory and supervisory interventions by the Reserve Bank. These initiatives continued till the late 1980s and the Reserve Bank provided the necessary conducive environment in the 1990s, in tune with the spirit of liberalisation and deregulation in developed and developing economies. These initiatives aimed at moderating branch expansion, while continuing to cover spatial gaps in rural areas, improving the financial viability of banks, introducing mechanisation and inculcating a better professional management and work culture. The social objectives of banking were re-oriented without jeopardising the need to sustain viability, profitability and professionalism in banking.

WAVE OF DEREGULATION: GLOBAL INFLUENCE

When India embarked upon financial sector reforms in the early 1990s, the Reserve Bank was conscious of the need to eliminate structural impediments to adjustment and growth. The aim was to allow the price mechanism to operate as freely as possible, in the real and in the financial sector.

The conditions in which financial activities were conducted were liberalised, while subsidised loans were cut back sharply. During the 1990s, Indian banks operated in a far more competitive climate than ever before. Quantitative and qualitative credit controls were progressively replaced by a more flexible monetary policy framework. The range of financial instruments and services was broadened. Restrictions on international financial transactions were reduced. Transactions became more transparent, paving the way for allocation of resources to become more optimal.[1]

Increased emphasis was placed on three pre-requisites for the efficient functioning of the financial sector, *viz.*, a well-designed infrastructure, effective market discipline, and a strong regulatory and supervisory framework. A well-designed infrastructure comprised a proper legal and judicial framework, good corporate governance, comprehensive accounting standards, a system of independent audits and an efficient payments and settlement system. Effective market discipline required a sound credit culture and well-developed equity and debt markets with a wide variety of instruments for risk diversification. The Basel Committee came out with the guidelines for capital adequacy and risk weights of book assets. Based on international consensus on what constituted sound practices in many areas of banking supervision and securities regulation, the Basel Committee released the core principles for effective banking supervision and the International Organisation of Securities Commission (IOSCO) proposed the necessary guidelines for the securities industry.[2]

The financial sector reforms of the 1990s offer interesting insights into the overall policy framework evolved by the country's policymakers. First, the financial sector reforms were undertaken early in the reform cycle. Second, the reform process was not driven by any banking crisis and it was essentially home-grown, the initial trigger been provided by the structural adjustment packages supported by the International Monetary Fund (IMF) and the World Bank. Third, the design of the reforms took on board, international best practices. Fourth, the reforms were carefully sequenced with respect to instruments and objectives. Thus, the prudential

1. Larosiиre, Jacques De (1992). "The Worldwide Adjustment Process in the 1980s", *C.D. Deshmukh Memorial Lecture.* Mumbai: Reserve Bank of India. March 24.

2. Jalan, Bimal (2002). "International Financial Architecture: Developing Countries Perspective", in *India's Economy in the New Millennium: Selected Essays.* UBS Publishers. pp.76-77.

norms and supervisory strengthening measures were introduced initially in the reform cycle, followed by interest rate deregulation and a gradual lowering of statutory pre-emptions. The more complex aspects of legal and accounting measures were addressed subsequently, when the basic tenets of reforms were already in place.[3]

LEARNING FROM INTERNATIONAL BEST PRACTICES

The Indian thinking on financial reforms was greatly influenced by global developments and practices. The Reserve Bank kept a close watch, attempted to learn, imbibe and internalise new policies and practices, adapting them to Indian conditions. Several constraints *viz.*, government ownership of major financial institutions (FIs) and banks, directed lending with substantial allocation for the priority sector, regulated interest rate structure, pre-emption of bank resources under reserve requirements at very low rates of return and exchange controls limited the scope and speed of deregulation. The Reserve Bank in close co-ordination with the Government provided momentum to enhance the efficiency of the financial system with the objective of reducing rigidities and delays, improving flexibility and speed of operations, allowing for functional and institutional diversification and generally bringing about a more competitive environment in the system.

The Reserve Bank's success as a central bank at this time can be attributed to its ability to understand the approaches followed by central banks the world over in their regulatory and supervisory systems and attempt to customise these to the domestic financial system, particularly the banking system. Knowledge-sharing through lectures by eminent international bankers in the late 1980s and early 1990s was a notable feature in the Reserve Bank. The benefits of such information dissemination had a positive reflection in the working of the Indian banking system. In furtherance of the initiatives, the Reserve Bank became a shareholding member of the Bank for International Settlements (BIS) on November 1, 1996.

The period 1989–1992 proved to be a turnaround because of the severe impact of the balance of payments (BoP) crisis. Policymaking at this point was caught between two mindsets. One was the urgently felt need to switch

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3. Reddy, Y.V. (2009). *India and Global Financial Crisis, Managing Money and Finance.* New Delhi: Orient BlackSwan. p.125.

to the process of liberalisation in tune with the international trend and give up the restrictive practices prevalent in the financial system. The second was the fear that adjustments could create imbalances in the economy, and the achievements in terms of social and economic priorities as well as equitable distribution could be thwarted. However, the successful experience of other developing economies, particularly in the rest of Asia, prompted the authorities to go ahead with the liberalisation, albeit in a gradual manner.

The period 1992–1997 witnessed a sea-change in the financial system in general and in the banking system in particular. There was a transformation in the outlook, and the need to foster a sound and healthy banking structure took root, especially in the Government's philosophy and the Reserve Bank's approach. The market-oriented approach in line with the international trends and adoption of best global practices helped the banking system become resilient to shocks emanating both from the domestic and international financial markets.

The first wave of financial liberalisation during this period took the form of interest rate deregulation. This represented a shift from a prolonged period of administered system of interest rates that was influenced by budgetary concerns and characterised by a high degree of concessional directed loans. Under the administered system, interest rate margins were kept sufficiently large by keeping deposit rates low in relation to the non-concessional lending rates along with an element of cross-subsidisation. The yields on government securities also reflected the demand and supply conditions in the market. Based on the recommendations of the Chakravarty Committee, the coupon rates on government bonds were gradually increased.

The process of bank consolidation that had begun in the late 1980s continued in the 1990s. It meant moderation in the pace of branch expansion, filling the spatial gaps in rural areas, improvement in the financial viability of banks and introduction of mechanisation and computerisation to inculcate a more effective management culture. The target orientation for the priority sector was, however, retained but in a more pragmatic manner, avoiding indiscriminate lending and without loss of viability and sustainability of banking operations. Overall, the Reserve Bank's policy initiatives from 1992 were directed at building strength and ensuring safety and stability of the financial system. Compared with the experience of many developing countries embarking on financial sector reforms, India tread cautiously to minimise the adjustment costs involved in the process. In other words, the frictions of transition were tackled by both a gradualist and a balanced approach, rather than by a 'big bang' approach.

Following the report of the Narasimham Committee, more comprehensive reforms were pursued. The reforms consisted of: (i) a shift of banking sector supervision from intrusive micro-level intervention over credit decisions towards prudential regulations and supervision; (ii) reduction in cash reserve ratio (CRR) and statutory liquidity ratio (SLR); (iii) interest rate deregulation and entry relaxation; and (iv) adoption of prudential norms. Further, in 1992, the Reserve Bank issued guidelines for income recognition, asset classification and provisioning, and also adopted the Basel Accord of capital adequacy standards. The Government established the Board for Financial Supervision (BFS) in the Reserve Bank and recapitalised PSBs in order to give banks sufficient financial strength and enable them to gain access to the capital markets. In 1993, the Reserve Bank permitted private sector to enter the banking sector, provided that new banks were well capitalised and technologically advanced, and at the same time prohibited cross-holding practices with industrial groups. The Reserve Bank also imposed some restrictions on new banks with respect to the opening of branches, with a view to maintaining the franchise value of existing banks.[4]

As a result of the reforms, the number of banks increased rapidly. In 1991, there were 27 PSBs and 26 domestic private banks with 60,000 branches, 24 foreign banks with 140 branches, and 20 foreign banks with a representative office each. Between January 1993 and March 1998, 24 new private banks (9 domestic and 15 foreign) entered the market; the total number of scheduled commercial banks (SCBs), excluding specialised banks, such as regional rural banks (RRBs), rose from 75 in 1991–92 to 99 in 1997–98. Entry deregulation was accompanied by progressive deregulation of interest rates on deposits and advances. From October 1994, interest rates were deregulated in a phased manner and, by October 1997, banks were allowed to set interest rates on all term deposits of maturity of more than 30 days and on all advances exceeding ₹ 2 lakh. CRR and SLR, interest rate policy and prudential norms were applied uniformly to all commercial

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4. Shirai, Sayuri (2001). "Assessment of India's Banking Sector Reforms from the Perspective of the Governance of the Banking System", Paper presented at the ESCAP-ADB Joint Workshop on *Mobilizing Domestic Finance for Development: Reassessment of Bank Finance and Debt Markets in Asia and the Pacific*. Bangkok, November 22-23.

banks. The Reserve Bank, however, treated foreign banks differently with respect to regulation that required a portion of credit to be allocated to the priority sector. In 1993, foreign banks — which were earlier exempt from this requirement — while all other commercial banks were required to earmark 40.0 per cent of credit — were made to allocate 32.0 per cent of credit to the priority sector.

The Governor, Shri R.N. Malhotra, speaking on the occasion of silver jubilee of the Reserve Bank Staff College (RBSC) in 1989, indicated that there were three challenges confronting the banking industry that required appropriate policies. The first challenge was posed by the rapid changes taking place in the international financial markets. Although the Indian banking industry had generally remained immune to these changes, the linkages between domestic banking and international markets was gradually increasing. Most of the changes related to computerisation and the communication technology. The second challenge that had a bearing on the work of a training institution was that the traditional roles of commercial banking were undergoing transformation abroad and with the result that the distinction between the operations of banking and non-banking entities was getting blurred. In India also, banks had started the business of merchant banking, venture capital, leasing and other activities. The interface of commercial banks with the financial market had, therefore, broadened. The third challenge was how to handle the transition from conventional banking to the evolving situation. While certain traditional practices and principles were no doubt valuable, the new developments could not be ignored and had to be assimilated.

CHAPTER OUTLINE

This chapter covers four related aspects. First, the road map set for financial sector reforms, including that for the banking system, based on the recommendations of the high level committee appointed by the Government to review the financial system under the chairmanship of Shri M. Narasimham (also known as the committee on the financial system, *i.e.,* the CFS), which submitted its report in November 1991. The nature and dimensions of these recommendations and the action taken form a significant part of the narrative that follows. Second, the financial system in the early 1992 was afflicted by irregularities in government securities market transactions that threatened systemic stability. An immediate scrutiny by a Deputy Governor of the Reserve Bank and later by the Joint Parliamentary Committee (JPC) on the nature of the irregularities resulted in several safeguards being placed in the functioning of government securities markets and in particular, in the operation and settlement system of securities transactions. The major steps taken in this regard are discussed next. Third, several aspects of financial sector regulation and supervision were examined either internally or by working groups and committees appointed for specific purposes, and fresh guidelines and directions were issued by the Reserve Bank over the period. Such guidelines largely followed international best practices and aimed at placing the system on a stable and sound footing, while making the operations more flexible and market-oriented. The details of such developments appear thereafter. Subsequent to this, developments relating to the urban co-operative banking sector are covered. During the 1990s, there were parallel changes in the process of financial intermediation and the role of FIs including non-bank financial companies (NBFCs), in the inter-institutional linkages, and the Reserve Bank's role in the regulation and supervision of such institutions. While the general aspects of reform and policy developments are covered with reference to FIs and NBFCs, some specific developments in policy and the operations of these two categories are narrated before making the concluding observations.

FINANCIAL/BANKING SECTOR REFORMS: THE NARASIMHAM COMMITTEE, 1991

BACKDROP

It was increasingly felt that developments in the financial sector, in particular the banking sector would have to be supportive of the metamorphic changes being undertaken in response to the challenges posed by the twin deficits, namely, fiscal deficit and the current account deficit (CAD). The financial sector reforms were expected to generate greater competition between banks, FIs and NBFCs, with a move towards establishing a level playing field between different types of institutions and between public and private sector institutions. The reforms were aimed at further development and integration of the money and capital markets. A concomitant of these changes was the need for structured prudential norms and discipline that was to be applied universally. Increased competition was seen as a means to provide an efficient system of financial intermediation, with diversified FIs and instruments catering to the varied needs of savings and investment classes. In order to ensure that the institutions did not lag behind in facing a more competitive environment, they were supposed to revamp in terms of organisational systems and procedures, and modernise and improvise.

Easier access and exit and rigorous prudential norms for risk management, as also transparency in operations, needed to be induced expeditiously. Inefficiencies in the financial system tended to make the cost of intermediation unduly high. The changing environment of competition amongst various segments of the financial system called for work and management ethos that were professionally oriented and goal and performance-driven. The tasks before the banks and FIs in this respect were onerous and, as the financial sector reforms had to be consistent with the overall economic reforms, banks and FIs were required to undertake major changes in their operations.

These issues were examined by the Narasimham Committee. The committee made wide-ranging recommendations, which formed the basis of financial sector reforms relating to banks, development financial institutions (DFIs) and the capital market in the years following the BoP crisis. The committee's recommendations included, *inter alia*: (i) phased reduction in SLR to 25.0 per cent over a period of five years; (ii) progressive reduction in CRR from its high level; (iii) phasing out directed credit programmes and redefining the priority sector; (iv) deregulating interest rates so as to reflect emerging market conditions; (v) achieving a minimum 4.0 per cent capital adequacy ratio in relation to risk-weighted assets by March 1993; (vi) adopting uniform accounting practices, particularly with regard to income recognition and provisioning against doubtful debts; (vii) imparting transparency to bank balance sheets and ensuring full disclosures; (viii) setting-up special tribunals to speed up the process of recovery of loans; (ix) establishing an asset reconstruction fund (ARF) to take over from banks and FIs a portion of their bad and doubtful debts at a discount; (x) restructuring of the banking system so as to have 3 or 4 large banks, which could become international in character, 8 to 10 national banks with a network of branches throughout the country engaged in universal banking, local banks whose operations were generally confined to a specific region, and rural banks (including RRBs) whose operations were confined to rural areas and whose business was predominantly to engage in financing agriculture and allied activities; (xi) setting-up one or more rural banking subsidiaries by each of the PSBs to take over all its branches; (xii) permitting RRBs to engage in all types of banking business; (xiii) abolishing branch licensing and leaving the matter of opening or closing of branches to the commercial judgment of the individual banks; (xiv) liberalising policy with regard to allowing foreign banks to open offices in India as branches or as subsidiaries; (xv) rationalising the foreign operations of Indian banks; (xvi) permitting individual banks the freedom to recruit officers; (xvii) inspection by supervisory authorities being based on the internal audit and internal inspection reports; (xviii) ending duality of control over the banking system between the Reserve Bank and the Banking Division of the Ministry of Finance and making the Reserve Bank the primary agency for regulating the banking system; (xix) hiving-off the supervision over banks and other FIs to a separate authority to operate as a quasi-autonomous body under the aegis of the Reserve Bank, separate from other central banking operations of the Reserve Bank; (xx) making recommendations on the appointment of chief executives of banks and directors on the boards of PSBs and institutions; (xxi) transferring the direct lending function of the Industrial Development Bank of India (IDBI) to a separate institution, while retaining only its apex and refinancing role; (xxii) obtaining resources from the market on competitive terms by the DFIs and phasing out their privileged access to concessive finance through SLR and other arrangements; (xxiii) enabling substantial and speedy liberalisation of the capital market and dispensing with the prior approval of any agency for any issue in the market; (xxiv) providing supervision over institutions such as merchant banks, mutual funds, leasing companies, venture capital companies and factoring companies by a new agency to be set up under the aegis of the Reserve Bank; (xxv) enacting new legislation along the lines existing in several countries to provide an appropriate legal framework for the constitution and functioning of mutual funds; (xxvi) laying prudential norms and guidelines governing the functioning of such institutions as in the case of banks and FIs; and (xxvii) properly sequencing reforms in the financial system.

The recommendations of the Narasimham Committee were extensive in their scope and had far-reaching implications for the working of the banking and financial system. The feasibility of implementing the recommendations, the sequencing of measures and the infrastructure necessary in a reformed financial system were examined by the Government and the Reserve Bank in the second half of 1992. Accordingly, financial sector reforms were initiated as part of the overall structural reforms to impart efficiency and dynamism to the financial sector. The country's approach to reforms in the banking and financial sector was guided by five principles: (i) reform measures were to be cautious and sequenced; (ii) introduction of norms that were mutually reinforcing; (iii) introduction of complementary reforms across sectors (monetary, fiscal, external and financial sectors); (iv) development of FIs; and (v) development and integration of financial markets.

IMPLEMENTATION OF THE RECOMMENDATIONS OF THE NARASIMHAM COMMITTEE

Many of the recommendations of the CFS were accepted and implemented,[5] with some implemented in a manner that was somewhat different from what was intended.[6] The actions taken by the Reserve Bank with regard to commercial banks and the FIs are the main areas reviewed in the following paragraphs.

DIRECTED CREDIT

The committee recommended that directed credit programmes should be phased out. It recognised that it was necessary for a measure of special credit support through direction to a redefined priority sector for which the suggested target could be fixed at 10.0 per cent of aggregate credit. As regards credit to the target group, which was not included in the new definition, the Reserve Bank and other refinance agencies could institute a preferential refinance scheme to cover incremental credit to these sectors.

According to the assessment of the Reserve Bank, the priority sector as redefined by the committee accounted for a little less than 30.0 per cent of net bank credit. It was, therefore, decided to maintain the existing targets for priority sector lending. Concessional finance was, however, limited to small loans below ₹ 2 lakh and for differential rate of interest (DRI) advances. For advances above ₹ 2 lakh, banks were free to charge an interest rate linked to the prime lending rate (PLR). The scope of priority sector lending was enlarged to include finance to the state industrial development corporations (SIDCs)/state financial corporations (SFCs), refinance to RRBs by sponsor banks and investments in bonds issued by specified institutions. Overall, the target orientation of lending was considerably diluted over the years by relaxing the norms of coverage of the priority sector.

5. Implementation of recommendations pertaining to monetary instruments and operations is covered in chapter 14: Monetary Management.

6. Those relating to SLR, CRR, payment of interest on CRR balances, interest rate structure and interest rate on government securities have been dealt with in detail in chapter 14: Monetary Management.

CAPITAL ADEQUACY

Identifying the causes for the deterioration in the financial health of the banking system over time, the committee recommended measures that included, *inter alia*, capital adequacy norms, prudential norms for income recognition, asset classification and provisioning for bad debts. The committee proposed that the BIS norms on capital adequacy should be achieved over a period of three years ending March 1996, the period being accelerated for banks that had sufficient international presence. Profitable banks could immediately approach the capital market to enhance their capital, and for the other banks the Government could meet the shortfall either by direct subscription to equity or by providing a loan that could be treated as subordinated debt.

In 1988, the Basel Committee decided to introduce a capital measurement system, the Basel Capital Accord, popularly known as Basel I. This system provided for the implementation of a credit risk measurement framework with a minimum capital standard of 8.0 per cent to be attained by end-1992. Since 1988, this framework has been progressively introduced not only in member countries but across all countries with an international banking presence.

In April 1992, the Reserve Bank announced detailed guidelines on the phased introduction of norms on capital adequacy, income recognition, asset classification, and provisioning in pursuance of Basel I norms. Banks with an international presence were directed to achieve the capital adequacy norms by March 1995 and other banks in two stages by March 1996. Eight banks could not achieve the prescribed norms as on March 31, 1996. As on March 31, 1997 only two banks had not achieved the 8.0 per cent norm. Five nationalised banks, the State Bank of India (SBI) and two subsidiaries of the SBI successfully raised capital from the market from 1993 for a total of ₹ 6035 crore (including the premium on the issue prices). The Government also directly subscribed to the capital of nationalised banks to the extent of ₹ 20,046 crore up to February 28, 1998.

The committee defined the term non-performing asset (NPA) and recommended that no interest should accrue in respect of NPAs. Income recognition norms were to be introduced in a phased manner over a period of three years. It recommended a four-way classification of assets and provisions against each category of sub-standard assets. A four-year period was suggested for banks to conform to these provisioning norms.

Banks were directed that income from NPAs should not be taken to the profit and loss account unless income was realised. NPA was defined as a credit facility in respect of which interest had remained 'past due' for a period of four/three/two quarters as on March 31, 1993, March 31, 1994, and March 31, 1995, respectively. A credit facility was 'past due' when the instalment had not been paid within 30 days from the due date. Similarly, banks were required to classify assets as NPAs, based on their status, into sub-standard, doubtful and loss assets, and make appropriate provisions. These norms were applied to DFIs, except that in the case of DFIs an advance became an NPA if interest remained overdue for more than 180 days and/or the instalment of principal remained overdue for more than 365 days.

TRANSPARENCY IN FINANCIAL STATEMENTS

The committee recommended that transparency and disclosure standards as proposed in the international accounting standards (IAS) be implemented in a phased manner. The Reserve Bank modified the format of balance sheets of banks in 1992 with a view to introducing greater transparency and disclosures. In their 1996 accounts, banks were required to disclose the capital adequacy ratios and in the 1997 accounts, further disclosure requirements were introduced, the more significant being the break-up of provisions made during the year, percentage of net NPAs to net advances and investments on gross and net basis. For the year 1998, banks were directed to disclose seven critical ratios relating to productivity and profitability.

FOREIGN BANKS

The committee recommended a liberal approach in permitting foreign banks to open their branches or subsidiaries, as the Reserve Bank considered appropriate, subject to minimum assigned capital and reciprocity. Joint ventures (JVs) between foreign banks and local banks would also be permitted. Foreign banks/finance companies were permitted to invest up to 20.0 per cent as a technical collaborator (within the overall 40.0 per cent ceiling) in a new private sector bank, subject to the government approval, provided the foreign bank did not have a presence in India. Foreign equity in new Indian private banks was also permitted. JVs between foreign and local banks in non-bank financial services were allowed in accordance with the foreign investment policy of the Government. In January 1992, 19 new foreign banks with a total of 47 branches were allowed to operate in India. The committee had recommended that foreign banks should be subject to the regulation as domestic banks and, in case of constraints, if foreign banks were unable to fulfil requirements such as targeted credit, the Reserve Bank could work out alternative methods.

It was accordingly made mandatory in April 1993 for foreign banks to achieve the minimum target of 32.0 per cent of net bank credit for priority sector lending by March 1994. Within the target of 32.0 per cent, two sub-targets in respect of advances: (i) to the small scale sector (minimum of 10.0 per cent); and (ii) exports (minimum of 12.0 per cent) was fixed. Foreign banks were exempted from targeted credit for agricultural advances because they did not have branches in rural areas.

TAX TREATMENT OF PROVISIONS

The committee recommended that income recognition norms be implemented by the Reserve Bank. The specific provision made by banks and DFIs in line with its recommendations should be tax deductible. As regards general provisions, the tax deductibility should be restricted to 0.5 per cent of the aggregate average non-agricultural advances and 2.0 per cent of the aggregate average advances by rural branches to all banks including those with overseas operations. While income recognition norms were implemented as proposed in respect of the specific provisions made by banks against classified assets, these were not considered tax-deductible unless the amount was written-off. The Reserve Bank took up the matter with the Government. As regards general provisions, the limit of admissible deductions was enhanced to 5.0 per cent of the income and 10.0 per cent of average aggregate advances of rural branches.

DEBT RECOVERY TRIBUNALS

The committee's recommendation for setting-up special tribunals to speed up the process of recovery by specific legislation was implemented in August 1993 with the passage of the Recovery of Debts Due to Banks and Financial Institutions Act, 1993. Eight debt recovery tribunals were established to cover 20 states and 4 union territories (UTs). An appellate tribunal was established in Mumbai.

ASSET RECONSTRUCTION FUND

The committee recommended setting-up an ARF to take bad and doubtful assets off the balance sheets of banks and Fls, so that banks could recycle the funds realised through this process into more productive assets. The

ARF, funded by the Government, the Reserve Bank, PSBs and FIs, was to be provided with broader powers for recovery as an entity. The committee also suggested the manner in which assets could be transferred.

However, the Reserve Bank felt that there were several critical issues that needed attention, and, before implementing such a scheme, it was necessary to be clear about the sources of funding and the impact of the scheme on the recovery climate. Although special recovery tribunals would enable the speedy enforcement of banks' claims, an ARF combined with the prudential requirements would require large amounts of funds. If these large capital requirements were to be met by the Government or the Reserve Bank, it implied large-scale monetisation with obvious deleterious effects on the economy. Thus, the strategy for raising fresh capital by banks needed to be carefully worked out. An ARF also posed the problem of moral hazard of lenders being distanced from the recovery process and this was seen as not providing the most efficient procedure for recovery. Further, such a fund could erode accountability by perpetuating a climate of expectations of such waivers in the future. A limited ARF could, however, be considered for weak banks, provided the alternative of a merger was ruled out and the modalities of avoiding further repetition of the bad lending scenario were worked out. These banks could be provided the facility of bad debts being taken over at face value, but this would have to be conditional on major adjustments being made by banks in terms of drastic changes in their management, sacrifices by the staff, control on the growth of assets and, above all, increase in productivity. These were required to be clearly spelt out through memoranda of understanding (MoU). Issues remaining to be solved were the management of such ARFs and their ability to recover more efficiently than the parent banks, among others. Once such aspects were resolved, a limited approach to ARFs could be considered. The ARF route was supposed to be the option available only to banks that could not undertake the adjustments through other options and that could also be restructured to come under effective management.

ENTRY OF PRIVATE SECTOR BANKS

The Reserve Bank Central Board considered the recommendation of the committee regarding entry of private sector banks in its meetings held on September 11, 1992 and January 21, 1993 and agreed to grant permission for establishing such banks, subject to certain terms and conditions. In accordance with this stipulation, the Reserve Bank issued guidelines on January 22, 1993 for the entry of new private sector banks. The Narasimham Committee had envisaged a larger role for private sector banks in the system. While at that time, there was no legal restriction on the entry of private sector banks, no new private bank was licensed in practice. However, it was considered that time was apposite to allow entry to a few new private sector banks, so as to generate competition in banking.

In the case of new private sector banks, it was desirable to set a sufficiently high minimum start-up capital to ensure that banks had inherent strength and a comfortable capital risk assets ratio. The prudential norms were to be observed from their inception. The minimum paid-up capital for a new private sector bank was set at ₹ 100 crore and it was required to observe prudential norms and a capital adequacy ratio of 8.0 per cent at inception. The question of a level playing field in areas such as rural branches and priority sector credit needed to be addressed, along with issues relating to limits on the concentration of shareholding by individuals/groups and limits on voting power. The issue of whether financial companies should be allowed to set up banks also came up; in such cases the question of cross-share holdings and cross-directorships needed to be given attention. Important aspects that deserved consideration included controlling groups lending money through banks to projects owned or managed by them and commingling of industrial groups and banks leading to the concentration of economic power, which was best avoided.

The committee's recommendation to allow the entry to new private banks was implemented and, as on March 1996, nine private sector banks had commenced business, with a network of 76 branches spread over semi-urban, urban and metropolitan centres. None of the banks opened branches in rural areas.

STRUCTURE OF THE BANKING SYSTEM

The committee had indicated a broad structure for the banking system, consisting of 3 or 4 large banks, which could become international in character, 8 to 10 national banks with a network of branches throughout the country engaged in universal banking, local banks whose operations were generally confined to a specific region and rural banks that operated in rural areas.

The Reserve Bank took the view that the move towards this structure should be market-driven, based on considerations of operational efficiency and brought about through mergers and acquisitions. Except for the merger of one weak PSB, namely, New Bank of India, with another PSB, namely, Punjab National Bank (PNB), on September 4, 1993, there was no restructuring of banks. Six[7] weak private sector banks were closed/merged during this period.

REGIONAL RURAL BANKS

The committee's recommendations that each PSB should set up one or more rural banking subsidiaries to take over all its rural branches and, where appropriate, swap its rural branches with those of other banks was not accepted. The approach instead was to strengthen and restructure RRBs on a 'stand-alone' basis.

BRANCH LICENSING

The committee recommended that branch licensing be abolished and the matter of opening or closing of branches (other than rural branches, at that point of time) be left to the commercial judgement of individual banks.

Branch licensing policy was not abolished, but banks were given greater operational freedom to open specialised branches, offsite automated teller machines (ATMs) and other non-branch offices. Banks were free to close branches in urban, semi-urban and metropolitan centres and to convert rural branches into satellite offices. In 1994, it was decided to allow banks that fulfilled specified criteria to open branches, *viz.*, net owned funds (NOFs) of ₹ 100 crore, three-year track record of net profits, 8.0 per cent capital adequacy ratio and percentage of gross NPAs to total advances not exceeding 15.0 per cent.

FOREIGN OPERATIONS OF INDIAN BANKS

The committee recommended rationalising the foreign operations of Indian banks. While the SBI's international operations continued and were strengthened, other Indian banks with the significant presence overseas could jointly set up one or more subsidiaries to take over their existing branches abroad. It was also suggested that larger Indian banks could be permitted to acquire smaller banks abroad to intensify their presence. This recommendation was, however, not implemented.

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7. Bank of Tamil Nadu Ltd, Bank of Thanjavur Ltd, Parur Central Bank Ltd, Purbanchal Bank Ltd, Kashinathseth Bank Ltd and Baridoab Bank Ltd.

AUTONOMY MEASURES

The committee recommended that individual banks should be free to make their own recruitment of officers and, wherever appropriate, banks could voluntarily come together for a joint recruitment system for officers. As regards clerical cadres, the system of banking services recruitment boards (BSRBs) in vogue could continue. It was also recommended that guidelines relating to matters of internal administration, such as creation and categorisation of posts, promotion procedures and similar matters, be rescinded.

The Government announced in 1997 a package of measures for PSBs that fulfilled certain criteria, *viz.*, capital adequacy of more than 8.0 per cent, net profit during the past three years, net NPA level below 9.0 per cent and minimum owned funds of ₹ 100 crore. Banks that fulfilled these criteria were allowed to recruit specialised officers and undertake campus recruitment for partly meeting their requirements for probationary officers. The boards of banks were given powers to decide their own policy for creation, abolition, upgrading/modification of posts up to the level of deputy general managers (DGMs).

SUPERVISORY AUTHORITY

The committee recommended that duality of control over the banking system between the Reserve Bank and the Banking Division of the Ministry of Finance should end, and that the Reserve Bank should be the primary agency for regulation. The supervisory control over banks and FIs be hived-off and entrusted to a separate authority to operate as a quasi-autonomous body under the aegis of the Reserve Bank, but separated from other central banking functions of the Reserve Bank. This recommendation was implemented, but in a somewhat different manner. The BFS under the aegis of the Reserve Bank with four members drawn from the Reserve Bank Central Board and serviced by a separate Department of Supervision (DoS) was constituted on November 16, 1994. An expert advisory council was set up to advise the BFS on various policy matters. A clarification on the issue of instituting the BFS revealed that if the BFS were to be constituted outside the Reserve Bank, the process would have entailed a separate legislation providing statutory powers to the former for exercising supervision over banks. After detailed deliberations, the BFS was constituted under the aegis of the Reserve Bank, a position somewhat similar to that in the Bank of England (BoE).[8] On the issue of banking regulation and supervision remaining within the purview of central banks, Shri S.S. Tarapore[9] noted in the year 2000:

> While in some countries regulation/supervision has been separated from the central bank there are some disadvantages in doing so. In a crisis, it is the central bank which has to act and a central bank without hands on experience of banking organisations faces a tremendous handicap. Hence at this stage of our financial development, there is much merit in keeping regulation/ supervision within the RBI.
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> While on the issue of regulation and supervision it is necessary to recognise that the days when more administrative controls would restrict activity are clearly over. Thus regulators and supervisors have to learn to work with, rather than against, market forces.

APPOINTMENT OF CHIEF EXECUTIVE OFFICERS/BOARD MEMBERS

Laying stress on the de-politicisation of appointments for the post of the chief executive offices (CEOs) and board membership of PSBs and FIs, the committee recommended that such appointments could be based on a convention of the Government accepting the recommendations of a group of eminent persons invited by the Governor of the Reserve Bank.

The Government set up an appointments board for board-level appointments in PSBs. The board, which was chaired by the Governor, Reserve Bank made recommendations to the Government for the appointment of chief executives and executive directors in nationalised banks and the chief executives of FIs. The selection by the board was based on professional experience and expertise in the relevant fields. The other members of the board were the Finance Secretary; the Deputy Governor, Reserve Bank; a management expert and a banking expert. The Special Secretary (Banking)/Additional Secretary (Banking) functioned as the member secretary of the board.

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8. Minutes of the first meeting of the Board for Financial Supervision (BFS), December 7, 1994, Reserve Bank of India, Bombay.
9. Tarapore, S.S. (2000). "Financial Economics". *Special Lecture: T.S. Santhanam Chair*. Chennai. June 23.

SECURITIES SCAM: IRREGULARITIES IN SECURITIES TRANSACTIONS (1992)

THE BREAK-OUT

In 1992, the Reserve Bank came to face an unprecedented situation when banks and the brokers colluded in irregular securities transactions. The scam, which broke through a news report in April 1992, involved the siphoning-off of about ₹ 5,000 crore from the financial system through a nexus between stockbrokers and senior executives of the nationalised banking industry. The scam exposed weaknesses in market regulation and securities settlement practices, along with highlighting serious technological gaps.

It was noticed that some banks had been engaged in large-scale transactions in government securities through brokers, in the course of which they violated the Reserve Bank's guidelines issued in July 1991 to refrain from undertaking certain transactions in securities, which were considered irregular. They had also been advised to frame and implement a suitable investment policy to ensure that operations in securities were conducted in accordance with sound and acceptable business practices. While evolving policies, with the approval of the respective boards, banks were required to adhere to the prescribed guidelines. For the purpose of diversification of their portfolio business, the Reserve Bank issued instructions to banks and their subsidiaries to offer portfolio management services to their clients in the form of investment consultancy/ management for a fee for long-term investible funds and provided entirely at the customers' risk. Banks/their subsidiaries were prohibited to accept funds for portfolio management for a period of less than one year. The funds accepted for portfolio management were to be deployed in capital market instruments and were not to be used for lending in the call money/bill market and lending to/placement with corporate bodies. One foreign bank, *viz.*, ANZ Grindlays Bank, was permitted to make portfolio investments in a leasing company up to 30.0 per cent of the paid-up capital of the companies.

It was a different world then in that it posed potential market failures in the absence of appropriate safeguards. At this point SEBI existed, but without any statutory powers; there were no demat accounts and no computers. Bank managers and chief dealers used calculators, while bond traders in the banks checked manuals that looked like logarithmic tables to match the price and yield of a security. According to a former chairman of the SBI, the bank that was badly hit in the scam, one broker had precipitated the problem as most dealers in government banks did not know the difference between current yield and yield to maturity, or the basics of bond mathematics. They were taken for a ride by smarter multinational banks. Money was scarce and a few big brokers could cut favourable deals with banks that financed them.[10]

At this point, the broker responsible for the irregularities thought that he could make it big. Traders followed him blindly, while bankers looked the other way. Companies with IPO issues backed him, and the Reserve Bank, which made single-entry records of banks' bond deals in a ledger, was clueless about what was happening. The brokers used the government bond market to access finance and used the money to buy stocks. The stock buying fuelled the 1992 boom and took share prices to hitherto unseen high levels. As interest rates surged in the inter-bank market, call money rates touched 100.0 per cent. Bond prices fell as a result, and the brokers could buy back bonds at a cheaper price to cover up. Often, borrowing banks, which were not in a position to give securities, issued bankers' receipts (BRs).

The original intention behind issuing the BRs was to enable institutions to sell bonds against a letter of allotment. The practice was misused and irregular deals multiplied with some banks issuing BRs with no proper underlying assets or securities. They thus sold fake securities. There were parallel deals by another set of operators who shorted bonds as well as stocks. Instead of buying stocks with bond market money, they lent the money against shares in *badla* trades to those who wanted to roll over positions. Almost simultaneously, they sold these shares, building a short position to buy back shares at a cheaper price. Both groups with opposite views on the stock market misused the bond market to raise money. The web of transactions in the securities scam involved public sector undertakings (PSUs), banks, scores of operators, foreign lenders, FIs, co-operatives and small banks. This reflected the failure of markets to perform their designated roles, which led to a perverse kind of market integration.[11]

As one bank borrowed money from another against bonds in a transaction where brokers were involved, the cheque was not credited to the borrowing bank's account. Instead, money went to brokers' current

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10. Ghosh, Sugata (2011). "Spook on the Bond Market", *The Economic Times*, Golden Jubilee Special Edition. March 24.

11. Ibid.

accounts. In a way, the brokers were shorting the bond market and going long on stocks. This reflected weaknesses in the internal governance practices in the banks.

THE JANAKIRAMAN COMMITTEE AND FOLLOW-UP

At the instance of the Government, the Reserve Bank set up a committee with the Deputy Governor, Shri R. Janakiraman as chairman on April 30, 1992 to investigate the irregularities in funds management by commercial banks and FIs, particularly in their dealings in government securities, public sector bonds, Unit Trust of India (UTI) units and similar instruments.

The committee submitted three reports dated May 31, July 5 and August 23, 1992 that were immediately released to the public. The committee detected serious deficiencies in the functioning of banks and FIs involved and the absence of necessary internal control in various functions — raising money without the backing of genuine securities, diverting call money funds to the current accounts of chosen brokers, and massive collusion between the concerned officials and brokers in dealings in government securities, public sector bonds and units. The committee listed the devices adopted for diverting funds from the banking system to the individual accounts of the brokers that prima facie constituted evidence of fraudulent misrepresentation. Fund management operations were conducted in gross violation of and with utter disregard to instructions and guidelines issued by the Reserve Bank. The report detailed the breakdown of essential discipline regarding the issue and recording of the BRs, the receipt and delivery of securities, and the receipt and payment for settlement of the transactions. The committee also came across instances where brokers were financed by banks through discounting of bills that were not supported by genuine transactions.

The committee made a series of suggestions for remedial action, which included the introduction of proper control systems, strengthening of monitoring and removing lacunae in the existing systems and procedures so as to avoid the recurrence of such irregularities. In this regard, the Reserve Bank and the Government moved with the single objective of restoring confidence in the country's financial system, both in India and in international markets. It was envisaged that the financial system would become stronger and more efficient by undertaking appropriate follow-up measures in light of this episode.

The Reserve Bank and the Government took several steps to unearth the ramifications of the irregularities, recover the bank dues, punish the guilty and set in motion enduring measures of a preventive nature. They also took follow-up action on several recommendations of the committee. The measures included examining the securities transactions of banks and FIs undertaken in the immediate past, placing the Bank of Karad Ltd under liquidation, placing Bank of Madura Ltd under a Reserve Bank observer, initiating wind-up proceedings against Metropolitan Co-operative Bank Ltd, de-listing three brokers from the Reserve Bank's list of approved brokers, entrusting the entire investigation to the Central Bureau of Investigation (CBI), attaching the properties of those involved, establishing a 'special court' to attend to the cases relating to the securities transactions of banks and FIs, appointing reputed firms of chartered accountants to conduct a special audit of the treasury operations of major players in the market under the provisions of section 30 (1B) of the Banking Regulation (BR) Act, 1949 and issuing special guidelines, including prohibiting inter-bank ready-forward deals in dated securities and approved/trustee securities other than Treasury Bills of all maturities and forbidding double ready-forward deals in government securities including Treasury Bills.

There were other important guidelines issued along the following lines: (i) the prohibition on buy-back deals between banks in other securities, such as PSU bonds and units, was continued; (ii) banks were to ensure that subsidiary general ledger (SGL) transfer forms covering their sale transactions in government/approved securities were issued only if they had sufficient balance in their respective SGL accounts in the Public Debt Offices (PDOs) of the Reserve Bank and in the event SGL transfer forms bounced, banks were liable for penal action; and (iii) banks were not to issue BRs under any circumstances on transactions in government securities for which the SGL facility was available. BRs could be issued in the case of other securities issued for covering transactions relating to either portfolio management scheme clients or other constituents, including brokers.

In its third report submitted on August 23, 1992, the Janakiraman Committee gave the statistics for the securities transaction undertaken by banks and FIs from April 1, 1991. Data were presented as the total value of the transactions — both sales and purchases — put through by banks during the period. Also, the report provided the findings of the scrutiny in respect of 16 banks/FIs, including two co-operative banks. The amount aggregated to ₹ 3,543 crore, after taking into account the value of securities seized by a bank from a broker for the amount of ₹ 350 crore. Though it represented only around 5.0 per cent of the total investment of SCBs in government securities amounting to

₹ 75,945 crore in 1992–93, what was critical was the systemic nature of the risk that would have undermined confidence in the banking system. The government ownership of most of the banks saved the banking system from any serious run on that occasion.

Another aspect brought out by the committee related to transactions that had resulted in problem exposures and the links between banks and the brokers in this regard. The committee also commented extensively on the features observed in operating the portfolio management scheme (PMS) and similar schemes, under which banks and FIs mobilised large sums of money, mainly from PSUs, and pointed out that in handling PMS clients' funds, there were large-scale violations by banks of the Reserve Bank's prohibition on ready-forward deals in PSU bonds and units, which were undertaken primarily to yield guaranteed return to those clients and that these funds seemed to have played a significant role in financing brokers. In this context, the committee highlighted the substantial volume of PSU bonds held by banks either in their own account or on PMS account and the significant erosion in their value due to the fall in market value of the relative bonds. Funds were diverted to brokers involved in these irregular transactions and their associate concerns in several such transactions put through particularly by the National Housing Bank (NHB), State Bank of Saurashtra, SBI and SBICAPS.

In many transactions, the counterparties mentioned in the contracts provided by the concerned broker existed only in name. Further, the facility of netting the contracts afforded by the SBI and SBICAPS to the brokers, the collection and credit of bankers' cheques issued in favour of SBI in the broker's accounts and the issue of bankers' cheques of SBI as per the instructions of the concerned broker had resulted in irregular operations. The irregularities observed by the committee with regard to SBI's transactions with the broker indicated that the investment account in the SBI's books and accounts with the PDO of the Reserve Bank were manipulated to accommodate the broker's transactions. The committee found that the functioning of the PDO of the Reserve Bank required considerable tuning and computerisation to handle the large number of transactions and to provide relevant information to banks for reconciliation at regular intervals to detect fraudulent/irregular transactions.

The committee made the following recommendations in its first interim report: (i) The practice of banks entering into ready-forward and double ready-forward deals with other banks should be restricted to government securities and should be prohibited in other securities, including PSU bonds, units and shares. (ii) Ready-forward and double ready-forward deals should be prohibited under PMS. (iii) The Reserve Bank's prohibition regarding banks entering into buy-back deals with non-bank clients should be strictly enforced. (iv) Banks should be required to formulate internal exposure limits for transactions including limits concerning brokers. (v) Brokers' contract notes should indicate the counterparty and brokerage charged. (vi) When banks act as custodians of brokers' or other parties' securities, the documentation for all transactions effected for such customers should indicate the banks' status. (vii) The prohibition on banks issuing cheques drawn on their account with the Reserve Bank for third-party transactions should be strictly enforced. (viii) Banks' transactions on behalf of their merchant banking subsidiaries should be transparent, giving full details to the subsidiaries. (ix) Banks were required to conduct all their transactions in PSU bonds, units and similar securities through a separate institution like the Stock Holding Corporation of India Ltd (SHCIL), which could be established to obviate the need to issue BRs. (x) Work in the SGL section of the PDO and furnishing information to banks should be speeded up. (xi) The scope of Reserve Bank inspections should be widened, with greater emphasis on treasury transactions, and the on-site inspection should be supplemented by reporting the compliance by banks duly certified by statutory auditors, with prudential and other guidelines. (xii) The Reserve Bank should review the adequacy of the internal audit department of banks. (xiii) There should be a separate audit by the bank's statutory auditors for the portfolio management operations of banks. (xiv) The Reserve Bank's organisational arrangement responsible for market intelligence should be strengthened. (xv) Institutional arrangements for inspection of the NHB should be made.

Apart from accepting these recommendations and initiating follow-up action with utmost speed and urgency, the Reserve Bank took several other steps to avoid a repeat of such irregularities. The scrutiny of the securities transactions of banks/institutions was continued with a view to tracing the flow of funds involving various cheques drawn by banks and the brokers. The Government and the Reserve Bank took serious note of the gross violation of the Reserve Bank guidelines and the failure of internal control systems, as also the flouting of banking norms regarding account payee cheques. The process for fixing responsibility for lapses and fraud was initiated and a CBI enquiry was instituted. The Government initiated steps to ensure that action was taken to recover dues of banking system.

The Governor held a special meeting with the chairmen, managing directors and chief executives of banks and FIs on June 9, 1992 for a detailed discussion on the findings and recommendations of the Janakiraman Committee's first interim report. The meeting took note of the public concern at the revelations in the securities transactions of banks and FIs and emphasised the need to restore public confidence in the functioning of the financial system as quickly as possible. The chief executives informed the Governor that remedial actions had already been initiated to introduce proper internal control systems, strengthen monitoring and remove lacunae in the existing systems and procedures so as to prevent the recurrence of similar lapses. The executives expressed their commitment to implementing guidelines as and when issued by the Reserve Bank based on the Janakiraman Committee report.

The Reserve Bank and the Government took the following steps to unearth the ramifications of the episode and enable appropriate remedial measures: (i) The complete record of securities transactions of all banks and institutions for the past few years were to be examined by the inspecting officers of the Reserve Bank. (ii) Actions were taken to facilitate the investigations by the committee, as also the CBI, which was asked by the Government to investigate the matter. (iii) The chairman and two directors of the Bank of Karad Ltd, which was involved in the case, were served with show-cause notices by the Reserve Bank, asking them to step down; subsequently, to protect the interests of the bank's depositors, the Bank of Karad Ltd was put under liquidation, and a liquidator was appointed to take care of the assets of the bank. The Bank of Karad Ltd, a private bank with an asset base of ₹ 80 crore, had an exposure of ₹ 753 crore on account of issuing BRs without any backing or against non-existent securities. Any option other than liquidation (*i.e.*, amalgamation/merger or moratorium) was not considered feasible in the circumstances. The decision to place the bank in liquidation was also in the best interests of small depositors. An amalgamation/merger with some other bank would have meant that the acquiring bank would have to take on a liability of ₹ 794 crore. A moratorium would have made it possible for institutional creditors to move their preference claim against the banks' assets to the detriment of the interests of a large number of small depositors even to get their deposit insurance money released to the extent of ₹ 30,000 each. On the recommendations of the Reserve Bank, the Deposit Insurance and Credit Guarantee Corporation (DICGC) was directed to release necessary funds against their insurance liabilities. (iv) The operations of the Bank of

Madura Ltd were investigated and an observer from the Reserve Bank was appointed. (v) The Reserve Bank had recommended to the Government of Maharashtra to direct the Registrar of Co-operative Societies in the state to proceed with winding-up of the Metropolitan Co-operative Bank, which was involved in the securities malpractices. (vi) To safeguard the interests of the banks/institutions and speed up the process of recovery of their dues, the Government promulgated an ordinance to attach the properties of all those involved in the malpractices and place them with the custodian appointed by the Government. (vii) The Reserve Bank de-listed four brokers from the Bank's list of approved brokers. (viii) The Reserve Bank directed SBI and ANZ Grindlays Bank Ltd, to make provisions for squaring up their obligations to the NHB. Both the SBI and ANZ Grindlays accordingly settled the claims. (ix) The Government set up a 'special court' to attend to the cases relating to the securities transactions of banks/institutions.

The Reserve Bank took up the work of computerising the SGL section of PDO on a priority basis. Computerisation of SGL transactions was operationalised in 1992–93 and SGL transactions including interest calculation for both central and the state government loans were undertaken at Bombay (now Mumbai), Madras (now Chennai), Calcutta (now Kolkata), New Delhi, Ahmedabad, Bangalore (now Bengaluru), Hyderabad and Kanpur. Software packages were developed and made operational for processing the auction of 91-day Treasury Bills and open market operations (OMOs) by the Internal Debt Management Cell (IDMC). The system provided for prompt and immediate processing of SGL transfer forms and the despatch of certain essential statements to the individual SGL account holders.

A committee under the chairmanship of Shri S.S. Nadkarni, chairman of IDBI was appointed by the Reserve Bank to suggest modalities for setting-up a depository along the lines of the SHCIL for banks and institutions to trade in units and PSU bonds and the committee's report received on August 8, 1992 was considered. The Reserve Bank also appointed experienced firms of chartered accountants to verify the securities transactions of several banks/institutions, including subsidiaries of banks, mutual funds and four foreign banks.

The inspection procedure of the Reserve Bank's Department of Banking Operations and Development (DBOD) was modified to allow detailed annual inspection of all banks with a focus on financial evaluation. The treasury operations of banks were specifically looked into and at more regular intervals. The role of the audits was enlarged in the Reserve Bank's supervisory process with immediate effect.

The committee presented its fourth report in March 1993 and the fifth and the sixth (final) reports in April 1993. While the fourth and fifth reports covered specific banks and FIs, the final report set out the overall findings. The reports contained detailed findings for 32 banks and institutions, where the irregularities were serious. The findings reiterated the nexus between brokers/FIs and banks and the fact that banks and their subsidiaries covered in the reports consciously sought to circumvent the Reserve Bank's guidelines on PMS to facilitate brokers/financial companies access large funds for use in the stock market for huge profits.

The reports identified four key factors in the perpetration of irregularities: (i) improper and indiscriminate use of BRs; (ii) brokers increasingly dealing on their own accounts and taking positions; (iii) banks' failure to periodically reconcile investments; and (iv) complete breakdown of internal control system in several banks. The committee observed that as a consequence of these irregularities, the investment portfolios of banks had become fragile and weak. The committee's final estimate of the gross problem exposure of banks was of the order of ₹ 4,024 crore in 1992–93, which was 31.6 per cent of the total assets as on March 19, 1993 of all scheduled banks.

In addition to the existence of weak internal control systems in banks, and lacunae in the supervisory mechanism, the committee pointed to the lack of specialised knowledge of the sophisticated electronic data processing systems used by foreign banks, the absence of sound market intelligence system, the overstretched resources of the supervisory system due to stipulation about coverage of a large number of branches during the inspections, and the insufficient importance given to treasury functions during inspections as some of the main reasons for the delay in detecting the widespread irregularities. Commenting on the role of external auditors, the committee, *inter alia*, observed that the auditors did not examine all the transactions and did not perceive this as part of their duty to examine the violations of the Reserve Bank's guidelines. The committee further observed that the irregularities could possibly have been detected earlier, if there had been greater co-ordination among the different controlling agencies.

Banks were asked to undertake an immediate review of the adequacy of their internal audit department. Modifications were also made in the inspection system of the Reserve Bank, providing for more detailed annual financial inspection of banks and the appointment of experienced firms of chartered accountants to verify the securities transactions of some banks; a ceiling of 5.0 per cent of total transactions put through the brokers was placed on the transactions through each approved broker in a year. Banks were advised to place adequate systems in place for undertaking security transactions so that irregularities of the nature pointed out by the committee did not recur. Other measures included setting-up an electronics clearance settlement and depository (ECSD) system. A group set up in the Reserve Bank was entrusted to guide and co-ordinate the work of establishing an electronic system for clearance and settlement of trading in public sector bonds and units by the SHCIL and the UTI.

A central depository for all securities in which banks normally dealt needed to be set up. This was in line with the recommendation of the Nadkarni Committee on trading in public sector bonds and units of mutual funds. Regional offices of the Reserve Bank were asked to look into the compliance aspect *vis-a-vis* major and important instructions/ directives of the Reserve Bank during the course of inspection and were also entrusted to scrutinise compliance certificates submitted by banks at prescribed intervals.

The SGL operation in the PDO at Bombay, Calcutta, New Delhi, Madras, Hyderabad and Bangalore were computerised. The expertise of retired senior government officials was drawn on by appointing them as special officers to fix responsibility for the irregularities in some banks; a detailed circular was issued by the Reserve Bank to all commercial banks for suitably regulating their investment transactions. While exhorting the FIs to strictly follow the spirit of the instructions issued to commercial banks, they were also advised to place before their respective boards of directors, a comprehensive note regarding the policies and practices followed in their respective institutions for ensuring that the transactions were handled and accounted for in a transparent and accurate manner.

At the instance of the Reserve Bank, banks in which serious irregularities had occurred lodged criminal complaints with the CBI and simultaneously initiated departmental proceedings against the errant officials. By the end of June 1994, the reports submitted by four retired senior officials of the seven appointed as special officers in six subsidiaries of five banks were examined and were sent to the Government with the recommendations of the Reserve Bank. The progress with regard to the action taken by banks and FIs against erring officials was monitored by the Reserve Bank on a quarterly basis and communicated to the Government periodically.

The Reserve Bank carried out a special audit of 10 banks with irregular securities transactions. The audit firms, against whom adverse comments appeared in the report of the Janakiraman Committee, continued to be denied bank audit assignments for the second year, *i.e.,* 1993–94. Following the submission of further reports by the committee, 17 more firms were denied bank audit assignments for the year 1993–94. Besides, the Institute of Chartered Accountants of India (ICAI) was requested to take suitable disciplinary action against the erring auditors. In the case of foreign banks, the irregularities in securities transactions were kept in view while permitting them to open branches in India and before they remitted profits.

In order to trace the end-use of funds raised by brokers during the securities irregularities and to recover the assets created from these funds, the Reserve Bank, in consultation with the Government, constituted an inter-disciplinary group (IDG) under the chairmanship of the custodian with representatives from the Reserve Bank, the CBI, the Income Tax Department and the Enforcement Directorate. The IDG prepared a draft interim report, which was submitted on June 28, 1994 to the Government and the Reserve Bank.

After the Joint Parliamentary Committee (JPC) was set up in August 1992, the committee called the Deputy Governor of the Reserve Bank for a briefing in the matter. The Reserve Bank emphasised the issues involved and stated that while such irregularities could not be condoned, these irregularities occurred in the context of very large pre-emptions of banks' resources through CRR and SLR and regulations on interest rates. There were, however, undoubtedly certain lacunae in the monitoring system and market information collection mechanism. Subsequently, when the issue of imposing penalties for these irregularities came up, notwithstanding the fears about prolonged litigation, the Reserve Bank commissioned detailed work on the extent of the irregularities and undertook to oversee the entire process to ensure that there was no slackness on its own part in the exercise. Further, the Bank went ahead with imposing penalties, which all banks paid-up without demur and there was no recourse to any litigation.[12]

12. Tarapore, S.S. (2011). "Episodes from Monetary and Other Financial Policies (1982–1997): An Anecdotal Presentation", in Sameer Kochhar (ed.), *Growth and Finance: Essays in Honour of C. Rangarajan*. New Delhi: Academic Foundation.

PENALTIES FOR SECURITIES IRREGULARITIES

After considering the issues and taking into account the gravity of the irregularities committed by banks in respect of PMS/ready-forward transactions, the Reserve Bank issued a show-cause notice on July 25,1994 to banks about why the funds accepted by them under PMS and deployed in violation of the Reserve Bank's instructions should not be treated as deposits for the purpose of determining their net demand and time liabilities (NDTL) for arriving at the minimum average daily cash balances to be maintained by them with the Reserve Bank under section 42 of the Reserve Bank of India (RBI) Act, 1934. Similarly, in the case of banks that had undertaken ready-forward deals in PSU bonds and units of the UTI and also ready-forward deals in government and other approved securities with non-bank clients, the Reserve Bank asked the banks why the funds so obtained should not be treated as 'borrowings' for the purpose of determining NDTL. On September 26, 1994, the Bank issued a show-cause notice to one more PSB for violation of ready-forward deals. The aggregate amount of interest recovered as well as the penal interest levied, for which show-cause notices were issued, amounted to around ₹ 146 crore. All the 21 banks paid the penalties.

In the case of 35 SCBs, the Reserve Bank decided to withdraw with effect from August 6, 1994, and in respect of two more banks with effect from October 1, 1994, the exemption given in April 1992 under section 42(7) of the RBI Act, 1934 from maintenance of 10.0 per cent incremental cash reserve ratio.

THE JOINT PARLIAMENTARY COMMITTEE

A 30-member JPC comprising members from both Houses of Parliament was constituted in August 1992 with the following terms of reference: (i) to go into the irregularities and fraudulent manipulations in all its aspects and ramifications in transactions relating to securities, shares, bonds and other financial instruments and the role of banks, stock exchanges, FIs and PSUs in transactions relating thereto, which had or might come to light; (ii) to fix the responsibilities of the persons, institutions or authorities in respect of such transactions; (iii) to identify the misuse, if any, of and the failures/inadequacies in the control mechanism and the supervisory mechanism; (iv) to make recommendations for safeguards and improvement in the system to eliminate such failures and occurrences in future; and (v) to make appropriate recommendations regarding policies and regulations to be followed.

The JPC, in its report submitted in December 1993, identified non-observance of the prescribed rules and procedures as the major factor for the irregularities, with critical comments on the mode of functioning of banks, both Indian and foreign, the brokers, PSUs and ministries and the failure of the supervisory authorities. The committee heavily drew upon the findings of the Janakiraman Committee.

GOVERNOR'S DEPOSITION BEFORE THE JPC

The Reserve Bank Governor deposed before the JPC on November 26 and 27, 1992. The deposition began with a *suo moto* statement by the Governor giving his assessment of the irregularities in the securities transactions and the role played by the Reserve Bank in unearthing it. He enunciated his views on the supervisory role of the Reserve Bank and suggested an agenda for strengthening the Bank's supervisory functions in view of the experiences. In recognition of the need for a self-review, the Governor placed on record the Reserve Bank's ongoing efforts and clarified that restructuring required legislative changes and had to meet parliamentary requirements before implementation.

The Governor submitted that it was the supervisory operations undertaken by the Reserve Bank that broke the chain of fraudulent transactions in the banking system; the Bank took quick action to unravel the irregularities in the securities market and found out the *modus operandi* in respect of the concerned bank and its subsidiaries. It was the Reserve Bank inspecting officials who alerted the system to the abuse of BRs and issued instructions in July 1991 that pointed out the absence of reconciliation of the SBI investment accounts with the PDO and sought for the reconciled accounts as on March 31, 1992. The Reserve Bank supervisors alerted the chairman of the SBI on March 13, 1992 to the possibility of irregularities in the account of a broker Harshad Mehta and the need to monitor the account.

A word of caution was passed on to banks and institutions regarding the impact of the stock market boom. The irregularities committed by M/s Fairgrowth Financial Services Ltd (FFSL) were also unearthed by the Reserve Bank officials who zeroed in on the forgery of documents by the FFSL. The Reserve Bank speeded up the inter-bank reconciliation of bank receipts, which helped to bring out the large irregularities at the Standard Chartered Bank and the Canbank Financial Services Ltd (Canfina). It was emphasised that a strong supervisory system must be accompanied by continual improvement in bank management, internal controls and audit.

Further, the quality and efficiency of bank managers must be constantly upgraded. Failure to observe the professional, prudential and supervisory guidelines, it was felt, needed to be dealt with firmly.

Submitting on weaknesses in the system, the Governor emphasised that the Reserve Bank did not and in fact should not continually monitor the internal management and operations of bank branches and FIs. This responsibility primarily was vested with the top-level executives of these institutions. While external inspection and audit did expose violations of regulations and policies, it was beyond even the most efficient supervisory organisation for continuous policing of the follow-up to policy instructions. Changes in terms of the supervisory skills and techniques were not fully commensurate with the increased complexity of the markets. The disclosure that top management of any of the affected banks was not aware of the activities of the funds management division under their charge was a pointer to the laxity in approach in this vital area. The source of profits arising from funds management was not being scrutinised carefully by the managements of the banks. The Reserve Bank's instructions were also being flouted.

Referring to the question whether the Reserve Bank was alert to the movements in the stock market, the Governor said that the Reserve Bank was closely monitoring the stock market indices and modulating its actions accordingly to restrict speculative market activities that could have adverse consequences for unsuspecting investors. Securities and Exchange Board of India (SEBI), which was the primary agency for the regulation and control of the stock market, was empowered to exercise fuller control and the Reserve Bank, as the monetary authority, had always acted in close concert with SEBI.

Dwelling on the policy reforms, the Governor emphasised transparency with no concealing or window dressing. The inspection and audit systems of banks and FIs were expected to be made thorough and more systematic. A focus was required on systems becoming sensitive to potential fraud and taking immediate action. Supervision was anticipated to be highly professional and guided by a group of people with experience and skill. The Governor explained the Reserve Bank's supervisory methods and the steps required to improve supervisory skills and institutional reforms at the Reserve Bank. Enumerating the details of the important committees set up as a follow-up, the Governor stated that a committee under the chairmanship of Shri S. Padmanabhan to review the system of inspection at the Reserve Bank and to identify its defects and inadequacies had been constituted. A committee was also appointed under the Deputy Governor, Shri A. Ghosh to suggest a system of preventing fraud in banks. Matters relating to urban co-operative banks were comprehensively reviewed by Shri S.S. Marathe.

In conclusion, the Governor stated that the Reserve Bank was a strong pillar of the financial system of the country. He explained the significant role played by the officials of the Reserve Bank during the BoP crisis of 1991. During the period of irregularities in securities transactions, the Bank was able to avert panic in the banking system. He felt that it was his duty to appreciate the arduous work done by the officers and staff, but also recognised that, like all human institutions, the Reserve Bank needed critical evaluation and re-organisation.

INVOLVEMENT OF NBFCs

While dealing with irregularities in the securities transactions of NBFCs, the JPC had observed that certain non-bank subsidiaries of major PSBs had accepted sizeable deposits as inter-corporate placements from private and public sector companies at various rates of interest and for varying periods by entering into 'ready-forward sale' deals with these corporate bodies purporting to cover the sale of long-term investments. These non-bank subsidiaries also indulged in irregular transactions through imprudent investment of funds in the securities market under the PMS on the stock exchanges through brokers. The major observations of the committee were:[13]

> Scrutiny of various transactions in various banks has revealed that the non-banking subsidiaries of major public sector banks such as SBI Capital Markets Limited, Canbank Financial Services Ltd., Allbank Finance Ltd., Andhra Bank Financial Services Ltd. etc. indulged in irregular transactions and in imprudent investment of funds into the security market under the portfolio management scheme and in unauthorised investments on the stock exchanges through brokers even though these companies were incorporated essentially for undertaking Merchant Banking and such other activities. In a large measure they adopted portfolio management of temporary surplus funds of PSUs and other larger corporate clients of their parent banks. These subsidiary companies

13. At serial no. 15 of the chapter titled: Observation/conclusion/recommendations of the report.

> violated PMS guidelines of the Reserve Bank in various ways and almost as of routine. The funds so deployed became one of the principal sources for fuelling the stock market. Large volumes of unauthorised investment transactions were undertaken by these NBFCs through repos, BRs, *etc.* All these investment operations of public funds were not supervised adequately and there was absence of suitable policies for investments. The transactions also revealed nexus with select brokers through whom sizeable transactions were put through. In many cases brokerage was not also being paid as the deals were at the instance of brokers and for their benefit. These NBFCs had the advantage of the names of their parent banks to attract deposit funds and at the same time offered high returns. Each company devised its own scheme to attract funds. Competitive and wholly unverifiable claims about returns were advertised to attract investments. This gross irresponsibility was not checked either by the parent bank, who in fact encouraged it, or by the government, who in the ultimate are the trustees of this public asset.

The committee's observations on certain non-bank subsidiaries of banks were: SBICAPS violated all established norms and that it was with the knowledge of the parent bank that the company parted with substantial funds in favour of the broker Harshad Mehta and it did so without any security. Canfina took the role of 'market maker' and handled 75.0 per cent of the total PSU bonds issued. It also shifted its activities to 'portfolio management' and 'corporate investment advisory services'. Canfina had been violating the Reserve Bank guidelines on PMS for a long time. There was practically no internal control machinery to check irregularities. It was observed that the parent bank had not conducted any inspection or periodic scrutiny of the affairs of Canfina.

The bulk of funds collected by Andhra Bank Financial Services Ltd (ABFSL) were from PSUs. Thus, as on March 31, 1992, of the total deposits collected by way of 'inter-corporate' and 'security transactions' at over ₹ 500 crore, an amount of ₹ 350 crore was from PSU clients. A substantial portion of these funds raised was passed on to three parties, *viz.*, FFSL, H. P. Dalal and Standard Chartered Bank, ostensibly under ready-forward transactions and without complying with the Reserve Bank guidelines in this respect. Thus, the company had merely acted as a conduit for the diversion of funds from public sector enterprises to private sector companies and foreign banks, thus circumventing the investment guidelines for PSUs that prohibited their investing/depositing money with private sector finance companies. Allbank Finance Ltd had functioned mostly for the benefit of M/s V.B. Desai and, in contravention of all principles of safety of funds, passed on its customers' deposits to the broker for investment and speculative deals in the share market.

With a view to affix the responsibility of the top management, including the chairmen of the subsidiaries, for irregularities in securities transactions, special officers were appointed by the Reserve Bank. The reports of the special officers in respect of SBICAPS, ABFSL, Canfina, Allbank Finance Ltd and BoI Finance Ltd, which brought out the lapses on the part of the top management of the subsidiaries, were sent by the Government to the CBI for consideration.

TABLE 17.1

Officials Against Whom Action Taken by Banks

Subsidiary	*No. of Officials*
SBICAPS	11
ABFSL	7
Canfina/Canbank Mutual Fund (CBMF)	15
BoI Finance Ltd/BoI Mutual Fund	11

Source: Reserve Bank of India, internal documents and notes.

Departmental action was also initiated or taken by the respective parent banks against the officials involved in the irregularities (Table 17.1). The departmental action involved dismissal, compulsory retirement or termination. In the case of Allbank Finance Ltd, the case was referred to the CBI for investigation.

The committee concluded that the control mechanism in the parent banks to monitor the activities of the subsidiaries was inadequate. Several measures were introduced for effective control over the activities of the subsidiaries as discussed below.

From December 1992, SEBI was empowered to inspect banking subsidiaries that undertook merchant banking activities. The Reserve Bank also conducted inspection of the subsidiaries of banks. The Bank took steps to ensure adequate supervision of these institutions by the banks themselves through a regular review by the board of the working of the subsidiaries and their periodic inspection by the parent bank/outside agencies, if necessary.

The lacunae highlighted by the scam regarding non-adherence to the guidelines issued by the Reserve Bank were rectified and comprehensive guidelines were issued to commercial banks relating to securities transactions that covered prudential investment policy, prohibition of buy-back deals, use of SGLs/BRs, internal control systems, accounting standards, submission of reports to the Reserve Bank regarding monthly concurrent audit of treasury transactions, half-yearly review of investments and half-yearly certificate of compliance with Reserve Bank instructions. Statutory auditors' certificates about compliance in key areas were made applicable, *mutatis mutandis* to subsidiaries/mutual funds established by banks.

Banks were also advised that when they exercised custodial functions on behalf of their merchant banking subsidiaries, such functions were subject to the same procedures and safeguards as other constituents.

FFSL and its associate companies were issued directives[14] that prohibited them from undertaking deposit acceptance, borrowing and investments, and practically froze their functions till further orders. The company was directed to report compliance on a daily basis.

FURTHER FOLLOW-UP MEASURES

Pursuant to the recommendations of both the Janakiraman Committee and the JPC, the Reserve Bank initiated several measures to prevent the recurrence of such irregularities. Detailed instructions that covered several areas, including norms for the proper conduct of investment transactions, were issued that comprised: (i) framing of investment policy; (ii) restrictions on the use of BRs; (iii) use of SGL transfer forms, including penalty provisions if they bounced; (iv) restricting ready-forward deals to Treasury Bills and certain specified government securities among banks; (v) conduct of business through brokers, including prescribing a ceiling of 5.0 per cent per broker on the business routed through them annually; (vi) internal control measures such as concurrent audit of investment transactions; (vii) separate audit of PMS transactions; (viii) capital adequacy norms and accounting standards for FIs as well as NBFCs; and (ix) exercising precautions in the sphere of bills discounting and rediscounting. In particular, during the year 1993–94, banks were advised

14. Reserve Bank of India, letter no DFC (COC) No. 17/169-91/92 dated July 1, 1992.

not to restart or introduce any new PMS or similar schemes without obtaining specific prior approval from the Reserve Bank. Further, banks were advised to introduce a system of concurrent audit covering at least 50.0 per cent of the business operations during the year 1993–94. For this purpose, a note broadly defining the concepts of concurrent audit, scope, coverage of business/branches for the audit and reporting system was circulated to banks for their reference.

Considering the lapses in the observance of the regulatory framework, on July 25, 1994 the Reserve Bank withdrew the exemption from maintenance of 10.0 per cent incremental CRR for 35 SCBs and for two more banks on September 26, 1994. The Bank simultaneously issued show-cause notices for levy of penalty on 20 such banks and on one more bank on September 26, 1994 for irregularities in PMS/ready-forward transactions and also for shortfalls in maintaining minimum average daily cash balances with the Reserve Bank.

The manner in which irregularities committed by banks should be dealt with came up for discussion at the meetings of Central Board of the Reserve Bank. The BR Act, 1949 provided for levying only nominal penalties by the Reserve Bank for violation of its directives. The Act had to be amended to penalise the errant banks and the Reserve Bank took recourse to the provisions relating to the maintenance of CRR in the RBI Act, 1934 to impose penalties, as major irregularities committed by banks related to these areas. These were the issues commented upon by the Janakiraman Committee and also the JPC. These banks were, therefore, asked in July 1994 to show why the funds accepted and deployed by them under PMS should not be treated as 'deposits' and the amount received by them as sales proceeds under ready-forward deals as 'borrowings' and included in the demand and time liabilities on reporting Fridays for calculating the minimum average daily balance for the minimum balance commencing from August 9, 1991 to June 26, 1992. Show-cause notices were issued to 21 banks for payment of penalty for an aggregate amount of ₹ 146 crore.

In addition to the above penal action, the exemption given to SCBs for maintenance of 10.0 per cent incremental CRR was withdrawn in respect of 37 banks for lapses in observing the regulatory framework.

Several measures, such as reduction in the validity period of BRs from 30 days to 15 days, specifying penalties for misuse of the BR facility, introduction of D*v*P system and appointment of audit committee of boards in banks were introduced by the Reserve Bank to strengthen the supervisory mechanism in banks and improve their overall functioning.

Administrative action was initiated based on a preliminary investigation against officials directly or indirectly responsible for the irregularities that were committed. The chairman of the NHB resigned; the chairmen of UCO Bank and SBI were asked to proceed on leave as also the deputy managing director of the SBI and the managing director of Canbank Financial Services Ltd. The chairman, Bank of Karad and two directors on its board were removed, while the board of Metropolitan Co-operative Bank was superseded; subsequently, these two banks were taken into liquidation. The services of the chairman of UCO Bank were terminated.

The Reserve Bank issued fresh instructions to regulate transactions in securities by banks. Treasury transactions were now subject to a concurrent audit by internal auditors and the findings were to be put up to the chairman and managing director (CMD) once every month. It was decided that a special cell in the Reserve Bank would also scrutinise these reports.

The Reserve Bank modified its inspection procedures to provide for detailed annual inspection of all banks with a focus on financial evaluation. The absence of computerisation and reliance on manual processing in the PDO was one factor that made it difficult for banks to set up effective internal control systems to supervise trading in government securities. A process of computerisation of the PDO was initiated. Certain officials in the PDO were suspended.

RELATED QUESTIONS

Questions were raised about whether the Reserve Bank, which was responsible for supervision of banks, could have been more vigilant. There were references in the media to a circular issued by the Reserve Bank in July 1991 that laid down norms for banks dealing in securities transactions. The press reports emphasised that the Reserve Bank should have been more cautious in pursuing compliance. The fact was that the Reserve Bank had directed banks to submit compliance reports, and also received compliance reports from most banks indicating that their procedures were in line with the July circular. Subsequent developments, however, showed that this was not the case.

The Reserve Bank could not undertake micro-management in all the cases, and it was only in identified problem cases that detailed scrutiny, with onsite inspection, was undertaken. The Reserve Bank, after the detection of fraudulent deals, undertook inspection of Bank of Karad, Andhra Bank and Bank of Madura, and these investigations indicated evidence of continuing irregularities. Action against these banks was being contemplated when the wider dimensions of the scam became apparent. However, it was true that even these enquiries did not reveal the full extent of the problems in Bank of Karad, which surfaced only later when the Reserve Bank carried out inter-bank reconciliation.

The irregularities and fraud that came to light were, contrary to the general perception, not attributable to financial liberalisation. They had surfaced under a regime of well regulated banking activity. Over-regulation of interest rates and excessive pre-emption of bank resources into low interest assets had contributed to some extent to the bank managements looking at non-traditional activities to bolster profits. Measures, therefore, were initiated by the Reserve Bank in consultation with the Government to allow flexibility in determining interest rates and reducing the statutory pre-emptions of banks' resources.

STRENGTHENING MARKET INTELLIGENCE IN THE AFTERMATH OF THE SECURITIES SCAM

As a sequel to the unearthing of irregularities and fraudulent transactions in the banking system in the early 1990s, the Government conveyed to the Reserve Bank its concerns about the need to strengthen the system in three areas to ensure that such events did not recur. Shri Montek Singh Ahluwalia, Secretary, Department of Economic Affairs, in a letter to the Governor dated July 14, 1992 identified these areas, namely, market intelligence, the mechanism of bills discounting and manipulation in foreign exchange transactions.

The Government stressed that apart from overall supervision through a system of rules and guidelines with periodic inspections, a more systematic method of gathering market intelligence was needed. It was expected to serve as an early warning system, alerting authorities to the possibility of misuse within the system. The Government suggested setting-up the banking intelligence cell in the Reserve Bank.

The Government's perception was that even though the guidelines issued by the Reserve Bank were clear that bills should be discounted only against genuine trade transactions, industrial companies were misusing this mechanism to raise fictitious bills in order to obtain short-term liquidity from the banking system. These accommodation bills were particularly easy to draw between companies within the same group and represented no substantive trade transactions. The Government strongly felt that the credibility of the banking system would be considerably shaken if companies defaulted when payments of bills to banks became due and if it was subsequently found that the bills were not genuine trade bills. The imposition of deterrent penalties on banks that failed to identify the underlying trade transactions before agreeing to discount bills was mooted. Spot checks were also envisaged on banks that liberally provided such rediscounting facilities. While conceding that there was a danger that banks might become more risk-averse in discounting of bills, the ministry felt that this was all for the good, as it would lead to disappearance of fraudulent transactions in the bills market.

Next, the area of foreign exchange transactions was accorded special attention. According to informal reports received by the Government, extensive manipulation took place in the foreign exchange dealing rooms of banks. This occurred because arbitrage possibilities opened up due to exchange rate fluctuations in a day's trading, which enabled banks to take the most favourable exchange rate from their point of view in converting funds across currencies. The Government was of the view that the solution lay in ensuring complete automation of dealing rooms with a mandatory stipulation that a continuous record was kept of transactions and exchange rates through the day, with information recorded on a magnetic tape or a disc that the Reserve Bank could access. "Unless such tough signals are sent to banks, it is likely that the existing permissiveness in their attitudes would continue and dubious transactions may easily be accommodated", was the prognosis of the finance ministry. The letter added that these comments and suggestions were submitted by way of communicating perceptions that had surfaced in their internal discussions. Further, the Finance Minister was kept informed that the Reserve Bank would be advised on these issues.

The Reserve Bank acted with alacrity. The Governor, in his letter dated July 28, 1992, conveyed his concurrence with the contents of the letter and outlined the actions taken. A decision was taken to set up a market intelligence cell (MIC) to go beyond the developments in banking and extend its reach to stock exchanges. Even though the Reserve Bank had impressed upon banks the need to ensure that there was an underlying trade transaction behind the bills rediscounted, to put the issue beyond doubt, instructions were issued prohibiting the discounting of accommodation bills in a circular to commercial banks dated July 27, 1992. The Reserve Bank shared the Government's apprehensions in foreign exchange transactions, and hastened to assure that while detailed guidelines existed for dealing room operations, the Bank was examining the issue of mandatory prescriptions relating to maintenance of a continuous record of transactions and exchange rates during the day, and was also contemplating imposition of severe penalties on those found engaged in dubious transactions.

MAJOR DEVELOPMENTS IN BANKING POLICY AND OPERATIONS: 1990–1997

The reforms process for the banking sector included, *inter alia* — monetary and credit policy issues (dealt with elsewhere in this volume) as well as institutional matters, such as introducing competition through entry of new banks, mergers, improvising supervisory and surveillance mechanisms and in house strengthening of banks. The measures initiated touched upon several areas, such as, strengthening and consolidating banks, prescribing prudential norms relating to assets classification and income recognition, adequate provisioning for bad and doubtful assets, introducing a system of capital to risk-weighted assets ratio for banks and establishing a strong supervisory system. The reforms were necessitated by the fact that over time Indian banks had developed many stresses and strains and had to be revitalised. There was, however, opposition to the reforms and, in particular, to the privatisation of nationalised banks.

The implementation of prudential norms and guidelines constituted a significant step towards introducing transparency in accounting practices and bringing the norms up to international standards. This was expected to help build confidence in the efficiency of the Indian financial system, improve the competitive position of the banking industry and enhance public accountability. All these were, in turn, expected to significantly improve the functioning of the banking system.

Prior to initiation of the reforms process, several external and internal factors impinged on the functioning of the banking system. External factors broadly related to the high levels of CRR, SLR and the administered structure of interest rates. Reduction in the CRR and SLR requirements and simplification of the administered structure of interest rates were some of the measures successfully implemented to address the external issues. Among internal factors, the introduction of prudential norms relating to income recognition, asset classification and capital adequacy worked to assure the viability of the banking system. These norms not only ensured that the balance sheets and income and expenditure statements provided a true reflection of the health of banks, but also acted as a tool of financial discipline and compelled banks to look more carefully at the quality of loan assets as well as the risks attached to lending. The policies also ensured that banks conformed to international accounting standards and got their due place and recognition in the global financial market. Despite severe budgetary constraints, the Government extended capital support to banks to enable them to conform to the capital adequacy requirements.

The major task before the banks was to improve their financial performance and bring about a change in the mindset. The banks in the early 1990s were classified into three categories based on their performance, *viz.*, banks that had positive operating profits and positive net profits after provisioning, banks that had positive operating profits but negative net profits after provisioning, and banks that had negative operating profits and negative net profits. Improving the profitability was a major issue and it required special emphasis. The major drag on the profitability of Indian banks was the presence of a high level of non-performing loans (NPLs). The situation warranted that banks should cut costs, improve productivity and ensure better recovery of loans, which was possible only if they became competitive, notwithstanding the fact that they had to drastically bring down the large amount of NPAs. Against this backdrop, a need was felt to set up debt recovery tribunals and special recovery branches to concentrate on bad loans and their recoveries.

As part of the additional capital made available to PSBs, banks had to draw a memorandum of understanding with the Reserve Bank indicating their performance criteria and commitment to achieve the business targets. This imposed a greater sense of discipline among banks. Since then, banks made significant progress year after year in the areas of computerisation, achievement of priority sector targets, reduction in NPAs, and improvement in operating results. It also ensured that banks complied with the requirement of full provisioning against NPAs and did not allow accumulation of NPAs in their over-enthusiasm to improve net margins by taking risky decisions or even becoming prone to concentrating loan portfolios among a few borrowers in certain sectors. Steps were initiated for progressive deregulation of interest rates to evolve a diversified competitive market place, move towards market-determined exchange rate mechanism and introduce technological changes in line with the advances in information technology.

The approach to lending was also liberalised, although the directed credit and interest rate administration remained largely untouched. Industrial sector credit, where the banks could make some margin of profit, was under the discipline of the credit authorisation scheme (CAS), which was replaced later by a credit monitoring arrangement (CMA); it got a boost in the later part of the 1980s. This led to some indiscriminate lending by banks. The initial liberalisation extended by the Reserve Bank and the Government was not without some adverse impact on the lending portfolio, but these measures paved the way for rapid expansion of the industrial sector.

Banks were required to equip themselves to operate in a more deregulated interest rate environment. This implied that they had to fix the rate on deposits and loans depending on overall liquidity conditions and demand factors. Banks were given the freedom to fix the rates on deposits, subject to a maximum. This forced banks to determine, on their own, the rate of interest on deposits of different maturities below three years, which enabled some market leaders to emerge. Similarly, on the lending side, there was only the prescription of a minimum lending rate. Over the years, banks developed appropriate criteria for determining the rate to be charged to individual borrowers. They also learnt in the process, the limitations of this freedom in a competitive market and the demand for and pressures on the available resources.

BRANCH LICENSING POLICY

After the branch licensing policy of 1985–1990 came to an end in March 1990, the Reserve Bank did not frame a new policy. Instead it issued policy guidelines to enable banks to take up need-based expansion of branches. The validity period of the licenses issued under the earlier policy in rural/semi-urban areas, which could not be utilised before March 31, 1990 was extended by a year to March 31, 1991 and further to March 31, 1992 to enable banks to fully utilise their pending licenses. Considering that the objective of providing adequate infrastructure throughout the country, particularly in rural areas, was broadly achieved with the completion of the branch expansion policy for the period 1985–1990, the Reserve Bank decided to confer greater freedom on banks to rationalise their branch network by relocating branches, opening specialised branches, spinning-off business at their locations, setting-up controlling offices/administrative units and establishing extension counters. Banks were permitted to close down branches other than those in rural areas, as well as swap branches that were not remunerative or those in remote areas, with a view to protecting the financial viability of banks.

As per the new guidelines: (i) no fresh branches in rural areas were to be considered in cases where the service area allocated to a particular branch was unmanageable and where there was a large spatial gap or if the increased volume of business warranted opening an additional branch; (ii) in semi-urban centres, branch expansion was to be considered on the basis of well-established need, depending upon growth in trade and industry, increase in other economic activities and the viability of the proposed branch; (iii) the criteria for industrial/project areas were clearly spelt out, wherein the new branches were to be considered with reference to the immediate need and outlay on projects; and (iv) in urban and metropolitan/port town centres, the identification of unbanked/under-banked localities was entrusted to small working groups, consisting of, *inter alia,* representatives of major commercial banks and under the overall supervision of the Reserve Bank's concerned regional office.

MOVE TO BRING PUBLIC SECTOR BANKS/FIs UNDER THE AUDIT PURVIEW OF THE COMPTROLLER AND AUDITOR GENERAL

The Reserve Bank had all along enjoyed autonomy over regulation and supervision of banks and FIs. The Comptroller and Auditor General (CAG) wrote to the Finance Minister in 1989 about bringing banks and FIs within the purview of CAG audit. The issue was examined in detail by the Reserve Bank and the Government was advised that the Bank had sufficient means to judge the efficiency, economy and performance of commercial banks and, therefore, the need for adding another element of supervision by way of CAG audit was not clear. The Governor's views are best captured in the following:[15]

> The main business of commercial banks was lending the resources which were provided by depositors. By comparison, the involvement of government funds as bank capital was very small. Bank credit was essentially a matter of discretion and there was necessarily an element of risk involved in the business. This was also the position of financial institutions which were in the lending/investment business. Bank inspections had, therefore to be approached in a manner which was very different from expenditure audit. The Reserve Bank provided the requisite specialised supervision under the Banking Regulations Act and the

15. Letter from the Governor, Shri R.N. Malhotra to Finance Secretary, Dr Bimal Jalan, dated July 18, 1990.

Reserve Bank of India Act. The Reserve Bank had also the powers to call for information from and conduct inspections of financial institutions other than banks under Section 45 L and Section 45 N of the RBI Act. The Reserve Bank's oversight on financial institutions was exercised in an informal manner through periodic meetings and the nomination of senior Reserve Bank officers on their boards. However, considering large amounts of money which passed through the financial institutions it was decided by the Reserve Bank after discussions with Chairman, IDBI and several other heads of financial institutions to structure our supervision mainly with a view to ensuring financial health and sound quality of their assets and greater co-ordination between commercial banks and financial institutions. To that end, in consultation with the institutions, an annual financial review was introduced. These institutions were also subject to external audit. In this background the Government was advised that introduction of yet another supervisory agency was likely to cause confusion and conflict of opinion entailing a lot of extra work and correspondence.

The BR Act, 1949 contained provisions for maintaining the confidentiality of a bank's business with its clients. It also provided protection to banks against disclosure of some elements of their financial operations. While the latter protection was gradually relaxed, a crucial concern continued to be the maintenance of public confidence in the viability of commercial banks. Further, under the existing provisions of the law, the Government kept Parliament informed about the accounts and performance of banks. Besides, the parliamentary committees reviewed the functioning of banks/FIs from time to time. A larger number of questions pertaining to banks/FIs were also answered by the Government in successive sessions of Parliament. This enabled Parliament to exercise sufficient oversight over the working of banks and FIs. The Governor, Shri Malhotra concluded in his letter that he was of the firm view that the present supervisory regime should continue.

FINANCIAL HEALTH OF THE BANKING SYSTEM

In the early 1990s the concern for banks' health attracted wide attention, leading to frequent correspondence between the Reserve Bank and the Government on the subject. The Reserve Bank's responses to individual complaints can be illustrated by a few instances during that period.

The chairman of the Institute of Public Affairs (India) addressed a letter in February 1990 to the Finance Minister, with a copy to the Governor, expressing serious apprehensions about the financial health of nationalised banks and the Reserve Bank's supervisory control over banks, citing a specific case involving UCO bank. Enclosing a press report on the state of affairs at UCO bank, he wrote that it was a disturbing situation, which must have arisen over the years and not just in one year.

The Reserve Bank sent a detailed reply, clarifying and explaining the extensive powers of regulation, supervision and control that the Reserve Bank had over the commercial banks under the BR Act, 1949 and the RBI Act, 1934 with a view to: (i) ensure solvency of the banking system, quality of assets, adequate liquidity and profitability; (ii) watch adherence to statutory and regulatory requirements; and (iii) oversee implementation of national socio-economic policies and development objectives. After referring to the internal control and governance mechanisms in place, the Bank added that the general public had access to information in the audited annual accounts of banks that contained the auditors' observations. Wide publicity about the operations of banks was given in various publications of the Reserve Bank. Under the circumstances, there was no reason for the depositor community to think that their interests were not being protected. The continued confidence in the banking system was corroborated by the fact that the deposits of SCBs were increasing steadily every year. There had been no commercial bank failures since the early 1960s.

In another instance, in April 1990 the Government of Maharashtra sent a note to the Reserve Bank indicating the problems faced by Indian banking and suggesting line of action to improve their position. The difficulties that were highlighted included a continuous decline in bank profitability, the increasing number of loss-making branches because of the breakneck speed of branch expansion, the expansion of manpower without a corresponding increase in productivity, the high overhead costs of banks, managerial deficiencies in running the banks, the imposition of social objectives without ensuring the efficiency of the existing schemes, a lack of market-orientation, deficiency in customer service, problems due to overstaffing and intense unionisation, recovery issues involving the Board for Industrial and Financial Reconstruction (BIFR) and lack of infrastructure for efficient functioning of RRBs.

The Governor in his reply, while highlighting the steps already taken by the Reserve Bank to improve the functioning of banks in almost all the areas, added that the major aim of the Reserve Bank was to ensure the strength and stability of the financial system through higher capital provisions, diversification of business, recognition of bad debts, strict enforcement of health classification of all loan accounts and introduction of innovative instruments to meet the growing and diverse demands of market participants.

PRIORITY SECTOR TARGETS FOR FOREIGN BANKS

An issue relating to the treatment of foreign bank branches in India needed to be dealt with. For a considerable period, foreign banks were not subject to priority sector targets on par with other commercial banks. For many, this seemed to be banking without social responsibility. Foreign banks countered the argument and opined that they not only had a limited deposit base, but also lacked extensive branch network akin to the domestic banks. They were also not allowed to set up separate merchant banking entities, nor could they offer insurance or mutual funds or provide stock broking services. Consortium lending was also difficult.

Nevertheless, there were pressures to bring foreign banks under the discipline of lending to the social and priority sectors. The Reserve Bank started laying down targets for the priority sector for foreign banks beginning with 10.0 per cent to 12.0 per cent in 1990 and further to 15.0 per cent of total advances in 1991. However, despite all the difficulties and some major disinvestments by international corporations, foreign banks continued to find good business. New entrants were limited to the major centres; the Reserve Bank had put a freeze on the increase of foreign bank branches since 1969. However, the Reserve Bank did not relax this ruling, although it relented on the question of allowing entry to new banks.

CONCERNS ABOUT CUSTOMER SERVICE: THE GOIPORIA COMMITTEE

In the annual budget for the year 1990–91, the Finance Minister indicated:

> Our bank managers and employees are, as a group, the most qualified, dedicated and hard working. But it is also a fact that the level of public satisfaction with the banking services is not as high as it should be. Over the years, perhaps some structural rigidities have crept in. These need to be removed. There is need for greater competition and greater operational flexibility in respect of banking services. The banking culture has to be made

> more responsive to the needs of the public. I am requesting the Reserve Bank of India to set up a Committee of Bankers, bank employees, depositors and borrowers to consider these aspects and make recommendations to the Government.

The Reserve Bank in a notification dated September 15, 1990 appointed a committee on customer service in banks under the chairmanship of Shri M.N. Goiporia. The terms of reference of the committee were: (i) identifying causes for the persistence of below-par customer service in banks; (ii) ascertaining areas in which deficiencies in customer service were prevalent and how these could be remedied; (iii) improving work culture and inculcating greater customer orientation among bank employees; (iv) identifying structural and operational rigidities and inadequacies in the existing systems and procedures that adversely affected the working of banks and suggesting remedial measures for greater flexibility and faster transaction of business; and (v) upgrading technology for improving customer care on one hand and achieving better housekeeping, faster flow of information, effective supervision, managerial control and greater competitive strength on the other. The committee submitted its report in December 1991 with notes of dissent by two members.

After examining the recommendations of the committee, the Reserve Bank initiated speedy action and issued guidelines to banks relating to advancing working hours, extending business hours, introducing bank orders on various denominations, accepting small denomination notes, exchanging mutilated and soiled notes, publishing the full text of interest rate directives and their amendments in newspapers, immediate credit of local cheques up to ₹ 5,000, and paying interest at an enhanced rate on delayed collection of outstation instruments and at minimum lending rate when the proceeds of instruments were to be credited to cash credit, overdraft or loan account with a view to compensating such customers equitably. The implementation of the recommendations was closely monitored and revised guidelines were issued after taking into consideration representations received from members of the public and banks, which included: (i) not to insist on photographs of customers for opening new savings bank accounts without cheque facility, and for term deposits up to ₹ 10,000; and (ii) reducing the time frame for collection of local as well as outstation cheques. The Reserve Bank asked chief executives of all commercial banks to constitute a committee under a general manager to identify the areas and factors responsible for the delays in collection of outstation instruments and put in place new systems, procedures and necessary infrastructure for faster collection.

ACTION PLANS 1990–1992

The action plans for 1990–1992 placed a heavy emphasis on augmenting banks' profitability and strengthening their financial base. The Reserve Bank advised banks to observe prudent accounting standards and guidelines for classification of advances under the prescribed health codes, as also to stop application of interest on advances classified under the health code 5, besides those under codes 6 and 8. Banks were advised to improve their volume of business, concentrate on effecting quicker recoveries of their dues, ensure efficient management of funds by exploring new avenues of income, control expenditure effectively and reduce the incidence of bad debts. Banks were also asked to reduce the quantum of sticky advances and NPAs in a time-bound manner (Table 17.2). Smaller banks were advised to consider reverting to a 3-tier organisational structure from their 4-tier structure to save costs as well as to improve the speed and efficacy of decision-making. More importantly, banks were advised to devote continued attention to improving branch-level performance.

TABLE 17.2

Non-Performing Advances of Public Sector Banks as on March 31, 1992

(₹ crore)

Health Code	
Sick, non-viable (4)	4,955
Debts recalled (5)	1,757
Suit-filed Accounts (6)	3,479
Decreed Debts (7)	814
Bad & Doubtful Debts (8)	6,385
Total	17,389

Source: Reserve Bank of India, *Report on Trend and Progress of Banking in India, 1992–93.*

In terms of the recommendations of the Ghosh Committee to consider full disclosure in published accounts, SCBs (excluding RRBs) were advised to give details of accounting policies in key areas of operations at one place along with notes on accounts in their financial statements for the accounting year ended March 31, 1991 and onwards on a regular basis. Working results of SCBs for 1991–92 are captured in Table 17.3.

To obviate the major shortcomings in the annual financial review (AFR), a modified scheme of bank inspection for all PSBs was introduced on an experimental basis from January 1, 1991. To make the AFR more purposive and its findings more pointed, the regional offices of the Reserve Bank were advised to take up inspections of as many larger branches as possible with the intention of covering all branches with advances of more than ₹ 5 crore each. The principal inspecting officers were instructed to factor in and update/supplement their findings with observations from the branch notes.

COMMITMENT CHARGES

With a view to bring in discipline in availing the bank finance among borrowing units and facilitating better management of funds by banks, the Reserve Bank advised banks to levy effective January 1, 1991 a minimum commitment charge of 1.0 per cent per annum on the unutilised portion of quarterly operative limits, subject to a tolerance level of 15.0 per cent of such limits. The measure was applicable to borrowing units with working capital limits of ₹ one crore and above.

BILL CULTURE

On the recommendations of the Reserve Bank, the Government exempted certain categories of bills from stamp duty. Borrowing units availing of discretionary inland bill limits were exempt from the additional interest of one per cent over the normal rate of interest. To ensure better compliance with bill discipline, effective January 1, 1991 interest at 2.0 percentage points above the relevant rate of interest charged for cash credit limits was levied by banks on the portion of the book-debt finance that was in excess of the prescribed norm of 75.0 per cent of limits sanctioned to borrowing units under the CMA for financing inland credit sales.

SICK INDUSTRIAL UNDERTAKINGS

The Reserve Bank issued fresh guidelines to banks in August 1991 on industrial sickness, including measures to strengthen banks' organisational machinery for detection of incipient sickness, taking corrective measures like augmentation of capacity by promoters, better co-ordination between banks and FIs, mandatory participation by banks in the rehabilitation packages, designation of a nodal monitoring agency and devising a time frame for implementation of the rehabilitation package. The Reserve Bank evolved a single window concept for lending under the consortium arrangement for sick/weak units for disbursement of credit (working capital/rehabilitation/term loan). The Sick Industrial Companies (Special Provisions) Act (SICA), 1985 was amended in December 1991, widening its scope and coverage so as to bring public sector and government companies within the purview of the Act. The total number of sick units stood at 2,47,111 locking up an amount of ₹ 8,888 crore as on March 31, 1992.

THE PROCESS OF CONSOLIDATION

The efforts at bank consolidation continued to moderate branch expansion, while continuing to cover spatial gaps in rural areas, improving the financial viability of banks, introducing mechanisation and computerisation and inculcating a more effective management culture. The annual action plans covering the period April 1990 to March 1992 envisaged several measures to improve banks' operational efficiency, such as strengthening their organisational structure, upgrading the internal supervision and control system, placing greater focus on human resource development, improving customer service and housekeeping, reinforcing financial viability by better credit management, and raising productivity. The series of measures taken to improve banks' profitability and to provide them with a competitive edge included augmentation of banks' capital base, increase in coupon rates on government securities, withdrawal of the ceiling on lending rates for a sizeable part of their advances, an upward revision in service charges, introduction of new money market instruments, setting-up of subsidiaries to undertake para-banking activities, swapping of branches and opening of extension counters as also closure of branches in centres other than rural areas.

The low operating efficiency, growing NPAs and relatively inadequate capital base were, however, continued to cause concern. The increases in establishment expenses and narrowing interest spread had affected the profitability of the industry. The relatively high level of NPAs and the health code stipulations requiring provision for bad and doubtful debts resulted in a further deterioration in the banks' operating results. Until 1989–90, banks had the discretion to charge interest on accounts falling under health codes 4 and 5 (advances recalled) and carry them to income account. From 1990–91, this discretion was limited to accounts in health code 4 and banks were expected not to charge interest on accounts classified under health code 5.[16]

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16. Banks had already been advised not to charge interest on accounts under health codes 6 to 8.

TABLE 17.3

Working Results of Scheduled Commercial Banks (1991–92)

(₹ crore)

Particulars	*Public Sector Banks*	*Private Sector Banks*	*Foreign Banks*
i) Interest Income	30,750	1,380	2,829
ii) Other Income	3,696	148	845
I. Total Income (i+ii)	34,446	1,528	3,674
II. Expenditure			
i) Interest expended	21,022	810	1,845
ii) Other operating expenses	7,884	424	570
iii) Provisions & Contingencies	4,737	212	939
III. Total expenditure (i+ii+iii)	33,643	1,446	3,354
IV. Profit for the year	803	82	320
V. Working Funds	3,01,717	14,069	25,103
VI. Profit as % to Working Funds	0.27	0.58	1.27

Source: Reserve Bank of India, *Report on Trend and Progress of Banking in India, 1992–93.*

While the spread between the cost of funds and the return on funds as reflected by the structure of interest rates was reasonable, bank profitability was under strain because of NPAs (debts recalled, suit-filed accounts, decreed debts and debts classified as bad and doubtful, all of which reflected an unhealthy assets portfolio of the bank). The NPAs of PSBs (under health codes 6 to 8) as a percentage of total advances amounted to 8.3 per cent as at the end of March 1991. In the context of added emphasis on asset liability management (ALM) and with a view to complying with the Basel Committee framework on international convergence of capital measures and capital standards, a risk-weighted capital ratio for banks (including foreign banks) in India was intended to be prescribed.

ASSESSING FINANCIAL HEALTH AND SOUNDNESS

In order to address these issues, several mutually reinforcing measures were initiated. To improve the health of the banking sector, internationally accepted prudential norms relating to income recognition, asset classification and provisioning, and capital adequacy were introduced in April 1992 in a phased manner. Banks were advised that they should not charge and take to income account interest on NPAs. For this purpose, NPAs were clearly defined based on objective criteria. Compared with the existing system of eight health codes, banks were required to classify their advances into four broad groups, *viz.*: (i) standard assets; (ii) sub-standard assets; (iii) doubtful assets; and (iv) loss assets.

In the old eight-category health code system, four categories were deemed as NPAs, *viz.*, debts recalled, suit-filed accounts, decreed debts, and debts classified as bad and doubtful and banks were not to recognise interest income on these categories.[17] However, in the absence of a clear definition of problem credits in actual practice, banks recognised interest income on all NPAs. The revised norms revealed the true position of banks' health. Aggregate domestic NPAs of all PSBs, which constituted 14.5 per cent of total outstanding advances at end-March 1992 based on the old health code system, worked out to 23.2 per cent as on March 31, 1993 based on the revised classification. This implied that about one-fourth of banks' advances were locked up in unproductive assets. This not only adversely affected banks' profitability, but also prevented recycling of funds, thereby constraining the growth of their balance sheets.

Banks were also required to make provisioning to the extent of 10.0 per cent on sub-standard assets and 20.0 per cent to 50.0 per cent on the secured portion of advances classified as 'doubtful', depending on the period for which the assets had remained doubtful. On the unsecured portion of 'doubtful' assets and on 'loss' assets, 100.0 per cent provisioning was required to be made. The health code system of classification of assets was to be pursued by banks as a management information tool.

The tentative provisioning required by banks was estimated at around ₹ 10,000 crore by the Reserve Bank. Further, banks needed additional resources to meet the capital adequacy norms.[18] The total resource requirement of banks was close to ₹ 14,000 crore. Of this, banks were able to provide about ₹ 4,000 crore from their own surplus generated over a two-year period and about ₹ 10,000 crore was required by the system as additional resources.

With a view to restoring and maintaining the financial soundness of banks, as also enabling them to meet the gap created by application of the first stage of prudential accounting standards and capital adequacy norms, the Government embarked on a recapitalisation programme of nationalised banks beginning from the financial year 1993–94. The total

17. Refer to chapter 7: Developments in Banking Supervision.

18. For details refer to the section on capital adequacy norms in this chapter.

capital contributed by the Government to nationalised banks up to March 1998 aggregated at ₹ 20,046 crore. Besides, the Government provided a sum of ₹ 1,532 crore during the year ended March 1997 to write-off the losses of two banks against their capital to cleanse their balance sheets so that they could make early public issues.

Since capital infusion by the Government was inadequate to enable banks to fulfil further provisioning norms and take care of additional capital needs while capital adequacy guidelines were fully implemented, the Government decided to allow PSBs to approach the capital market directly to mobilise equity funds from the public by amending the relevant acts. It was prescribed that the government ownership of the nationalised banks would remain at least at 51.0 per cent of the equity. However, in view of the oversized equity base, combined with the projected stream of earnings coming in the way of tapping the capital market by a number of nationalised banks, the Government allowed banks to reduce the paid-up capital. The paid-up capital, however, in no case was to be reduced below 25.0 per cent of the paid-up capital of a nationalised bank as on the date of the amendment. The aggregate capital allowed to be written-off by nationalised banks till March 31, 1997 was ₹ 3,038 crore. However, four banks returned to the Government the paid-up capital aggregating ₹ 842 crore during 1996–97 to improve their earnings per share.

By end-March 1998, nine PSBs raised capital (including premium) aggregating ₹ 6,015 crore from the market, including proceeds from the global depository receipt (GDR) issue of the SBI aggregating ₹ 1,270 crore raised during 1996–97. Besides, some banks also raised subordinated debt for inclusion in their tier II capital. The raising of capital by banks led to — diversification of ownership of PSBs, which made a significant qualitative difference to their functioning due to induction of private shareholding with attendant issues of shareholder value and representation of private shareholders on boards.

In order to contain fresh NPAs from arising on account of adverse selection, banks were put on guard against defaulters to other lending institutions. For this purpose, the Reserve Bank put in place a scheme for sharing credit data in April 1994. Apart from containing fresh NPAs, the issue was also to recover NPAs that had already accumulated. In this context, commercial banks were advised to increasingly make use of *lok adalats* (people's courts), which were conferred judicial status and had emerged as a convenient and low-cost method of settling disputes between banks and small borrowers. Further, The Recovery of Debts Due to Banks and Financial Institutions Act was enacted in 1993, which provided for the establishing tribunals for expeditious adjudication and recovery of such debts. Following the enactment, 29 debt recovery tribunals (DRTs) and 5 debt recovery appellate tribunals (DRATs) were established at several places in the country.

In August 1995, the Reserve Bank took a major decision to withdraw the credit information scheme that had been introduced in 1962. The scheme, which was intended to pool and supply information relating to the total banking commitments to the constituents of banks and notified FIs to help them make a realistic assessment of viability and credit needs of borrowers, was found irrelevant by Shri TNA Iyer, consultant, appointed by the Governor to examine, *inter alia,* the need for continuing the scheme. In fact, a detailed review note dated April 3, 1995 prepared on the scheme by the Reserve Bank highlighted that the non-involvement of banks and FIs delayed the submission of returns, there was a lack of demand for information, enormous efforts and costs were involved, faulty and incomplete information was furnished and there had been drastic changes in banking over a period; hence, there was no justification for continuing the scheme.

Various measures introduced had a favourable impact on the quality of banks' balance sheets. Within a short time, banks were able to bring down their NPAs significantly. The gross NPAs of PSBs as a percentage of gross advances, which was 23.2 per cent at end-March 1993, declined to 16.0 per cent by end-March 1998. Despite increased provisioning, the overall profitability of the banking sector in general, and PSBs in particular, improved. The soundness of the banking sector showed substantial improvement. Eight nationalised banks, six old private sector banks and three foreign banks could not attain the prescribed capital to risk weighted assets ratio (CRAR) of 8.0 per cent by end-March 1996. These banks were given one-year extension to reach the prescribed ratio, subject to certain restrictions, such as, modest growth in risk-weighted assets, containment of capital expenditure and branch expansion, among others. At end-March 1998, of the 27 PSBs, 26 banks attained the stipulated 8.0 per cent capital adequacy requirement. All banks, other than five banks (one PSB and four old private sector banks) were able to achieve the stipulated CRAR of 8.0 per cent (Table 17.4).

TABLE 17.4

CRAR Position

(End-March)

Bank Group	*1996*		*1997*		*1998*	
	No. of Banks with 8.0 per cent and above	*No. of Banks with CRAR less than 8.0 per cent*	*No. of Banks with 8.0 per cent and above*	*No. of Banks with CRAR less than 8.0 per cent*	*No. of Banks with 8.0 per cent and above*	*No. of Banks with CRAR less than 8.0 per cent*
(1)	*(2)*	*(3)*	*(4)*	*(5)*	*(6)*	*(7)*
Public Sector Banks	19	8	25	2	26	1
Private Sector Banks	28	6	30	4	30	4
Foreign Banks	28	3	39	-	42	-
Total	75	17	94	6	98	5

Note: - : Nil.

Source: Reserve Bank of India, *Report on Currency and Finance, 2006–2008.*

REMOVAL OF EXTERNAL CONSTRAINTS ON BANKS

A major factor that affected banks' profitability was the high pre-emptions in the form of CRR and SLR, which had reached a historic high level of 63.5 per cent in the early 1990s. These were progressively reduced as described elsewhere in this volume. The reduction in statutory pre-emptions not only removed the external constraints on banks and enhanced their profitability, but also augmented the lendable resources available to them. Further, with the more normal liquidity conditions in the money market, there was a further enhancement in the proportion of bank funds that were made available for financing growth and employment in the private sector. However, despite augmentation of lendable resources of banks, credit growth slowed in 1996–97, both on account of demand and supply-side factors. In view of application of prudential norms, banks became wary of enlarging their loan portfolio. The relatively high level of NPAs, in particular, had a severe impact on weak banks. Banks' capacity to extend credit was also impaired due to the little headroom available in the capital adequacy ratio (8.7% at end-March 1996). At the individual bank level, some banks, as indicated earlier, were not able to meet the capital adequacy requirements at end-March 1998.

The demand for funds by the corporate sector also slackened. In the wake of increased competition in the product market, the corporate sector shifted its focus from expanding capacity to restructuring. Increased competition also forced corporate entities to restructure their balance sheets, whereby they increased their reliance on retained earnings and reduced their borrowings. Rise in real interest rates caused by downward stickiness of nominal interest rates coupled with a falling inflation rate also contributed to slackness in credit expansion. Hence, despite the lowering of the statutory pre-emptions in the form of CRR and SLR, banks continued to invest in government securities, far in excess of the requirements. Banks' investment in SLR securities at end-March 1996 was 36.9 per cent of net demand and time liabilities (NDTL) as against the statutory requirement of 31.5 per cent.

TABLE 17.5

Movement of Interest Rates of Commercial Banks

(Per cent)

Year (April-March)	*Deposit Rates*			*Lending Rates*
	1 to 3 yrs	*Over 3 yrs and up to 5 yrs*	*Above 5 yrs*	*Minimum Rate (General)*
(1)	*(2)*	*(3)*	*(4)*	*(5)*
1990–91	9.00–10.00	11.00	11.00	16.00*
1991–92	12.00	13.00	13.00	19.00*
1992–93	11.00	11.00	11.00	17.00*
1993–94	10.00	10.00	10.00	14.00*
1994–95	11.00	11.00	11.00	15.00@
1995–96	12.00	13.00&	13.00&	16.50@
1996–97	11.00–12.00&	12.00–13.00&	12.50–13.00&	14.50–15.00@
1997–98	10.50–11.00&	11.50–12.00&	11.50–12.00&	14.00@

Notes: & : Refers to the deposit rates of five major public sector banks as at end-March; @ : Lending interest rates were deregulated from October 1994. The rate indicated refers to the prime lending rates of five major public sector banks.

* : Key lending rate as prescribed by the Reserve Bank for commercial banks.

Source: Reserve Bank of India, *Handbook of Statistics on the Indian Economy, 2006–07.*

Banks were, as mentioned elsewhere in this volume, also provided with the freedom to fix their own deposit and lending rates. The structure of interest rates, which had become extremely complex, was first rationalised and then deregulated, barring a few rates, both on the deposits and lending portfolios. The information on the interest rates over the period is presented in Table 17.5.

The reduction in NPAs along with a reduction in CRR/SLR and deregulation of interest rates had a significant positive impact on the profitability of the banking sector (Table 17.6). With the application of objective prudential norms, 14 banks (12 PSBs) had reported net losses for the year ended March 1993. In 1996–97, the number of loss-making SCBs declined to eight (of which three were PSBs). Although in the following year, the number of loss-making banks increased to 11, the number of loss-making PSBs declined to two.

TABLE 17.6

Profitability Indicators of Scheduled Commercial Banks

Year (April–March)	*No. of Profit-making SCBs*	*No. of Loss-making SCBs*	*Overall Profit/ Loss (–) (₹ crore)*	*Return on Assets (%)*	
				SCBs	*PSBs*
(1)	*(2)*	*(3)*	*(4)*	*(5)*	*(6)*
1992–93	59 (15)	14 (12)	–4,150	–1.08	–0.99
1993–94	60 (15)	14 (12)	–3,625	–0.85	–1.15
1994–95	73 (19)	13 (8)	2,154	0.41	0.25
1995–96	80 (19)	14 (8)	939	0.16	–0.07
1996–97	92 (24)	8 (3)	4,505	0.67	0.57
1997–98	92 (25)	11 (2)	6,502	0.82	0.77

Notes: 1. SCBs : Scheduled Commercial Banks.
2. PSBs : Public Sector Banks.
3. Figures in parentheses indicate the number of PSBs.

Source: Reserve Bank of India, *Report on Currency and Finance, 2006–2008.*

BOARD FOR FINANCIAL SUPERVISION

The growing volume and complexity of the business conducted by banks and FIs in the country and the need for a sensitive and strong supervisory mechanism was increasingly recognised by the Narasimham Committee. It recommended that the supervisory functions of the Reserve Bank should be separated from the more traditional central banking functions and that a separate agency, which could pay undivided attention to supervision, should be set up under the aegis of the Reserve Bank. The committee underlined the advantages of having a single integrated system of supervision over different constituents of the financial systems, so as to avoid segmentation of supervisory functions and the associated problem of inadequate co-ordination among all the supervisory authorities.

The need for a strong system of supervision was felt early in the reform phase for the following reasons: (i) to ensure effective implementation of prudential regulations; (ii) the blurring of the traditional distinctions among the financial intermediaries; and (iii) the increased risks faced by banks in a liberalised environment. Keeping these considerations in view, the BFS was set up within the Reserve Bank to attend exclusively to supervisory functions and provide effective oversight in an integrated manner over the banking system, FIs and NBFCs. The proposal contained in the Deputy Governor's memorandum dated February 12, 1993, regarding the setting-up of the BFS, was approved by the Central Board in its meeting held on February 12, 1993.[19] The BFS was to be a separate body within the Reserve Bank. In terms of regulation 15 of the RBI (BFS) Regulations, 1994, the BFS was required to submit a half-yearly report on its activities to the Central Board of Directors of the Reserve Bank.

The BFS assumed supervisory responsibility for all-India FIs effective April 1995 and for registered NBFCs effective July 1995. The board consisted of the Governor as the chairman, the Deputy Governor as full-time vice-chairman and four members from the Central Board.

The scope of supervisory oversight by the BFS was initially restricted to banks, FIs and NBFCs. Subsequently, its scope was enlarged to include urban co-operative banks (UCBs), RRBs and primary dealers (PDs). The BFS initiated several measures to strengthen the supervisory systems. In order to have in place 'an early warning system' to take prompt corrective action, a computerised offsite monitoring and surveillance (OSMOS) system for banks was instituted in November 1995.

BANKING OMBUDSMAN SCHEME

While announcing the credit policy measures for the first half of 1993–94, the Governor indicated that effective grievance redressal machinery on the ombudsman model had to be introduced to attend to the large number of complaints emanating from the small scale industries (SSIs). Subsequently, in consultation with PSBs, it was felt that the proposed grievance redressal machinery should deal not only with grievances of the SSIs but with the

19. See Appendix 17.1 for details.

entire gamut of customer complaints regarding deficiencies in banking services and certain credit-related aspects. A scheme styled the banking ombudsman (BO) scheme, 1995 was drawn in consultation with the Government. The scheme and the operational guidelines envisaged setting-up offices of the BO at 15 centres to cover the entire country.

The Reserve Bank announced the BO scheme on June 14, 1995 under the provisions of the BR Act, 1949 for expeditious and inexpensive resolution of customer complaints in banking services. The scheme covered all SCBs and scheduled primary co-operative banks. It provided the public with an opportunity to approach the BO for grievances against a bank, provided the complaints pertained to a matter specified in the scheme. The BO scheme became operational with the appointment of a BO on a full-time basis in three centres — Mumbai, Delhi and Bhopal; it was then extended to several cities in subsequent years.

MARKET INTELLIGENCE

In 1992–93, an MIC was set up within the Reserve Bank on the recommendations of the Janakiraman Committee. The main objective of the MIC was to keep a track of market developments, especially those of a sensitive nature. This cell was constituted in addition to the Banking Intelligence Unit.

ESTABLISHMENT OF NEW BANKS IN THE PRIVATE SECTOR

The Narasimham Committee recommended, *inter alia*, that there be no bar to new banks in the private sector being set up, provided they conformed to the start-up capital and other requirements as may be prescribed by the Reserve Bank, the maintenance of prudential norms for accounting, provisioning and related aspects of operations.

The Central Board of Directors of the Reserve Bank considered this recommendation in their meetings held on September 11, 1992 and January 21, 1993 and agreed that the Reserve Bank would grant permission for the establishment of new private sector banks, subject to certain terms and conditions. Accordingly, the Reserve Bank issued a set of guidelines on January 22, 1993 for the entry of new private sector banks, heralding a new policy approach to foster competition. The minimum paid-up capital of a new private sector bank was to be ₹ 100 crore and it was expected to observe prudential norms and capital adequacy of 8.0 per cent from the time of its inception.

All three FIs, *viz.*, Housing Development Finance Corporation Ltd (HDFC), Industrial Credit and Investment Corporation of India Ltd (ICICI) and the UTI, to whom in principle approval was granted for setting-up new banks in the private sector, represented to the Reserve Bank for relaxation in the following conditions that formed part of the approval:

(i) The chairman of the new bank shall be a whole-time professional. He shall not take up directorship of other companies as per the provisions of section 10B (2) and (4) of the BR Act, 1949.

(ii) There shall not be any common directors on the board of the FI and the new bank promoted by it.

(iii) Applicability of the provisions of section 12(2) of the BR Act, 1949 which restricted voting rights per shareholder to 1.0 per cent of the total voting rights of the banking company.

(iv) The FI should ensure and establish an 'arm's length' relationship organisationally and operationally with the proposed bank.

(v) The FI shall accept the system of consolidated supervision by the Reserve Bank both for itself and the proposed bank.

It was considered necessary that the Reserve Bank took all appropriate steps to see that the new private sector banks were set up, to ensure that such banks were managed ably and that they were in a position to raise necessary capital from the market. Up to the end of February 1994, 143 applications/proposals were received for setting-up new private sector banks. Of these, only 23 were in the prescribed form under rule 11 of the Banking Regulation (Companies) Rules, 1949. The Committee of the Central Board had already approved the proposals received from HDFC Ltd, ICICI Ltd, UTI, Dr Jayanta Madhab & Associates, 20th Century Finance Corporation Ltd, Bennett Coleman & Co Ltd, Industrial Enterprises & Finance Ltd, Gujarat State Fertilisers Co Ltd, and the IDBI, subject to certain terms and conditions.

The proposal received from a former CMD, Punjab & Sind Bank (P&SB) was processed and it was proposed to give in principle approval to this proposal.

REVIEW OF NEW PRIVATE SECTOR BANKS AS ON MARCH 31, 1996

The total number of new private sector banks as on March 31, 1996 was nine. During the year, two more banks, *viz.*, Cox and Kings Bank Ltd and CRB Bank Ltd, were issued 'in principle' approval. All nine banks had complied with the capital adequacy norm of 8.0 per cent (of the risk-weighted assets stipulated by the Reserve Bank). As on March 1996, the nine new banks maintained a network of 76 branches and, of these, 16 were located in semi-urban and urban centres, while the remaining 60 branches were concentrated in metropolitan areas. None of the banks had opened branches in rural areas, although under the conditions of the licence these banks were required to establish 25.0 per cent of their branches in rural/semi-urban areas during the first three years after their inception. The aggregate deposits of these banks stood at ₹ 5,937 crore as on March 31, 1996, forming 1.3 per cent of deposits of all commercial banks. The advances of these banks stood at ₹ 4,890 crore as on March 31, 1996. The credit-deposit ratio averaged as high as 82.4 per cent against 58.6 per cent for all commercial banks.

The onsite assessment visits/inspections had revealed serious deficiencies, such as violation of the Reserve Bank instructions/guidelines on bill discounting, packing credit advances, consortium arrangements, stockinvest schemes and exceeding prudential exposure norms, apart from the banks not making a realistic assessment of the need-based requirements of borrowers. The new banks had generally adhered to the Reserve Bank norms relating to prudential guidelines on income recognition, asset classification and provisioning. However, show-cause notices were served to IndusInd Bank Ltd and HDFC Bank Ltd for irregularities in implementing the stockinvest scheme and for not complying with the regulatory requirements in bill financing.

All nine banks reported profits for the year ended March 31, 1996. Their net profits aggregated ₹ 165 crore and formed 1.8 per cent of their total working funds. Interest spread as a percentage of working funds worked out to 2.8 per cent for these banks. Of the nine banks, four banks, *viz.*, IndusInd Bank Ltd, ICICI Banking Corporation Ltd, Global Trust Bank Ltd, and Bank of Punjab Ltd had declared dividends, while the other banks had ploughed back their net profits into their business.

All the new banks were attuned to the objective of providing high-class customer service backed by high-tech and sophisticated systems and networks and had gone in for comprehensive information technology plans with the latest technology for computerisation and networking. All their branches were networked and linked to the corporate/central office through very small aperture terminal (VSAT) systems of communication. This facilitated prompt submission of DSB 9 (offsite monitoring) returns by almost all the banks. In addition to installing ATMs and providing telebanking services, most of the banks had become members of the Society for Worldwide Interbank Financial Telecommunication (SWIFT).

PRUDENTIAL NORMS

A major reform in 1992 was the introduction of new norms for income recognition and provisioning for bad debts and the prescription of new capital adequacy requirements in line with the Basel Committee norms. The new norms would ensure that the books of the banks reflected their financial position more accurately and in accordance with international accounting practices. However, because of the new norms, banks were expected to make larger provisions for bad and doubtful advances in their portfolios. The impact, it was anticipated, would be felt in 1993 and 1994 and, to protect the viability and financial health of the banking system, the budget made provision for a capital contribution of ₹ 5,700 crore to nationalised banks in 1993–94 to meet the gap created by the application of the first stage of provisioning norms. There was no immediate net outgo from the budget, as the Government's contribution was in the form of government bonds, although interest payment on these bonds and other ultimate redemptions would place a burden on future budgets. However, in order to meet the additional capital needs arising out of the subsequent phasing in 1994–95 and 1995–96, the Government decided to allow the SBI as well as other nationalised banks access to the capital market to raise fresh equity, retaining at the same time the major ownership and, therefore, effective control of the PSBs. The legislation to give effect to it was to be introduced subsequently, but speedily.

CAPITAL ADEQUACY NORMS

In order to strengthen the capital base of banks, the Reserve Bank, following the Basel Committee recommendations, introduced in April 1992 a risk-weighted assets ratio system as the basis for assessment of capital for banks (including foreign banks) in India as a capital adequacy measure. It was stipulated that Indian banks that had branches abroad should achieve a capital adequacy norm of 8.0 per cent as early as possible and latest by March 31, 1994 (later extended by one year to March 31, 1995). Foreign banks were to achieve this norm of 8.0 per cent by March 31, 1993. Other banks were to achieve a capital adequacy norm of 4.0 per cent by March 31, 1993 and the 8.0 per cent norm by March 31, 1996.

In 1992–93, banks completed the first year of the three-year phased programme of implementation of prudential norms relating to income recognition, provisioning and capital adequacy. Several banks faced practical difficulties in implementing the norms within the stipulated period without incurring large capital losses. The Reserve Bank constituted an informal group in 1992 to look into these problems. As suggested by the group, relaxations were made with regard to the 'past due' status of an account, the treatment of non-performing advances for agriculture, the net worth of borrowers/guarantors or the value of security, the treatment of loss assets, consortium advances, the phasing of provisioning for NPAs and depreciation in the value of investments.

In respect of accounts with an outstanding balance of less than ₹ 25,000, provisioning to the extent of 2.5 per cent of the total outstanding was to be made in 1992–93 (which was raised to 5.0% from February 4, 1994). Advances under this category of lending aggregated at ₹ 19,845 crore. Again, provisioning for NPAs was scaled down during 1992–93 from 50.0 per cent of the provisions on sub-standard and doubtful assets and on advances with less than ₹ 25,000 to 30.0 per cent. Data based on the revised classification of advances with outstanding balance of ₹ 25,000 and above into sub-standard, doubtful and loss assets, placed the total of NPAs at ₹ 36,588 crore, forming 24.2 per cent of the aggregate outstanding advances (excluding those with an outstanding balance of less than ₹ 25,000) of the PSBs as at the end of March 31, 1993. Of these, sub-standard assets amounted to ₹ 12,552 crore, doubtful assets ₹ 20,106 crore and loss assets ₹ 3,930 crore.

Details in respect of CRAR of foreign banks for the year ended March 31, 1993 revealed that all 23 foreign banks operating in India had already reached the stipulated level of 8.0 per cent CRAR as on that day.

The private sector Indian banks had generally complied with prudential guidelines relating to asset classification, income recognition and provisioning. During 1992–93, 11 banks increased their paid-up capital through rights issues and one bank raised the same in 1993–94. Fourteen banks had achieved a CRAR of 4.0 per cent, while the position for the other banks was under review.

CREATING A COMPETITIVE ENVIRONMENT

One of the major objectives of reforms was to bring in greater efficiency by permitting the entry of private sector banks and new foreign banks, liberalising licensing of more branches of foreign banks, and providing increased operational flexibility to banks. These measures were intended to infuse competition in the banking sector.

First, the Reserve Bank announced the norms for entry of new banks in the private sector in January 1993. Second, in the context of the steps towards deregulation and the changed banking scenario in the country, it was decided in May 1992 to give greater freedom to banks in the matter of opening branches. While banks could not close down branches in rural areas, in order to enable them to rationalise their branch network in rural/semi-urban areas, they were allowed to relocate branches within the same block and service area of the branch, shift their branches in urban/metropolitan/port town centres within the same locality/municipal ward, open specialised branches, spin-off business, set up controlling offices/administrative units and open extension counters. It was decided in December 1994 that banks did not need prior permission from the Reserve Bank to install ATMs at licensed branches and extension counters. Banks, however, were required to report such installation to the Reserve Bank. Banks were also given the freedom to install ATMs at other places, in which case they could obtain a licence from the concerned regional office of the Reserve Bank before operationalising the offsite ATMs. Third, a commitment was made in the Uruguay Round to allow 12 licenses a year for new entrants and existing banks. However, India adopted a more liberal policy in permitting foreign banks to open branches in the country. Fourth, deregulation of interest rates was undertaken to infuse competition. Fifth, consistent with the policy of liberalisation, it was decided to allow full operational freedom to banks in assessing the working capital requirements of borrowers. Accordingly, all instructions relating to maximum permissible bank finance were withdrawn in April 1997. Banks were given complete independence to decide on the method of assessing working capital requirements. It was for corporate entities to convince banks about their working capital needs. They could choose to go through a single bank, set up a consortium arrangement or take the syndicate route. Sixth, all restrictions relating to project loans by commercial banks were withdrawn. Traditionally, project finance was the domain of term-lending institutions.

While competitive conditions were created, competition within the banking sector during this phase did not infiltrate enough. Though the number of new private sector banks and foreign banks increased during the period, there were only four bank mergers. The lack of sufficient competition was also reflected in the net interest margins of banks, which increased during this phase from 2.5 per cent in 1992–93 to 2.9 per cent in 1997–98. This was despite the fact that banks during this phase were in a disadvantageous position since interest rates during this phase declined significantly. It may be noted that the effect of a reduction in interest rates on lending was mostly instantaneous, while on deposit rates, it came into operation after existing deposits matured.

STRENGTHENING OF INSTITUTIONS

A fresh review of the banks' inspection system was undertaken and a new approach to onsite inspection of banks was adopted from the cycle of inspections commencing in July 1997. The focus shifted to the evaluation of total operations and performance of banks under the CAMELS system (capital adequacy, asset quality, management, earnings, liquidity systems and control) for domestic commercial banks and CALCS (capital adequacy, asset quality, liquidity, compliance systems and control) for foreign banks. The role of internal and external audit was also strengthened. Besides auditing the annual accounts, external auditors were required to verify and certify other aspects, such as adherence to statutory liquidity requirements, prudential norms relating to income recognition, asset classification and provisioning as also financial ratios to be disclosed in the balance sheets of banks. Thus, supervision now, apart from covering the supervisory process of the Reserve Bank, also focused on external audit and internal audit.

The significant financial improvement, however, posed two issues: how to ensure that the turnaround was real and durable; and what approach to adopt for weak banks. It was noted that banks must recognise that as their asset portfolio diversified, greater specialisation in the technical aspects of lending and credit evaluation was necessary. Attention needed to be given not merely to the size of assets, but also to their composition. Simultaneously, loan recoveries had to be substantial and speedy. Computerisation and upgrading of technologies, at least in critical branch offices with a large business turnover, were to be immediately implemented. Branches also needed to set up systems that were dedicated to sector-specific loan-making. Further, efforts at reducing NPAs were to be continued and the endeavour was to bring down the banking system's average of NPAs to about 10.0 per cent in the next couple of years. Reduction in costs, rationalisation of branch structure and staffing pattern and strengthening of risk management/corporate management strategies formed some of the essential elements of a sustainable turnaround.

As regards weak banks, the consultants' reports on the banks were submitted to each bank and the Reserve Bank. The diagnosis of the problems of weak banks carried several similarities: large staff complement; unviable branches; low productivity per employee; high NPAs ranging between 20.0 and 27.0 per cent of total advances; and several critical institutional weaknesses. While clearly there was no single remedy for these banks, a sound and a viable strategy oriented to the overriding objective of reducing and wiping out losses had to be formulated. Two areas where weaknesses were glaring and common both to weak and well-performing banks were: inter-branch reconciliation of accounts and occurrence of fraud. The progress in reconciliation was reviewed and the chairmen of PSBs were given a revised time frame within which arrears in reconciliation were to be cleared. Likewise, banks were advised to create a separate cell to regularly monitor the recovery and staff accountability of old cases of fraud and devise strategies and controls on an ongoing basis to prevent fraud. In this context, it was necessary to have a fresh review of the efficacy and adequacy of the internal control systems in banks. A working group was appointed to review the internal controls, inspection and audit system in banks.

TRANSPARENCY AND DISCLOSURE

One significant area of improvement in the banking system was greater accuracy and transparency in the financial statements of banks. The acceptance of the recommendations with regard to bringing Indian accounting standards closer to internationally accepted norms, coupled with requirements of fuller disclosure on sensitive aspects of operations had rendered greater credibility and transparency to the financial statements of banks. The refinement of accounting practices and disclosure requirements to bring them fully in line with international norms was also done from 1992–93. Regular communications, reporting changes in prudential norms, tracking of NPAs, focus on profitability and attaining specified capital adequacy ratios were the main features of this period.

PERFORMANCE OBLIGATIONS AND COMMITMENTS

To enable banks not to slip on the exacting standards that prudential accounting and capital adequacy norms entailed, the Reserve Bank laid down various performance indicators. The release of funds by the Government to augment their capital base was made subject to the fulfilment of the performance obligations/commitments in respect of the following:

(i) Performance parameters: these were quantifiable targets to be attained with respect to deposits, advances, investments, increase in staff productivity, and interest spreads. In addition, upgrading technology at various levels was to be ensured.

(ii) Management: the response of the top management towards an improvement in the areas of operational policies, organisational structures, inspection and supervision within a stipulated period would be elicited. Operational policies would cover plans for improving liability management, investment management, recovery management, human resource development, limiting capital expenditure and loan exposures.

(iii) Capital: detailed quarterly review of growth in risk-weighted assets to growth in capital would have to be undertaken.

(iv) Customer service: periodic independent evaluation of customer satisfaction would be undertaken. Establishment of grievance redressal machinery could also be considered. These commitments would be reviewed by the banks on a quarterly basis at the board level and on a half-yearly basis at the level of the Reserve Bank.

RECAPITALISATION OF NATIONALISED BANKS

With a view to restoring and maintaining financial soundness of banks, particularly in the interests of depositors, as also enabling them to meet the gap created by application of the first stage of prudential accounting standards and capital adequacy norms, the Government contributed ₹ 5,700 crore as equity to recapitalise nationalised banks during the financial year 1993–94 (Table 17.7). As a result of recapitalisation, there was expected to be an improvement in the capital and reserves (including surplus) position of nationalised banks from ₹ 7,009 crore at the end of March 1993 to ₹ 12,709 crore at the end of March 1994. Bank-wise details of capital injection by the Government revealed that fresh capital injection was in the range of ₹ 45 crore and ₹ 705 crore. The recapitalisation of nationalised banks was undertaken to ensure that all banks were able to meet the minimum CRAR of 4.0 per cent as at the end of March 1993 and also maintained their capital unimpaired. The recipient banks were required to invest the Government's capital subscription in government bonds. In the past, the banks had been issued non-terminable, non-marketable special securities with a 7.7 per cent coupon rate. To strike a balance between fiscal adjustment and strengthening of bank capital, banks were allowed to invest in bonds of a finite tenor, so that, in addition to receipt of interest income, banks would receive a gradual inflow of principal over time.

The Government notified the issue of bonds, known as '10 per cent recapitalisation bonds, 2006' on January 1, 1994. Subscription to these bonds was limited to the extent of the amount allocated by the Government.

TABLE 17.7

Recapitalisation of Banks

(₹ crore)

S. No	*Name of the Bank*	*Allocation of Capital*
1.	Allahabad Bank	90
2.	Andhra Bank	150
3.	Bank of Baroda	400
4.	Bank of India	635
5.	Bank of Maharashtra	150
6.	Canara Bank	365
7.	Central Bank of India	490
8.	Corporation Bank	45
9.	Dena Bank	130
10.	Indian Bank	220
11.	Indian Overseas Bank	705
12.	Oriental Bank of Commerce	50
13.	Punjab National Bank	415
14.	Punjab & Sind Bank	160
15.	Syndicate Bank	680
16.	UCO Bank	535
17.	Union Bank of India	200
18.	United Bank of India	215
19.	Vijaya Bank	65
	Total	5,700

Source: Reserve Bank of India, internal records.

The important features of the bonds were that they: (i) would bear an interest rate of 10.0 per cent per annum, to be paid at half-yearly intervals; (ii) would be repayable in six equal annual instalments on the first day of January from the year commencing January 1, 2001 and onwards; (iii) would be transferable; (iv) would not be an approved security for purposes of SLR; and (v) would be considered as an eligible security for purposes of obtaining a loan from any bank or FI.

Since the capital infusion by the Government was not adequate to enable banks to fulfil further provisioning norms and take care of additional capital needs as capital adequacy guidelines were fully implemented, the Government decided to allow some PSBs to approach the capital market directly to mobilise equity funds from the public. For this purpose the SBI's provision for partial private holding in its statute was enhanced by an ordinance in October 1993, amending the State Bank of India Act, 1955. The SBI was the first PSB to access the capital market. It raised ₹ 2,210 crore in the form of equity and ₹ 1,000 crore through bonds. With this issue, the shareholding of the Reserve Bank in the equity of SBI came down to 68.93 per cent from 98.20 per cent. The Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 and 1980 were also amended with effect from July 15, 1994 to enable nationalised banks to raise capital funds from the market by public issue of shares. However, the holding of the Central Government would not be at all times less than 50.0 per cent of the paid-up capital of nationalised banks.

A few nationalised banks entered the capital market in 1994–95, but a number of them needed further injection of capital from the Government to clean up their balance sheets before they were in a position to approach the capital market.

The Oriental Bank of Commerce was the first nationalised bank that successfully accessed the capital market and raised ₹ 387 crore in October 1994, reducing the Government equity share from 100.0 per cent to 66.5 per cent. The equity base of several profit-making nationalised banks was oversized in relation to the projected stream of earnings, whereas banks with cumulative losses were not able to set off their losses against their capital. As this had come in the way of quite a few nationalised banks accessing the capital market and the loss-making banks in adjusting their cumulative losses, the Banking Companies (Acquisition and Transfer of Undertakings) Acts, 1970 and 1980 were amended, enabling banks to reduce their paid-up capital. The paid-up capital of nationalised banks could not be reduced at any time below 25.0 per cent of its paid-up capital as on the date of the amendment.

Of the 27 PSBs, 25 banks achieved the minimum CRAR of 8.0 per cent as at the end of March 1997. In order to shore up their earnings per share (EPS), three PSBs, *viz.*, Bank of Baroda (BoB), Corporation Bank and Bank of India (BoI) together returned ₹ 504 crore of their capital to the Government, while three more PSBs, *viz.*, Dena Bank (₹ 180 crore), BoB (₹ 850 crore) and BoI (₹ 675 crore) accessed the capital market during 1996–97. Four PSBs (PNB, State Bank of Mysore, State Bank of Travancore and State Bank of Bikaner and Jaipur) were also permitted to raise subordinated debt through private placement for inclusion under Tier II capital for capital adequacy purposes. The Government provided ₹ 1,532 crore during 1996–97 towards writing down the capital base against the accumulated losses of Allahabad Bank (₹ 532 crore) and Indian Overseas

Bank (₹ 1,000 crore). As regards recapitalisation of banks, the Government contributed during 1996–97, ₹ 1,509 crore towards the capital of six nationalised banks, *viz.*, Andhra Bank (₹ 165 crore), Central Bank of India (₹ 500 crore), P&SB (₹ 150 crore), UCO Bank (₹ 54 crore), United Bank of India (UBI) (₹ 338 crore) and Vijaya Bank (₹ 302 crore).

An important development in 1993–94 was entry of the SBI into the capital market with an equity-cum-bond issue of ₹ 2,532 crore. With a view to achieving the capital adequacy norm of 8.0 per cent by March 31, 1994, the SBI approached the capital market with a simultaneous public offer of 12, 40, 00,000 equity shares of ₹ 10 each at a premium of ₹ 90 per share and 50,00,000 bonds of the face value of ₹ 1,000 each. The public issue of equity was accompanied by a rights offer of 12,00,00,000 shares to existing shareholders in the ratio of three new shares for every five shares held and a preferential offer of 1,20,00,000 shares to SBI employees, both at a reduced premium of ₹ 50 per share. The SBI was permitted to retain 15.0 per cent over subscription in respect of the equity issue and 100.0 per cent over subscription in respect of the bonds issue. With this, the issued and paid-up capital of the SBI would be ₹ 456 crore as against the existing ₹ 200 crore. The rights entitlement of the Reserve Bank in the equity issue of SBI was 11,78,77,200 shares of ₹ 10 each at a premium of ₹ 50 per share, aggregating ₹ 707 crore. The bonds issued by the SBI were in the nature of promissory notes and constituted the direct, unsecured and subordinated obligation of the SBI. The bonds carried a floating rate of interest at 3.0 per cent over the maximum term deposit rate of the SBI, with a minimum coupon rate of 12.0 per cent annum and no maximum ceiling, subject to re-fixing at regular intervals of six months. If the deposits rates were completely deregulated, the maximum term deposit rate quoted by the Bombay main branch of the SBI would be the basis for the floating interest rate.

After making due provisions, the ratio of profit to working funds improved marginally in the case of the SBI and its associates, from 0.21 per cent in 1991–92 to 0.22 per cent in 1992–93. The banks in this group, however, could raise additional equity capital from the markets and strengthen their financial position. Given the need to meet the minimum capital adequacy norm of 8.0 per cent of risk-weighted assets by March 31, 1996 for the remaining Indian banks, the additional capital requirements of all the Indian banks were substantial. These large capital requirements were envisaged to be met by a combination of budgetary support, higher retained earnings and raising capital from the markets.

INCOME RECOGNITION, ASSETS CLASSIFICATION AND PROVISIONING

In response to suggestions regarding the practical difficulties that some banks faced in implementing the prudential system of income recognition and classification of assets as also the need to provide a longer period for compliance, an informal working group was set up in the Reserve Bank. As suggested by the informal group, it was decided to give certain relaxations, such as: (i) an amount under any credit facility should be treated as 'past due' when it remained outstanding for 30 days beyond the due date; (ii) for treatment as NPA of advances granted for agricultural purposes, where interest payment on half-yearly basis synchronised with the harvest; banks should adopt the agricultural season as the basis; (iii) the net worth of the borrower/guarantor need not be taken into account for the purpose of treating an advance as an NPA; (iv) negligible salvage value of the security may not be considered while providing for loss assets; (v) the reckoning for 'past due' in the case of project financing should commence only from the 'due' date for payment, *i.e.,* the date after the completion of the moratorium or gestation period; (vi) credit facilities backed by the central and state government guarantees need not be treated as NPAs; (vii) the treatment of NPA had to be borrower-wise; and (vii) to comply with prudential accounting standards, credit facilities with an outstanding balance of ₹ 25,000 and above alone needed to be considered.

However, for advances with an outstanding balance of less than ₹ 25,000, aggregate provisioning was required to be made to the extent of 2.5 per cent, (later raised to 5.0% from February 4, 1994) of the total outstanding amount. Again, to refine the capital adequacy requirement, it was decided on February 8, 1994 to make further changes in this area, *viz.*: (i) all claims on banks were assigned a risk-weight of 20.0 per cent, irrespective of the banks having domestic or overseas operations or between funded and non-funded facilities. Further, certain transitions with a non-bank counterpart of the off-balance sheets would be treated as claims on banks; (ii) investments in subordinated debt instruments and bonds issued by other banks or public FIs would carry 100.0 per cent risk-weight; and (iii) advances covered by the guarantee of the DICGC/ Export Credit and Guarantee Corporation (ECGC) would be assigned a risk-weight of 50.0 per cent.

In order to enable banks to absorb the impact of prudential norms, it was decided to allow phasing of provisioning over two years. In terms of these guidelines, banks were required to provide for not less than 50.0 per cent of their aggregate provisioning requirement as on March 31, 1993 and the balance, in addition to the provisions needed for 1993–94, by March 31, 1994. When these guidelines were reconsidered, banks were advised in March 1993 to make 100.0 per cent provision in respect of loss assets, and not less than 30.0 per cent of the total provisioning needed in respect of sub-standard and doubtful advances and advances with an outstanding balance of less than ₹ 25,000 during the year ended March 31, 1993. The balance of provisioning for the above categories of advances, not provided for as on March 31, 1993, together with fresh provisioning needed for credit facilities identified in the year ending March 31, 1994, had to be made as on that date.

The introduction of new norms for income recognition and provisioning for bad debts and the prescription of new capital adequacy requirements were expected to ensure that the books of banks reflected their financial position more accurately and in accordance with international accounting practices. In order to protect the viability and financial health of the banking system, a large provision towards capital contribution to the extent of ₹ 5,700 crore was made in the Union Budget for 1993–94 to meet the gap created by the application of the first stage of provisioning norms. The Government's contribution was subject to specific commitments obtained from each bank to ensure that their future management practices ensured a high level of quality loan portfolio so that the problems of doubtful and bad loans did not recur. However, the amount of recapitalisation proposed by the Government was not sufficient to enable them to fulfil the provisioning norms and take care of additional capital needs on account of the implementation of capital adequacy guidelines.

If banks were to make provisions for bad debts, they would also be able to realise the security on their bad debts. The legal process for releasing banks' dues was not conducive for quick recoveries. The Government, therefore, decided to set up special tribunals to expedite legal action by banks to enforce recoveries and for this purpose, a bill, *i.e.*, recovery of debts due to the banks and financial institutions bill, 1993 was approved by Parliament on August 17, 1993. The bill provided for the setting-up of special tribunals for the trial of claims for recovery of debts that were due to all commercial banks, including RRBs and FIs. The provisions of the bill were, however, not applicable if the amount of debt due to any bank or FI or to a consortium of banks or FIs was less than ₹ 10 lakh or such amount, being not less than ₹ 1 lakh, as the Government specified by notification.

As regards accounting standards for investments, investments in approved securities had to be bifurcated into 'permanent' and 'current' investments. Permanent investments were those that banks intended to hold until maturity and current investments were those that banks intended to deal in, *i.e.,* buy and sell on a day-to-day basis. To begin with, banks were to keep not more than 70.0 per cent of their investments in the permanent category from the accounting year 1992–93, but this ratio was to be brought down to 50.0 per cent in due course. While the depreciation in permanent investment was not likely to affect their realisable value and therefore did not need to be provided for, depreciation in the current investment was to be fully provided for. 'Permanent' investment could be valued at cost unless it was more than the face value, in which case the premium had to be amortised over the period remaining for the maturity of the security. Banks were not expected to sell securities in the 'permanent' category freely, but, if they did so, any loss on such transactions in securities in this category had to be written off. Besides, any gain was to be taken to the capital reserve account.

Foreign currency assets and liabilities and spot and forward foreign exchange transactions (not matured) were required to be revalued on a monthly basis. Spot and forward transactions were to be revalued at the prevailing spot and forward foreign exchange rates, respectively. Long/short positions were to be revalued as per regulations in force. Gains and losses arising from the above valuations were to be reported on a net basis in the income statement and were not to be aggregated with any other type of income or expenses.

OLD PRIVATE SECTOR BANKS

There were, in all, 28 Indian banks functioning in the private sector before the licensing of new Indian private banks. Bank of Karad was being taken into liquidation. The majority of these banks had their headquarters in the states of Tamil Nadu (6), Kerala (6), Maharashtra (5) and Uttar Pradesh (4). The remaining seven banks were in Karnataka (2), with one each in Jammu and Kashmir, Rajasthan, Sikkim, Haryana and Delhi. In terms of ownership, state governments held a substantial/major portion of capital in three banks and certain nationalised banks held substantial share capital in four other private sector banks. The deposits of these banks aggregated ₹ 11,912 crore as on March 31, 1992 and advances were ₹ 6,505 crore. Four of the private sector banks had deposits exceeding

₹ 1,000 crore. Following the rating norms of banks, the financial position of the 28 banks was classified as under (Table 17.8).

TABLE 17.8

Bank Ratings

Rating	*Number of Private Sector Banks*
Good	6
Satisfactory	14
Not Satisfactory	3
Unsatisfactory	5

Source: Reserve Bank of India, *Report on Trend and Progress of Banking in India, 1997–98.*

PROBLEMS AND CONSTRAINTS OF BANKS IN THE PRIVATE SECTOR

Apart from general problems like low capital base, large load of sticky advances/loan losses, low profitability and inadequate provisioning for bad loans, private sector banks were also beset with special problems that affected their performance and their ability to continue as viable units in the long run. Most banks in the private sector being small were not able to develop a managerial cadre from within the organisation. This was reflected in the sizeable number of banks (as many as 17) remaining weak. These banks had as their chairmen retired officers or officers on deputation from PSBs/state government/Reserve Bank.

In some of these banks, there was dissension within the board due to business rivalry of the dominant controlling groups, which affected the functioning of banks. In some banks, there was interference in day-to-day affairs by directors and it became necessary for the Reserve Bank to circulate instructions on the role of directors on the boards of private sector banks.

Most private sector banks had a low capital base. In fact, in eight of these banks, the ratio of paid-up capital and reserves to deposits was less than 2.0 per cent as against the desired norm of 2.5 per cent. Private sector banks were advised by the Reserve Bank to conform to the capital adequacy norms by raising their percentage of owned funds to risk weighted assets to 4.0 per cent by March 1993 and 8.0 per cent by 1996. Barring a few banks, almost all banks were able to improve their profitability during the year

1992. In the case of the old private sector banks, the level of sticky advances had gone up and it had a serious impact on their profitability and liquidity. In many of these banks the areas of concern were poor fund management, ineffective internal control, unsatisfactory credit appraisal, inadequate post-disbursal supervision, and lack of experienced and trained staff. Internal control mechanisms and the management information system (MIS) continued to remain unsatisfactory in most banks and the coverage of internal inspections continued to be deficient.

Among the old private sector banks, Bank of Karad Ltd, Bank of Madura Ltd, and Nedungadi Bank Ltd were affected by the irregularities in security deals. The Bank of Karad Ltd had undertaken large transactions in securities on behalf of some brokers without verifying the genuineness of transactions or the ability of the broker clients to honour commitments under bank receipts. In view of its small size and large liability, the bank had to be taken into liquidation, for which a petition was filed in the Bombay High Court. Although, Bank of Madura Ltd had not incurred any losses, the exposure of the bank to a potential risk of loss was high. The security transactions of Nedungadi Bank Ltd with ABFSL and FFSL were also not as per the Reserve Bank instructions.

There was an unusual incident of loss of cash held in an unassigned locker at the Madras (Mount Road) branch of Federal Bank Ltd. The money, according to the bank, belonged to its two constituents and the bank had initiated disciplinary proceedings against the officials involved. The bank also figured in the media in connection with its alleged dealings with FFSL. It was, however, affirmed that the bank's limited dealings with FFSL as a broker had not put the bank to losses.

There was adverse publicity in the press concerning the operations of Karnataka Bank Ltd as a sequel to the internal strife between the elected directors and the chairman of the bank. All the existing directors were replaced by a new set of directors by the shareholders at the annual general body meeting. The bank had extended certain credit facilities to FFSL and it had contended that the advances were fully secured.

In view of the liberalisation in the financial and economic spheres, several financial companies and industrialists were showing interest in joining the management of private sector banks. Substantial trading in banks' shares was taking place. Among others, the Narasimham Committee recommended that there be no bar to new banks being set up in the private sector, provided they conformed to the start-up capital and other requirements prescribed by the Reserve Bank. Most of the private sector banks were small and confined to limited areas of operations, but they served a useful purpose. It was, however, difficult for them to compete effectively with PSBs.

PROVISIONING FOR BANK ADVANCES OF LESS THAN ₹ 25,000

Banks were required to make provisioning to the extent of 5.0 per cent of the aggregate amount outstanding as on March 31, 1994 in respect of advances with balances of less than ₹ 25,000. Considering the proportion of NPAs in this category, the provisioning was considered inadequate and it was decided to increase the provisioning requirement for NPAs from the existing 5.0 per cent to 7.5 per cent of the aggregate amount outstanding in respect of advances with balance less than ₹ 25,000 for the year ending March 31, 1995 and further to 10.0 per cent for such balances for the year ending March 31, 1996.

Banks were required to maintain a margin of not less than 25.0 per cent for advances granted against deposits. To allow greater flexibility, the Reserve Bank gave banks the freedom to determine the margin on a case-by-case basis.

OFFSITE SURVEILLANCE AND MONITORING SYSTEM

In February 1995, the DoS introduced an OSMOS as the first step towards a new strategy of strengthening supervision of banks under the direction of the BFS. Prior to the introduction of OSMOS, the Reserve Bank was relying on onsite inspections to perform its supervisory role. With fast-paced changes in the financial environment and market orientation, data-based offsite surveillance was introduced to optimise supervisory resources and put in place a sound database for better supervision. This system depended on a package of prudential supervisory reports to be filed by banks on a quarterly basis, and was proposed to be introduced in two stages. These were used for prudential supervision of banks between onsite inspections in order to estimate the evolving financial condition of the banks and undertake prompt corrective action, if needed.

GOVERNMENT'S QUERY

In February 1995, the Ministry of Finance addressed a letter to the Reserve Bank stating that while the reforms in the financial sector had achieved the desired effect, the Government had received comments from various quarters highlighting some practical issues requiring attention in order to ensure efficient functioning of the financial system. The issues broadly related to CRR, bifurcation of credit facilities into a fixed loan and a fluctuating account, lending under consortium arrangement and installation of ATMs.

On the cash credit system of lending in Indian banking, it was pointed out that under this system, the volatility in the fund management exercise of banks increased and borrowers utilised cash credit limits to book arbitrage spreads in tight liquidity conditions. Conversely, banks lost out on interest when borrowers brought down cash credit drawals, when the market was flush with liquidity. It was, therefore, suggested that since companies had proved to be better managers of short-term liquidity than banks, a system based on bifurcation of credit facilities into a fixed loan and a fluctuating account, *viz.*, cash credit, appeared to be more useful than the cash credit system. It was also suggested that a higher interest rate should be charged on the cash credit component than on fixed loans.

In reply, the Governor in his letter of August 1995 clarified that as part of a historic reform of the credit delivery system, the Reserve Bank had introduced a loan system under which, for borrowers with maximum permissible bank finance of ₹ 20 crore and above, the cash credit component would be limited to 75.0 per cent of the maximum permissible bank finance, and if the borrower wished to avail of the balance 25.0 per cent of the maximum permissible bank finance, he had to necessarily take it in the form of a short-term loan. This was expected to bring about a measure of credit discipline.

In respect of consortium lending, the Secretary of the Ministry of Finance had observed that although the threshold limit for mandatory consortium lending had been raised from ₹ 5 crore to ₹ 50 crore, this did not seem to have made a substantial difference in the number of consortium borrowal accounts for the fear of loss of effective control over borrowers by banks. Also, borrowers were obtaining credit facilities from other banks either by not informing the lead bank or by waiting for a period of 10 to 15 days to lapse to get a no-objection certificate (NOC) from the lead bank. With the relaxation of the threshold limit for consortium lending, it had become mandatory for companies (with a net worth of ₹ 50 crore or so to begin with) to announce audited financial results half-yearly and later at quarterly intervals. It was added that companies should be asked to declare a schedule of all their borrowings from various sources along with details of securities charged, which would help banks keep better track of their borrowal accounts.

The Governor, in his reply highlighting the major relaxations made in the policy of consortium lending, stated that with deregulation of interest rates, the consortia arrangement would get replaced by syndication and borrowers would go in for multiple credit arrangements. As regards the suggestion to introduce mandatory audit on a quarterly basis for companies with a net worth of ₹ 50 crore and above, it was pointed out that as per the practice, banks were required to examine certificates obtained by borrowers from their statutory auditors regarding their borrowings from banks and FIs before a decision was taken on credit proposals. To keep track of borrowal accounts, a lending bank could obtain information audited or otherwise from its borrowers, particularly larger ones, about their borrowings and securities.

The Governor added that as competition became more intense among banks and institutions, consortia arrangement would gradually be dismantled and hence no further specific measures were warranted. On the Secretary's suggestion to remove the restrictions on grant of permission to banks to allow them to set up offsite ATMs to improve their popularity, the Governor replied that banks were permitted to install ATMs at places identified by them in addition to branches and extension counters for which they held licenses issued by the Reserve Bank subject to the condition that after the installation, banks should obtain a licence for the purpose from the concerned regional office of the Reserve Bank.[20]

DIVERSIFICATION OF ACTIVITIES BY BANKS: SETTING-UP OF SUBSIDIARIES

Some banks were given permission to set up subsidiaries to undertake para-banking and other incidental activities. In terms of the guidelines for primary dealers in government securities market issued by the Reserve Bank, the SBI, Canara Bank and PNB were given in principle approval to set up subsidiaries. The subsidiary of PNB would be wholly owned by the bank. The subsidiaries of SBI and Canara Bank were to be JVs with other PSBs. The Asian Development Bank (ADB) was contributing to the share capital of the SBI subsidiary to the extent of 15.0 per cent.

STOCKINVEST SCHEME

Four private sector banks and one foreign bank were allowed to introduce stocks schemes, bringing the total number of banks under the scheme to

20. Reserve Bank of India, circular no BP.BC 152/21.03.051/94 dated August, 29, 1994. This circular was also forwarded to the Government.

54. As per the extant instructions, stockinvests could be issued only to individuals and mutual funds. The scrutiny conducted by the DoS as also investigations by the Economic Intelligence Bureau of the Government revealed that corporate bodies/NBFCs/share brokers had misused the facility of stockinvest by using individuals as 'fronts'. The matter was followed up with the concerned banks (*i.e.*, Vysya Bank, IndusInd Bank and State Bank of Saurashtra) and, at the instance of the Reserve Bank, Vysya Bank took action against the erring staff and also stopped the issue of stockinvests from the erring branches. A show-cause notice was issued under section 47A of the BR Act 1949 to the State Bank of Saurashtra. In light of the irregularities, Reserve Bank made a proposal to SEBI to prescribe a ceiling of ₹ 1 lakh per individual per capital issue for the issue of stockinvests by banks.

EQUITY PARTICIPATION BY BANKS IN OTHER CORPORATES

Six PSBs and four private sector banks were allowed to participate in the equity capital of certain corporate that were being set up to provide specialised services. These specialised corporate were Canbank Computers Services Ltd, India Clearing and Depository Services Ltd, TAIB Capital Corporation Ltd, Weizmann Homes Ltd and Punjab Venture Capital Fund.

STUDY OF MANAGEMENT INFORMATION SYSTEM ON COMMERCIAL BANKING: OPERATIONAL AND REGULATORY ASPECTS

In view of the progressive liberalisation and deregulation of commercial banking operations, a need was felt to examine various returns called for by different departments of the Reserve Bank from banks so as to eliminate superfluous returns and streamline the reporting mechanism to conform to the new requirements. In January 1995, the Reserve Bank constituted a study group on review, rationalisation and redesign of returns relating to core commercial banking areas (Chairman: Shri T.N.A. Iyer). The group submitted its report on July 1, 1995 and recommended the following: (i) eliminating 120 returns; (ii) simplifying/redesigning/rationalising the remaining returns in terms of changing the frequency of submission; and (iii) immediate use of computer media for receipts, scrutiny and processing of returns. The follow-up on implementing the recommendations was initiated early to enable banks to reduce their workload and improve efficiency.

DEVELOPMENTS RELATING TO URBAN CO-OPERATIVE BANKS

OVERVIEW

The co-operative system developed serious weaknesses over time and UCBs were no exception. The UCBs continued to be subjected to the Reserve Bank's regulatory policies and directions. A separate department handled matters relating to UCBs. By and large, whenever changes were introduced in the regulatory and supervisory policies for commercial banks, they were extended to UCBs, after a review with suitable modifications. Although these banks were functioning like commercial banks, in view of the nature of their ownership and regulatory structure, the Reserve Bank extended special dispensations to UCBs in the applicability of various norms, such as those relating to licensing, regulatory and supervisory guidelines, lending and prudential norms and statutory prescriptions on cash and liquidity requirements.

When the Narasimham Committee addressed the problems of the banking system in 1991 and suggested a road map for liberalising the banking sector, a similar need was felt to relook at the regulatory issues relating to the UCBs, *de novo*. Accordingly, the Reserve Bank appointed the Marathe Committee in 1991. The recommendations of this committee were far-reaching, particularly in the realm of bank licensing, branch licensing and areas of operation. The Marathe Committee suggested dispensing with the archaic 'one district–one bank' licensing policy and recommended that banks be organised based on the need for an institution and the potential for the bank to mobilise deposits and purvey credit. It also felt that the existence of a commercial banking network should not prevent the co-operative banking initiative.

The Reserve Bank also appointed a working group under the chairmanship of Shri Uday M. Chitale in December 1995 to review the audit systems in the UCBs. With a view to instilling professionalism in the audit of the UCBs, the group suggested that the audit of banks with deposits of ₹ 25 crore and above should be done by chartered accountants, thus ending the monopoly of the state government's audit of the UCBs. It also suggested a revised audit rating model for the UCBs. None of the states with a large presence of co-operative banks, however, implemented the recommendations of the working group.

Besides easing regulatory restrictions, the Reserve Bank made several policy pronouncements in the operational sphere. The UCBs were allowed to invest 10.0 per cent of their surplus funds outside the 'co-operative fold'. The ceiling on quantum of advances to nominal members was increased substantially and scheduled UCBs were allowed to undertake merchant banking forex operations. Effective November 1996, UCBs were given the freedom to finance direct agricultural operations. Interest rates on deposits of urban banks were deregulated. They could also install ATMs without the prior approval of the Reserve Bank.

In the post-Marathe Committee dispensation, there was a paradigm shift in the Reserve Bank's regulatory approach. An excessively controlled regime gave way to a fairly liberalised era. The shift in the policy of the Reserve Bank on UCBs was a natural corollary of its stance on the financial sector. Most of the state governments, who were co-regulators, had not brought out any significant parallel reforms in tune with the liberalisation process set in by the Reserve Bank. The notable exception was Andhra Pradesh, which brought in the Mutually-Aided Co-operative Societies Act, 1995 that freed co-operative societies registered under this Act from the government control as long as they did not raise share capital or seek guarantees from the state government. The enactment provided complete freedom to UCBs to frame and amend their bye laws, conduct elections to the boards, select auditors and take important decisions on day-to-day operations. It also permitted them to decide independently regarding amalgamation, liquidation, division and reconstruction with no prior approval from the Reserve Bank. As there was no provision regarding 'insured co-operative bank' in the Act, co-operative banks registered under this Act were not eligible for deposit insurance cover under the DICGC Act. The government of Andhra Pradesh was advised of the lacunae and asked to consider proposing suitable amendments to the new Act.

A meeting of the presidents of the national federation and some state federations of primary co-operative banks, the chairmen of select primary co-operative banks and the Registrars of Co-operative Societies of certain states was held on December 2, 1995 to discuss the problems that these banks faced. The Governor of the Reserve Bank presided over the meeting. The representatives of urban banks and their federations highlighted the problems such as dual control by the Reserve Bank and the state governments, the enrolment of nominal members, restrictions on mobilising share capital, donations for charitable purposes, extension of the areas of operation beyond the state of registration and allowing UCBs to take up leasing and hire purchase activities. The Governor indicated that the UCBs would be allowed opportunities to grow and diversify if they followed the prudential guidelines and norms prescribed by the Reserve Bank. Action on the part of the Reserve Bank, where necessary, on the issues deliberated at the meeting was taken.

IMPLEMENTATION OF MARATHE COMMITTEE RECOMMENDATIONS

The Reserve Bank accepted most of the recommendations of the Marathe Committee with certain modifications and came out with a new policy in May 1993. The emphasis of the new policy was on need-based and healthy growth of these banks. Certain relaxations were allowed in the entry point norms for new UCBs in the least developed, tribal and desert areas and less developed states as also for banks organised by women and scheduled castes (SCs)/scheduled tribes (STs). The revised viability norms were to be attained within three years. UCBs were allowed to extend their areas of operation to the entire district without specific approval from the Reserve Bank. Banks with deposits of ₹ 50 crore and above were permitted to cross the borders of the states of their registration. Banks complying with certain norms were also allowed to open extension counters.

Banks operating in metropolitan/urban/semi-urban centres were permitted to extend their areas of operation to the peripheral rural areas to meet non-agricultural financial needs of their members. Norms for issue of licenses to the existing unlicensed UCBs were also relaxed, and those for inclusion of urban banks in the second schedule to the RBI Act, 1934 were proposed to be revised.

Weak and non-viable banks were sought to be weeded out by merger/amalgamation with stronger units and/or liquidation. The Reserve Bank urged the state governments to initiate measures in co-ordination with the former in this regard. State governments were advised to make appropriate amendments to the State Co-operative Societies' Law for promoting democracy and autonomy in the functioning of the co-operatives while also encouraging self-regulation and responsible action. Suitable legislative amendments to the BR Act, 1949 (as applicable to co-operative societies) were suggested to facilitate the merger/amalgamation of weak urban banks.

While accepting the recommendations of the Marathe Committee with regard to computerisation of UCBs, the Reserve Bank, on June 24, 1993 advised all UCBs, particularly those with working capital of ₹ 5 crore and above, to take appropriate measures to computerise their operations so as to render better customer service, enhance profitability and improve their overall efficiency.

LICENSING

A policy enunciated in 1986 to grant licenses to new UCBs in districts devoid of urban banking facilities continued through 1989–90. At the end of June 1990, there were 1,390 urban (primary) co-operative banks in the country, which included 36 *mahila* banks and 92 salary earners' banks.

Under the branch expansion programme for UCBs covering the three-year period 1991–1994, permission for opening branches was issued to a licensed bank that met the following requirements: (i) it was financially viable; (ii) it had deployed the stipulated level of credit to the priority sector; (iii) it had overdues within the prescribed limit; (iv) it had submitted proper compliance to the inspection reports; and (v) violations of directives, that had been pointed out, were complied with. Accordingly, during the branch plan period 1991–1994, of the proposals from 660 UCBs, those of 363 banks were approved and these banks were allotted 446 centres by the Reserve Bank for opening branches, as at end-June 1993.

On June 9, 1993, the Reserve Bank introduced relaxations in the guidelines regarding the opening of extension counters, shifting of offices and closure of branches; however, decisions on these had to be approved by the boards of directors of the respective banks under intimation to the Reserve Bank, obtaining post facto approval within one month of their implementation. With a view to giving greater freedom to financially strong and well-managed UCBs, banks that satisfied the prescribed norms were permitted to open branches at centres of their choice without prior approval from the Reserve bank.

UCBs were permitted to extend their areas of operation to rural centres, 10 kilometres beyond the boundaries of semi-urban/urban centres, subject to the condition that they provided financial assistance only for non-agricultural productive activities. In order to enable UCBs to freely extend their operation jurisdiction within the district of their registration, prior approval of the Reserve Bank was dispensed with, subject to their obtaining approval from the Registrar of Co-operative Societies. UCBs were, however, required to seek prior approval of the Reserve Bank for extension of field of operation beyond the district of registration. One UCB was deleted from the list of scheduled UCBs when it was converted into a commercial bank, while five UCBs were included in the second schedule of the RBI Act, 1934, which increased the total number of scheduled UCBs to 18.

A liberal policy of allowing new UCBs based on need, business potential and prospects of achieving viability within a specified time frame continued to be followed. The number of UCBs, including salary earners' societies, which stood at 1,653 at end-March 1997 increased to 1,811 at end-March 1998. Licensed UCBs whose demand and time liabilities were not less than ₹ 100 crore were qualified to be included in the second schedule to the RBI Act, 1934. The number of such scheduled UCBs stood at 29 at the end of March 1998. In 1997–98 (July–June), 388 centres were allotted to 54 UCBs. A total of 388 licenses were issued to 86 banks for opening branches.

REHABILITATION OF WEAK URBAN CO-OPERATIVE BANKS

Conscious of its responsibility to supervise, control and develop the urban co-operative banking system on a sound and viable footing, the Reserve Bank made special efforts to rehabilitate banks classified as weak. As on March 31, 1991, the number of UCBs classified as financially weak stood at 230. They were designated as 'weak' because of the heavy erosion in their owned funds, high level of overdues, non-compliance with minimum share capital required in terms of the provisions of section 11(1) of the BR Act, 1949 (as applicable to co-operative societies), not satisfying the viability norms prescribed by the Reserve Bank.

As a sequel to the adverse findings of inspection/investigation of complaints, indicating substantial deterioration in the financial position, directions under section 35A of the BR Act, 1949 (as applicable to co-operative societies) were issued to three primary urban co-operative banks, placing restrictions, among others, on payment to depositors incurring expenditure beyond specified amounts and prohibiting granting/renewal of loans and advances. With this, a total of 11 UCBs were working under such directions.

In view of serious irregularities/deficiencies observed in the functioning and/or their precarious financial position, directions were issued/modified/extended to 11 UCBs under section 35A of the BR Act, 1949. Of the 1,811 primary urban co-operative banks, 53 co-operative banks and 2 salary earners' societies were under liquidation. The number of UCBs classified as 'weak' as at end-March 1997 stood at 242. The performance of weak banks was closely monitored by the regional offices of the Reserve Bank in close co-ordination with the respective state federations of UCBs/Registrars of Co-operative Societies. The Registrar of Co-operative Societies, Government of Maharashtra issued orders for liquidation of two weak banks in 1997–98 (July–June).

SOME PENAL ACTIONS

Winding up of Metropolitan Co-operative Bank Ltd

The involvement of Metropolitan Co-operative Bank Ltd in Maharashtra in issuing BRs to some banks, the outstanding amount of which exceeded ₹ 1,300 crore as against the bank's total working capital of less than ₹ 8 crore, came as a shock to the Reserve Bank. Considering the seriousness of the irregularities, the Reserve Bank in May 1992 asked the Registrar of Co-operative Societies, Maharashtra, in terms of section 110A (iii) of the Maharashtra Co-operative Societies Act, 1960 to immediately replace the board of directors of the co-operative bank by an administrator who would take charge and run its affairs. After consulting the authorities, the Reserve Bank accorded its sanction for winding up the bank on June 19, 1992. The DICGC was requested to stand ready to pay to the depositors the amount outstanding to their credit up to a maximum of ₹ 30,000 per depositor.

The Reserve Bank issued directions to four primary urban co-operative banks under section 35A of the BR Act, 1949 (as applicable to co-operative societies), placing restrictions, among others, on the maximum amount of withdrawal of deposits, on grant/renewal of loans and advances and incurring expenditure beyond specified amounts. Further, show-cause notices were issued to two banks for working to the detriment of interests of their depositors under the provisions of the BR Act, 1949, and their licence to carry on banking business in India was cancelled. In respect of six UCBs, the boards of directors were superseded. On the recommendation of the Reserve Bank, six banks were placed under moratorium by the Government during the year 1992–93, and all these banks were amalgamated or cleared for amalgamation with other stronger units.

Directions under section 35(A) of the BR Act, 1949 (as applicable to co-operative societies) were issued to five UCBs, placing restrictions on their functioning in view of deterioration in their financial position. In respect of eight banks that were earlier issued such directions, the validity was extended. Of 233 weak/non-viable UCBs as also UCBs that did not comply with the minimum capital requirements, four banks were identified by the Reserve Bank for amalgamation with stronger units. In view of serious irregularities in their working, the boards of directors of five UCBs were superseded by the respective Registrars of Co-operative Societies.

In 1994–95, 14 banks were classified as weak banks, 8 banks were amalgamated with stronger units and 5 were liquidated. 18 banks were deleted from the list of weak banks after they showed improvement in their financial position.

GUIDELINES RELATING TO ACCOUNTING AND OTHER REGULATORY PRESCRIPTIONS

Accounting Period

The accounting period of the co-operative banks was brought in line with that of commercial banks with effect from 1991–92. Section 29(i) read with section 56 of the BR Act, 1949 was amended for the Central Government to specify the date with reference to which annual accounts were to be drawn by co-operative banks. The Central Government issued a notification on January 29, 1992 specifying March 31 of each year as the date for co-operative banks to close their annual accounts. Some credit policy changes/restrictions on commercial banks, such as those relating to the prohibition of chit business, loans for purchase of consumer durables and other non-priority sector personal loans, credit to individuals against shares and debentures/bonds, selective credit controls and interest rates on deposits and advances were also made applicable, with suitable modifications, to the UCBs and central co-operative banks (CCBs).

Interest Rates on Deposits and Advances

The discretion enjoyed by the UCBs allowing additional interest at a rate not exceeding 1.0 per cent per annum on domestic savings and term deposits was reduced to not more than 0.5 percentage points, effective July 24, 1991 in view of the higher interest rates on term deposits. For non-scheduled UCBs, the same 0.5 percentage points' interest discretion was prescribed for the maximum maturity of deposits of 3 years and above; for other maturities, it was retained at 1.0 percentage point. The discretion given to UCBs to allow additional interest at a rate not exceeding one per cent per annum on all savings deposits and at rates not exceeding 0.5 per cent per annum on all term deposits of not less than 46 days was continued.

Following the rationalisation of interest rates on advances made by commercial banks, a similar exercise was undertaken for UCBs and a new interest rate structure, keeping in view their size and preponderance of small loans, was prescribed with effect from June 1, 1991. As a sequel to a further step-up in interest rates on advances made by commercial banks, increases of a similar nature were effected for interest rates on advances charged by UCBs, effective July 24, 1991. In respect of the general category (*i.e.,* other than the concessional rates), the increase was 0.5 percentage points each to a range of 15.0 per cent to 16.5 per cent for all sizes of advances up to ₹ 2 lakh and from 17.0 per cent (minimum) to 18.5 per cent (minimum) for advances over ₹ 2 lakh.

The interest rates on deposits and advances were revised at periodic intervals. With effect from October 1992, the single prescription on deposit rate was revised to not exceed 12.0 per cent per annum. Effective March 2, 1992 the lending rate on UCBs' credit limits of over ₹ 2 lakh was reduced by 1.0 percentage point, from 20.0 per cent (minimum) to 19.0 per cent (minimum), but the effective interest rate on discounting of bills of exchange was fixed at 18.0 per cent (minimum) per annum. Given the nature of the activity of co-operative banks, it was subsequently decided that the lending and deposit rates of all co-operative banks would be completely deregulated and co-operative banks would be given the freedom to determine their deposit and lending rates, subject to the prescription of a minimum lending rate of 12.0 per cent per annum.

In line with the instructions issued to commercial banks, UCBs were advised to afford credit of interest to customers if the amount of interest payable on account of delay in collection of outstation cheques worked out to 25 paise or more. Further, UCBs were allowed to extend immediate credit for more than one outstation cheque at a time within the overall limit of ₹ 2,500. They were also advised to sanction advances against the security of kisan vikas patra, taking into consideration the purpose of the advance and in accordance with the directives issued by the Reserve Bank on interest rates. Besides, they were allowed to sanction advances against the pledge of national savings certificates (viii issue), subject to the usual terms and conditions. At the end of June 1991, 58 UCBs were permitted to open and maintain non-resident (ordinary/external) [NR(E)R/NRO] accounts.

The Reserve Bank, on June 2, 1993, permitted UCBs to sanction advances against the security of gold bonds, 1998 and 10.0 per cent relief bonds, 1993. While the interest rate on such advances would depend on the directives on advances issued by the Reserve Bank, the banks should also satisfy themselves about the genuineness of the credit needs of the borrower and proper end-use of the funds provided as loan.

Limit on Advances

To curb kite-flying operations by their clients, UCBs were instructed that drawals allowed against cheques sent for collection (both local and outstation) would be treated as unsecured advances and would be subject to the directives issued by the Reserve Bank. Clearing house authorities at various places were also advised to ensure that members complied with the rules governing utilisation of favourable clearing balances so as to deny them the use of such funds before the returned cheques were adjusted. With effect from May 20, 1991, the maximum limits on unsecured advances to a director (including relatives) or any other single party/connected group for trade, commerce, cottage and small scale industry and identifiable purposes, were revised upwards to ₹ 25,000 and ₹ 50,000 for UCBs with demand and time liabilities of ₹ 1 crore to less than ₹ 10 crore, and ₹ 10 crore and above, respectively. UCBs with working capital funds of ₹ 25 crore and above were allowed to take up financing of leasing/hire-purchase companies in consortium with SCBs.

Licensed and unlicensed UCBs specifically recommended by the Reserve Bank were eligible for guarantee cover under the small loans (SSI) guarantee scheme, 1981 and small loans (co-operative banks) guarantee scheme, 1984 administered by the DICGC.

Non-Resident Accounts

UCBs were authorised to open and maintain NR(E)R/NRO accounts, and as at the end of June 1990, 49 banks were allowed to have non-resident accounts.

Priority Sector Guidelines

The UCBs were required to lend 60.0 per cent of their total advances to the priority sector, of which at least 25.0 per cent should be to weaker sections. Priority sector advances of co-operative banks aggregated at ₹ 1,703 crore, forming 63.1 per cent of their total outstanding advances in 1991.

The facility of refinance against the collateral of government and trustee securities was extended to scheduled UCBs for the purpose of clearing imbalances. The refinance limit was restricted to 1.0 per cent of demand and time liabilities of the concerned bank and the rate of interest on this refinance was 12.5 per cent.

Income Recognition and Asset Classification

Apart from prescribing entry point, viability norms and the guidelines relating to their operations, the Reserve Bank also placed stipulations on UCBs in respect of income recognition, classification of assets and provisioning along the lines stipulated for SCBs, with suitable modifications, that could be implemented in a phased manner over three years commencing from the accounting year beginning April 1, 1992. Accordingly, the Reserve Bank issued detailed guidelines on February 9, 1993, advising all UCBs to ensure that necessary provisions against sub-standard assets, doubtful assets and loss assets were reflected in their profit and loss accounts and balance sheets from the accounting year ending March 31, 1993.

Participation in Inter-bank Market

The UCBs were permitted to deal with the Discount and Finance House of India Ltd (DFHI) in the inter-bank market, both as lenders as well as borrowers. In view of this, deposits received by the UCBs from the DFHI were exempt from the provisions of the directives on interest rates issued by the Reserve Bank.

Cash Reserve Ratio

Effective the fortnight beginning July 17, 1991, 11 scheduled UCBs were required to maintain CRR of not less than 6.0 per cent of demand and time liabilities in India as against the 3.0 per cent minimum being maintained by them. The three remaining UCBs that were included in the second schedule of the RBI Act, 1934 were required to follow the same prescription from the fortnight beginning January 11, 1992.

DEVELOPMENTS RELATING TO NBFCs AND FIs

NBFCs were a growing segment of the Indian financial system and there was a pressing need for their orderly development along well accepted prudential lines. During the period 1991 to 1997, the Reserve Bank was actively engaged in introducing necessary legislative changes and prudential norms for the sound functioning of these institutions, based on recommendations of the expert groups. The Reserve Bank also introduced a system of registration and strengthened its supervisory practices.

REGULATION OF DEPOSIT ACCEPTANCE BY NON-BANKING COMPANIES

Effective July 27, 1991 the maximum rate of interest that NBFCs and miscellaneous non-banking companies could offer on their deposits was raised from 14.0 per cent to 15.0 per cent per annum. In September 1991, it was prescribed that interest could be paid or compounded at quarterly rests. From June 17, 1992, however, these companies were allowed to pay interest or compound interest at rests not shorter than monthly rests. The investment requirements in government and approved securities by hire-purchase and equipment-leasing companies was raised from 10.0 per cent to 15.0 per cent of the deposit liabilities, which could be achieved, in a phased manner, 1.0 per cent in each quarter commencing from November 1, 1991 and reaching 15.0 per cent on November 1, 1992. Of the 15.0 per cent liquid assets, a minimum of 5.0 per cent were required to be kept in the form of central and state government securities and/or central and state government-guaranteed bonds. The minimum and maximum period for which deposits could be accepted by loan and investment companies was raised from 6 months and 36 months to over 24 months and 60 months, respectively, as was the case with hire-purchase and equipment-leasing companies. It was stipulated that if a company was engaged in both hire-purchase finance and equipment-leasing activities, its business in both these activities would be considered in determining its principal business and classification. On a 3-year average, the company should hold at least 50.0 per cent of its assets in hire-purchase and equipment-leasing and should have at least one-third of its income from these two activities so as to be classified as a hire-purchase or leasing company.

OBSERVATIONS BY THE JPC

The JPC that enquired into irregularities in securities and banking transactions made certain observations and recommendations relating to NBFCs. The observations of the JPC, which acted as the trigger for the introduction of regulatory measures for effective monitoring, supervision and controls over NBFCs, were:

> The committee conclude that some non-banking financial companies played a dubious role in the scam. In this connection they note that the powers of the Reserve Bank of India to supervise and monitor the working of non-banking financial companies are derived from Chapter III B of the Reserve Bank of India Act. However, the control exercised by RBI in terms of the said provisions is not adequate being confined only to deposit taking activities. It is astonishing that no authority, either in the Government of India or in the Reserve Bank of India, appears to have taken stock of possible role of non-banking financial companies in securities and banking transactions nor of the limitations in the Reserve Bank of India Act to deal with such contingencies. Over a period of several years, an entirely new sector of financial activity was allowed to grow and flourish without

> giving any thought to deleterious consequences of the activities of this new sector. In the light of the role of the NBFCs in the current scam, the committee are of the considered view that there is an imperative need to ensure that the financial companies follow prudent practices for inculcating healthy financial discipline and therefore their overall functioning, particularly the deployment of funds has to be brought within the purview of some guidelines. The committee, therefore, recommend that government should examine whether the provisions in Chapter III B of the RBI Act are sufficiently wide to cover the necessary regulation. If not, the question of re-enforcing the existing legislation or to enact a separate legislation for the non-banking financial companies be examined so as to ensure proper functioning of NBFCs and also to protect the interest of the depositors.

THE SHAH WORKING GROUP

The Narasimham Committee had recognised that NBFCs would have to be integrated within the mainstream of the overall financial sector reform. The committee observed that prudential norms and guidelines for conduct of business should also be laid down for these companies and a system of offsite supervision based on periodic returns should be instituted within the purview of the agency proposed to be set up to supervise the entire financial system.

In order to prepare a programme of reform for the financial companies, the Reserve Bank constituted a working group in May 1992 under the chairmanship of Dr A.C. Shah, which submitted its report in September 1992. The working group provided a comprehensive framework for reforms of the financial companies and sought to strengthen their operations by laying down prudential norms.

The Reserve Bank accepted the recommendations of the Shah Working Group with some modifications. As the reform process was likely to require adjustment by the financial companies, the measures were proposed for implementation in a phased manner. Accordingly, the Reserve Bank introduced several changes in the directions with effect from April 12, 1993.

As part of the measures in the first phase, the Reserve Bank made certain changes in the directions issued to NBFCs in April 1993, which were amended in May 1993. The duration of deposits of all NBFCs was uniformly stipulated at a minimum of 12 months and a maximum of 84 months; this implied that the maximum duration of deposits for residuary non-banking companies (RNBCs) was reduced from 120 months to 84 months, while the minimum for all other financial companies was reduced from over 24 months to 12 months. The rules for premature deposits were revised in tune with the bringing down of the minimum period for deposits. Thus, this brought into alignment the maturity range of deposits of different types of companies. Inter-corporate deposits of private limited companies and funds raised through the issue of debentures or bonds secured by mortgage of immovable property, which were earlier in the exempt category of deposits, were brought under the purview of the Reserve Bank's directions. However, inter-corporate deposits accepted by financial companies up to a period of 12 months to the extent of two times their NOFs were not subject to the stipulations on interest rate and minimum period.

Hire-purchase finance and equipment-leasing companies were required to maintain liquid assets at 10.0 per cent of deposits. Loan and investment companies were required to maintain liquid assets to the extent of 5.0 per cent of their deposits. Half the liquid assets, *i.e.,* 5.0 per cent of the deposits in the case of equipment-leasing and hire-purchase finance companies and 2.5 per cent of the deposits in the case of loan and investment companies, were required to be maintained in the form of government securities and/or government-guaranteed bonds.

The RNBCs were also required to maintain a minimum investment in government securities and/or government-guaranteed bonds to the extent of 10.0 per cent of their deposit liabilities, within the limit of 70.0 per cent investment in approved securities. NBFCs and RNBCs that had not attained the prescribed liquidity ratios were allowed time until the end of March 1994 to attain these stipulations. All financial companies including RNBCs that had NOFs of ₹ 50 lakh and above were required to register with the Reserve Bank. The registration would, in due course, be vital for companies that were expanding their operations. The other recommendations of the working group were implemented in a phased manner and legislative changes as required were suggested to the Government.

DIRECTIONS ISSUED TO RESIDUARY NON-BANKING COMPANIES

RNBCs that accepted deposits under certain schemes were governed by a set of directions known as the RNBCs (Reserve Bank) directions, 1987. Since most RNBCs did not have adequate NOFs (*vis-a-vis* the quantum of their deposits), unlike the directions issued to financial and miscellaneous non-bank companies, these directions stipulated that at least 10.0 per cent of their deposit liabilities should be kept in fixed deposits with PSBs and another 70.0 per cent of the deposit liabilities be held in the form of approved securities. The constitutional validity of these directions was challenged by some RNBCs. Some of these companies were not showing their entire liability to depositors and were transferring a portion of the deposits to their profit and loss account to meet their revenue expenditure. The Supreme Court in its judgement dated January 30, 1992 upheld the validity of the directions and ruled that the RNBCs could not use any portion of the deposits to meet their working capital expenses.

The RNBCs (Reserve Bank) directions, 1987 were amended on April 19, 1993 in order to prohibit some residuary companies from violating the directions by collecting substantial amounts from their depositors/subscribers as processing/maintenance charges. One of the companies challenged this amendment in the Calcutta High Court. At the time of admission of the writ petition, the Reserve Bank gave the Court an undertaking that the relevant notification would not be enforced in respect of the petitioner company until further orders by the Court since there was not enough time for the Reserve Bank to file a counter-affidavit. In view of the delay in the disposal of the matter, the Reserve Bank made an application to withdraw this undertaking. The Court had, however, passed an order that the Bank would not enforce the provisions of the relevant notification until disposal of the petition.

THE CHIT FUNDS ACT

The Chit Funds Act was brought into force in 19 states/UTs in 1992–93. The other states and UTs were being persuaded to frame rules to bring the provisions of the Act into force. Here again, the validity of the Act was challenged in different courts and the Supreme Court; the case was heard in the Supreme Court in November 1992 and the Court, in its judgment dated July 17, 1993, upheld the validity of the Act in its entirety.

ACCEPTANCE OF DEPOSITS BY UNINCORPORATED BODIES

Several states/UTs had issued notifications authorising suitable officers to take action against unincorporated bodies as envisaged in sections 45T and 58E of the RBI Act, 1934. The number of such unincorporated bodies remained unaltered at 30 during 1992–93. The total number of unincorporated bodies that had to pay penalty was six; while one case was quashed by the concerned High Court. During 1994–95, the Reserve

Bank initiated proceedings against 19 unincorporated bodies under the legislation.

The constitutional validity of the stipulations regarding the ceiling on the number of deposit accounts to be accepted by individuals, firms and other unincorporated bodies as governed by chapter III-C of the RBI Act, 1934 was challenged, but the Supreme Court, in its judgment dated February 5, 1993, upheld the constitutional validity of chapter III-C of the Act.

PRUDENTIAL NORMS FOR NBFCs

A major step towards implementing the Shah Committee recommendations was taken by the Reserve Bank during 1994 when it decided to put in place the prudential norms on asset classification, provisioning, income recognition and capital adequacy requirements. However, the Reserve Bank felt that legislative changes in the provisions of chapter III-B of the RBI Act, 1934 were necessary, because without the enabling provisions in the Act, the prudential norms could be challenged in Court. The Governor, Dr C. Rangarajan, in a letter on December 31, 1993 to Shri Montek Singh Ahluwalia, Finance Secretary, stressed the need for these changes. This was followed by another letter by the Deputy Governor, Shri S.S. Tarapore to the Chief Economic Adviser to the Government of India.[21] These letters clearly established the rationale for the various prudential measures proposed by the Reserve Bank to ensure transparency in the operations of the non-bank financial sector. Accordingly, the Reserve Bank on June 17, 1994 issued detailed guidelines to be followed by registered financial companies having NOFs of ₹ 50 lakh and above on prudential norms for income recognition, accounting standards, provisioning for bad and doubtful debts, capital adequacy and concentration of credit and investments. The details of these guidelines are provided in Appendix 17.3.

The chronological developments in tightening the supervisory and regulatory norms over NBFCs were elucidated by the Deputy Governor, Shri S.P. Talwar:[22]

> The recommendation of the committee (Chairman: Dr A.C. Shah) were implemented in a phased manner. While the scheme

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21. The Reserve Bank of India and OUP (1998). *The Reserve Bank of India (1951–1967).*
22. Talwar, S.P. (1997). *The Role and Regulations of NBFCs.* New Delhi: Associated Chambers of Commerce and Industry of India. August 27.

of registration was introduced in April 1993 for all NBFCs having NOF of ₹ 50 lakh and above, prudential norms/guidelines were issued in June 1994 for all registered NBFCs. These norms were more in the nature of guidelines which were not mandatory in the absence of necessary statutory powers. Subsequent to this in April 1995, underscoring the importance of setting out an effective supervisory framework, an expert group under the Chairmanship of Shri P.R. Khanna, Member of the Advisory Council for the Board for Financial Supervision was appointed to design an effective and comprehensive supervisory framework for NBFC sector. Most of the recommendations of the committee have been accepted and a supervisory framework comprising on-site inspection for bigger companies and offsite surveillance system for other companies has been designed and the same is being implemented in phased manner. As mentioned earlier, since mid-60s, legislative framework was structured mainly to regulate the deposit acceptance activities of NBFCs. However, in the changed scenario and in the light of the recommendation of the Shah Working Group as also the observations of the Joint Parliamentary Committee a comprehensive draft legislation was prepared in 1994 which however, required extensive discussion with Ministry of Finance and Law. Finally an ordinance was promulgated by the Government in January 1997, effecting comprehensive changes in the provisions of RBI Act. The ordinance has since been replaced by an Act in March 1997. The amended Act among other things provided for entry point norms of a minimum NOF of ₹ 25 lakh (even though the ordinance provides for the minimum limit at ₹ 50 lakh) and mandatory registration for the new NBFCs for commencing business, maintenance of liquid assets ranging from 5 to 25 per cent of deposit liabilities, creation of reserve fund by transferring not less than 20 per cent of the net profit every year, power to the Bank to issue directions relating to prudential norms, capital adequacy, deployment of funds etc., power to issue prohibitory orders and filing of winding-up petitions for non-compliance of Directions/Act.

Prudential norms were initiated for registered financial companies with NOFs of ₹ 50 lakh and above, whereby these companies were required to achieve a minimum capital adequacy norm of 6.0 per cent on their risk-weighted assets and off balance sheet exposures by March

31, 1995 and 8.0 per cent by March 31, 1996. Besides, they were advised to get themselves rated by a credit rating agency. During 1994–95 the Reserve Bank revised the requirement of maintenance of liquid assets by financial companies. The rates of liquid assets of 10.0 per cent of deposits (including intercorporate deposits and debentures/bonds) in the case of equipment-leasing and hire-purchase companies and registered financial companies was raised to 15.0 per cent effective June 30, 1995. The ratio for unregistered loan and investment companies was raised from 5.0 per cent to 7.5 per cent. The entire increase in the liquid assets for all finance companies would be in the form of investments in government securities/ government guaranteed bonds.

Effective July 8, 1996, the exemption granted to mutual benefit financial companies, popularly known as *nidhi* companies, in respect of interest rates and brokerage was withdrawn. Accordingly, *nidhi* companies could not invite, accept or renew deposits at a rate of interest exceeding 15.0 per cent per annum. They were also prohibited from issuing advertisements and paying any brokerage to solicit deposits. These measures were taken in view of aberrations noticed in the functioning of the *nidhis*.

In July 1996, the Reserve Bank took policy measures to free the interest rate ceiling on deposits and remove/increase the ceiling on the quantum of deposits for registered NBFCs, subject to the condition that they fully complied with the provisions of the NBFC directions, adhered to prudential norms and fulfilled the requirement of minimum investment grade credit rating to determine their own rate of interest on deposits. The minimum grade of credit rating requirement was fixed at the level of 'A' or equivalent for all credit rating agencies. Those not complying fully with the credit rating and prudential requirement as well as other directions/guidelines would continue to be subject to deposit rate regulation and, where compliance was clearly lacking, these companies would face a curtailment of the ceiling on the amount of deposits they could raise. The relaxations would be effective from the date of receipt of the specific certificate from the Reserve Bank by the individual company after the Bank's satisfaction of its compliance with the credit rating requirements, prudential norms and other regulations.

ACCOUNTING PRACTICES

Another dimension to the legislative changes was the presence of heterogeneous and sometimes questionable accounting practices being followed by NBFCs and the imperative need to bring uniformity in the accounting practices. A well-knit accounting practice in conformity with international standards was a pre-requisite to repose faith in the industry. There were several instances where NBFCs had capitalised on the absence or inadequacies of standard accounting practices. One example was leasing. It was noticed that the leasing route was being used as a tool to defer tax liabilities. Sale and lease-back transactions were rampant, supposedly on items in the 100.0 per cent depreciable category, which prompted the Government to come out with an amendment to the Income Tax Act. In light of the amendments and also against the backdrop of developments relating to CRB Capital Market Ltd, several policy changes were introduced after 1997.

REGISTRATION OF NBFCs

In pursuance of requirements under legislative amendments effective January 9, 1997, no NBFC would commence or carry on financial activity without applying for or obtaining a certificate of registration to/from the Reserve Bank. The industry responded promptly to the legal requirements and around 37,500 applications were received before the deadline. Of these, a preliminary scrutiny revealed that only around 8,300 NBFCs had a threshold limit of NOFs of ₹ 25 lakh and above. The onerous task of issuing certificates of registration was attended to on a war-footing. In terms of the provisions of the Act, the Reserve Bank, among other things, was required to ascertain that the NBFC was in a position to pay its depositors; the general character of the management of the NBFC was not prejudicial to the interests of the depositor/public; it had adequate capital structure and earning prospects and any other conditions specified by the Reserve Bank. With regard to the huge number of applications to be processed, it was proposed to utilise the services of chartered accountants as a one-time exercise to conduct a special audit of applicant companies and to help the Reserve Bank determine the suitability for a certificate of registration.

Another important point related to the role of statutory auditors in certifying the financial statements and other documents of NBFCs. Some instances were noticed where the assets and investments shown in the balance sheet did not reflect the existence of actual assets. Therefore, there was an urgent need for the accounting practices to be made transparent. The role of credit rating agencies in assessing the debt-servicing capacity of NBFCs assumed importance. The agencies were required to establish themselves with a more credible assessment of their clients.

Registered NBFCs were instructed to furnish half-yearly returns effective March 31, 1995 that indicated capital funds and risk assets ratio, calculation of risk-weighted assets ratio, off balance sheet exposure and certain other data.

With regard to concentration of credit, financial companies were advised not to lend in excess of 15.0/25.0 per cent of their owned funds to a single borrower/borrowers belonging to a single group, respectively. Financial companies were also advised not to invest more than 25.0 per cent of their owned funds in shares and debentures/bonds of another company. To ensure compliance with these norms, the Reserve Bank advised financial companies to submit half-yearly returns from March 31, 1995.

REGISTERED FINANCIAL COMPANIES

As a liberalisation measure, NBFCs, other than equipment-leasing or hire-purchase companies (such as a loan or an investment company), that were registered with the Reserve Bank were allowed a higher limit of acceptance of deposits (including money raised through the issue of non-convertible debentures/bonds) equal to their NOFs instead of 40.0 per cent of their NOFs and the directions issued to these companies were suitably amended. These companies were required to maintain liquid assets to the extent of 10.0 per cent of their deposit liabilities by the end of December 1994 as against the earlier requirement of 5.0 per cent.

UNREGISTERED FINANCIAL COMPANIES

It was proposed to bring down the quantum of deposits (including inter-corporate deposits/borrowings) in a phased manner for all categories of finance companies that were not registered with the Reserve Bank to the levels of 25.0 per cent and 15.0 per cent of their NOFs from the public and shareholders, respectively.

NON-FINANCIAL COMPANIES

The companies (acceptance of deposit) rules, 1975 framed under section 58A of the Companies Act, 1956 by the Government, which governed the acceptance of deposits by non-banking non-financial companies, were amended on December 10, 1993, whereby the maximum rate of interest payable by non-banking non-financial companies on deposits was brought down from 15.0 per cent per annum to 14.0 per cent per annum. Interest could be paid at rests that should not be shorter than monthly rests.

This brought the rate of interest payable by non-banking non financial companies on par with that payable by NBFCs.

LENDING TO NBFCs

There was an unduly large increase in credit from banks to NBFCs. As banks/FIs were now active in equipment-leasing/hire-purchase, substantial moderation had been brought about in the overall limits of borrowing by NBFCs from banks/FIs. For equipment-leasing/hire-purchase companies with not less than 75.0 per cent of their assets in equipment-leasing and hire-purchase and 75.0 per cent of their income from these two activities as per their last audited balance sheets, the overall limit on bank borrowings was reduced to three times the NOF from April 17, 1995, as against the earlier stipulation of four times the NOF. In respect of other equipment-leasing and hire-purchase companies, such limits, which were reduced to three times in September 1994, were further reduced to two times the NOF in April 1995. The overall limits for loan and investment companies and RNBCs, which were reduced to two times the NOF in September 1994, were made equal to the NOF in April 1995. These ceilings for bank lending to different categories of NBFCs were also made applicable to lending by FIs.

BRIDGE LOANS

The bridge loans/interim finance that banks/FIs were permitted to extend to all companies, including finance companies, against public issues and/or borrowings from the market to a maximum extent of 75.0 per cent of the amount actually called up on each occasion in a capital issue was entirely withdrawn in September 1994 for NBFCs and in April 1995 for other companies. This was necessary in view of the possible misuse as well as the risk attached to this facility. In respect of loans that had already been sanctioned or disbursed, banks were instructed to ensure that such loans were utilised for the purpose for which they had been raised. Further, banks were to ensure timely repayment and not allow any extension for repayment of the existing loans.

Under the amended regulation announced by the Reserve Bank on July 24, 1996, NBFCs that fully met the requirements of registration, rating and prudential norms were free from interest rate ceilings on the quantum of deposits. Companies that did not fully comply with the directions/guidelines continued to be subject to the regulations, and where compliance was clearly lacking, the companies faced a progressive reduction in their deposit-taking limits and also a curtailment of other relaxations provided by the Reserve Bank. NBFCs that did not observe the regulations in letter and spirit faced adverse action. NBFCs that were provided the freedom to determine their own interest rates were expected to be judicious and avoid escalation in interest rates, which would only invite problems associated with adverse selection. A need was felt to amend the RBI Act, 1934 chapter III-B on non-banking institutions to enable better regulation and supervision of the NBFCs and also chapter III-C on unincorporated bodies.

As already mentioned, on July 24, 1996, the Reserve Bank announced a package of measures relaxing its controls on NBFCs that complied with its directions and guidelines. In the case of companies where compliance was clearly lacking, a lower ceiling on deposit mobilisation was imposed. Pending a review of the measures, the period up to which the liberalised dispensation could be availed by the eligible NBFCs was extended to September 30, 1997. The restriction on lending by banks to NBFCs in certain multiples of the latter's NOFs was removed in April 1997 for NBFCs that complied with the registration, prudential norms and credit rating requirements stipulated by the Reserve Bank. Accordingly, the level of credit to be provided to NBFCs was left to the discretion of the banks.

An expert group (Chairman: Shri P.R. Khanna) was set up in April 1995 by the Reserve Bank to recommend a framework for supervision of the financial companies. The recommendations included, *inter alia*, supervision of NBFCs through an offsite surveillance system and the introduction of a supervisory rating system for NBFCs. Further, in order to regulate NBFCs effectively and to improve their financial health and viability, certain amendments to chapters IIIB, IIIC and V of the RBI Act, 1934 were made through the enactment of the RBI (Amendment) Act, 1997. The major features of this amendment are provided in Appendix 17.4.

In July 1996, the Reserve Bank introduced policy measures to free the interest rate ceiling on deposits and remove the ceiling/prescribe an enhanced ceiling on the quantum of deposits for NBFCs, subject to the condition that they would obtain a certificate from the Reserve Bank to the effect that they had fully complied with the Bank's directives and guidelines. In respect of registered equipment-leasing and hire-purchase finance companies that had complied with the credit rating requirement and prudential norms, the liberalisation measures included: (i) removal of ceiling on deposits, which were 10 times the NOFs; (ii) reduction of the liquid assets-to-deposits ratio from 15.0 per cent to 12.5 per cent, while continuing with the stipulation that at least 10.0 per cent of the deposits be maintained in government securities/government guaranteed bonds; and (iii) freedom to determine interest rates on deposits of 1–5 years.

As regards registered loan/investment companies that complied with credit rating requirements and prudential norms, the overall ceiling on deposits, which used to be equal to NOF, was increased to twice the NOF. The stipulation of 12.5 per cent of liquid assets ratio and the freedom to determine interest payable on deposits as in the case of equipment-leasing and hire-purchase companies also applied to these companies.

For registered equipment-leasing and hire-purchase as well as loan/investment companies that complied with credit rating or prudential norms, the ceiling interest rate of 15.0 per cent on deposits and overall ceiling on deposits alongside the stipulation of 15.0 per cent liquid assets ratio was to continue. In the case of non-compliance with both the credit rating and the prudential norms, the overall ceiling on deposits was reduced in relation to the NOF from 10 times to 7 times for registered equipment-leasing and hire-purchase companies, and for registered loan and investment companies from equal to NOF to 15.0 and 25.0 per cent of NOF for deposits from shareholders and public, respectively.

The Union Budget 1996–97 proposed amendments to the RBI Act, 1934 to strengthen its regulatory powers over NBFCs. During January 1997 the Government promulgated an ordinance to amend the RBI Act, 1934, for regulating the activities of unincorporated bodies and NBFCs. In view of the difficulties faced by *nidhi* companies in achieving the ratio of NOF to deposits not exceeding 1:20, the Reserve Bank decided that the ratio would be made applicable only on the incremental deposit liabilities over the level as on January 15, 1997. With a view to effectively regulating the activities of NBFCs and thereby improving their financial health and viability, the Government promulgated an ordinance bringing about comprehensive changes in the provisions of chapters IIIB and V of the RBI Act, 1934, effective January 9, 1997. The ordinance was replaced by the RBI (Amendment) Act, 1997 in March 1997, which also modified the provisions of chapter III-C of the Act relating to acceptance of deposits by unincorporated bodies, effective April 1, 1997. The Act stipulated that: (i) a new NBFC could not operate unless it was registered with the Reserve Bank and had a minimum NOFs of ₹ 25 lakh; (ii) all existing NBFCs were required to apply for registration by July 8, 1997; (iii) NBFCs with NOFs of less than ₹ 25 lakh were given three years (extendable by another three years at the Reserve Bank's discretion) to reach that level; (iv) the Reserve Bank was empowered to cancel the certificate of registration issued to any

NBFC; (v) NBFCs would have to maintain liquid assets of not less than 5.0 per cent of their deposits or such higher percentage not exceeding 25.0 per cent as may be fixed by the Reserve Bank; failure to do so would attract penalty from the Reserve Bank; (vi) every NBFC would create a reserve fund and transfer to it at least 20.0 per cent of its net profit every year before declaring a dividend; (vii) the Reserve Bank was authorised to issue directives relating to disclosures, prudential norms on income recognition, accounting standards, provisioning for bad and doubtful debts and credit concentration; (viii) the Company Law Board was empowered to adjudicate and pass orders in the case of non-repayment of deposits/ interest by NBFCs; and (ix) unincorporated bodies engaged in financial activities were debarred from accepting deposits from April 1, 1997.

Housing finance companies (HFCs) were exempted from all the provisions of chapter III-B of the RBI Act, 1934, as amended in terms of the RBI (Amendment) Act, 1997, as they are regulated by a separate regulatory authority, the NHB. Accordingly, the HFCs were not required to apply for a certificate of registration from the Reserve Bank as provided in section 45-1(A) of the RBI Act.

DEVELOPMENTS IN SUPERVISION

The BFS and the DoS exercised powers of integrated supervision in relation to commercial banks, all-India FIs and NBFCs. The emphasis of the BFS and DoS continued to be on broadening and sharpening supervision strategies and skills. The DoS with the approval of the BFS put in place a new supervisory strategy that retained the importance of onsite inspection, but also introduced offsite surveillance, strengthened the internal control system in banks and increased the use of external auditors in banking supervision. An offsite monitoring system that was introduced on a pilot basis was formalised.

The work on supervision of NBFCs was taken over by the DoS from the Department of Financial Companies (DFC) in July 1995 and the regional offices of the DFC were transferred to the DoS. A financial companies division was set up in the central office of the DoS and financial companies' wings were opened at all the 16 regional offices of the DoS. The financial companies division at central office dealt with the interpretation of policy matters, developing new supervisory mechanisms, evolving new guidelines for companies, providing directions and guidance to the regional offices and granting approval for registration of NBFCs. The regional office extensions of the division dealt with identification and classification/registration of companies, onsite inspection of companies and offsite surveillance through returns and complaints. The RBI (Amendment) Act, 1997 conferred wide powers on the Reserve Bank for exercising closer supervision over NBFCs. Accordingly, the Bank could prescribe the minimum level of NOFs, and ensure compulsory registration with the Bank as well as the maintenance of liquid assets on a daily basis. All companies that had financial business as their principal activity, whether registered or not, were required to apply afresh to the DoS for a certificate of registration by July 8, 1997. The Reserve Bank received 37,478 applications for registration. For more effective co-ordination between the regulatory and supervisory functioning relating to FIs, the financial institutions cell (FIC) concerned with the regulatory aspects started functioning within the DoS as a separate division effective from June 18, 1997.

The BFS adopted the recommendations of the reports submitted by three expert groups constituted by the DoS *viz*., the group to review the system of onsite inspection of banks (Padmanabhan Committee), the group to review the internal control and audit system in banks (Jilani Committee) and the group for designing a supervisory framework for NBFCs (Khanna Committee). The Padmanabhan Committee had recommended far-reaching changes in the focus, scope and thrust of on-site inspections and follow-up. The main focus of the Jilani Committee was on the internal control and inspection/audit system in banks. The recommendations of the Khanna Committee were directed towards extensive supervision of NBFCs, mainly through an offsite surveillance system, and subjecting registered NBFCs to supervisory rating with the periodicity of their inspection being determined by their rating.

The recommendations of the Khanna Committee were accepted and implemented with modifications in keeping with the changing circumstances. Further, in light of the various recommendations made by Khanna Committee and the additional statutory powers vested in the Reserve Bank, a new manual for onsite inspection of NBFCs and offsite surveillance was prepared by a project group set up in the DoS.

BUDGET PROPOSAL TO DISCONTINUE RESERVE BANK'S ANNUAL ALLOCATIONS TO FIs

The Reserve Bank had been making annual allocations out of its profits to FIs like IDBI, National Bank for Agriculture and Rural Development (NABARD), Small Industries Development Bank of India (SIDBI), Industrial Reconstruction Bank of India (IRBI) and Export-Import (Exim)

Bank. The Union Budget for 1992–93 made a significant announcement that no further allocations would be made to these institutions by the Reserve Bank and correspondingly a higher amount of profit would be transferred to the Government. This policy decision adversely affected the viability position, especially of NABARD, despite the Government continuing to make allocations for these institutions to float public sector tax-free bonds at attractive rates of interest. The Governor in his letter to the Finance Secretary dated April 6, 1992 elucidated the adverse impact of this decision, especially on NABARD.

In the past, select institutions, other than NABARD, were provided funds under the annual allocations by the Reserve Bank at interest rates of 8.0–9.0 per cent. However, NABARD was provided funds at a zero rate of interest because NABARD was in turn extending credit to the co-operatives at very low interest rates by blending these resources with market-raised resources. The main and perhaps the only reason for such support to the co-operatives was that the bulk of lending by co-operative banks was at very low rates of interest that were below their deposit rates. However, this special treatment made deposit-based expansion of credit by the co-operatives untenable and, more importantly, it became necessary to provide a subsidy to NABARD through reduced interest rates as long as the ultimate interest charged by the co-operatives was low. The Reserve Bank posed the dilemma inherent in the situation, namely, if the Government permitted NABARD to raise funds at the standing rate for public sector bonds, an interest rate subsidy was inevitable unless NABARD raised its lending rate to the co-operative banks and they, in turn, were allowed to raise their lending rates. The Government was requested to consider expeditiously this matter as it involved the viability issue.[23]

REGULATION OF CAPITAL MARKET INSTITUTIONS

In May 1990, the Ministry of Finance sought the views of the Reserve Bank on a proposal to convert the SEBI into a statutory body from its existing position as a non-statutory body. The Reserve Bank, in its reply dated May 18, 1990 addressed to the Finance Secretary, expressed the view that the regulation of the capital market should be its direct responsibility rather than that of SEBI. The various reasons adduced by the Reserve Bank in support of its standpoint are briefly discussed.

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23. Also refer to chapter 18: Agriculture and Rural Development.

The Indian financial market was undergoing significant and rapid changes, and the financial sector had emerged as a key sector of the economy. The operations of FIs, the banking sector, NBFCs and the capital market were no longer confined to one segment of the market. In particular, the interface of banks and its subsidiaries with the capital market was on the increase. At the same time, non-bank financial institutions such as the UTI, Life Insurance of India (LIC) and General Insurance Corporation (GIC) had become lenders in the money market and insurance companies had entered activities like mutual funds and housing finance through their subsidiaries. The Reserve Bank averred that these developments, which were increasingly characterised by a de-segmentation of the financial market, had important implications for the kind and structure of the regulatory system that should be built.

Further, FIs were undergoing rapid changes, particularly in the multiplicity of financial services that they offered. This blurred the distinctions between institutions and market segments. The Governor noted, "More integrated markets would call for integrated supervision and avoidance of multiplicity of regulatory agency." In such a milieu, the Reserve Bank felt that the entire market, including the constituents in the capital market, should be made subject to the regulation by the central bank of the country since multiple authorities exercising supervision independent of each other over various overlapping segments of the market would inevitably lead to conflict of jurisdiction and confusion that should be avoided. The RBI Act, under chapter III-B, section 45L, empowered it to exercise 'comprehensive' oversight over the financial system. The Governor postulated, "Clearly, the intention of the law has been that the central banking authority of the country should exercise comprehensive oversight over the financial system as a whole." In countries where different supervisory authorities had evolved over time, there was a conscious effort to bring about greater co-ordination among them. In the Indian situation, instead of creating a new supervisory authority and finding ways to achieve co-ordination among different authorities, it was advisable for the central bank to exercise this power directly. The Reserve Bank proposed that it was in a position to undertake this work soon and it could also absorb whatever trained manpower was available in SEBI. The Government, however, went by its original plan.

PRUDENTIAL NORMS FOR FINANCIAL INSTITUTIONS

The Reserve Bank had advised the five all-India term lending institutions, *viz.*, IDBI, Industrial Finance Corporation of India (IFCI), ICICI, IRBI and Exim Bank, in March 1994 to implement prudential guidelines on capital adequacy and income recognition, asset classification, provisioning and other related matters in a phased manner from the accounting year commencing in April 1993. As against the stipulation of achieving a capital adequacy ratio of 4.0 per cent by March 31, 1994, all FIs achieved the ratio of 8.0 per cent by March 31, 1996. The provisioning requirements were also met by all FIs during 1993–94.

An important development during the year was the amendment to the IDBI Act, 1964 in October 1994 to enable it to restructure its capital, raise equity from the public and gain operational flexibility. Nevertheless, the equity holding of the Central Government at any time was not to be less than 51.0 per cent of the issued equity capital of the IDBI. The authorised capital of IDBI was increased from ₹ 1,000 crore to ₹ 2,000 crore which could be raised to ₹ 5,000 crore by a resolution in the general body meeting. The issued capital of ₹ 753 crore, which stood fully vested in and fully subscribed by the Central Government before the commencement of the IDBI (Amendment) Act 1995, was divided into 75.3 crore equity shares of ₹ 10 each.

The IDBI entered the capital market in July 1995 with the public issue of 16.8 crore equity shares of ₹ 10 at a premium of ₹ 120 per share, aggregating ₹ 2,184 crore. Besides, the IDBI, on behalf of the Government, offered for sale 144.2 lakh equity shares of ₹ 10 each at ₹ 170 per share, aggregating ₹ 187 crore. The issue was oversubscribed and after the public issue and the offer for sale by the Government, the Government's equity shareholding in IDBI declined from ₹ 500 crore to ₹ 486 crore which formed 72.7 per cent of the post-issue equity capital of IDBI as against 100.0 per cent before issue.

FIs had rationalised their interest rate structure in line with the overall economic environment. The IDBI, ICICI and IFCI introduced a variable interest rate loan scheme. They continued their efforts to widen their resource base and mobilised funds from domestic as well as international markets. In tune with the changing environment, they were diversifying their operations and reorienting their business strategies.

THE NATIONAL HOUSING BANK

The NHB augmented the flow of credit for housing activities by revising upwards its limit for refinance to SCBs to ₹ 5 lakh from ₹ 2 lakh, thus bringing its refinance eligibility on par with the specialised HFCs.

Cumulative disbursement on account of refinance to SCBs, HFCs and state-level apex co-operative housing finance societies in respect of eligible loans disbursed by them, along with subscription to special rural housing debentures floated by agriculture and rural development banks in respect of their eligible housing loans, amounted to ₹ 2,306 crore at the end of April 1995. Of the refinance provided, HFCs accounted for 81.9 per cent, co-operative sector institutions 11.1 per cent and the banking sector 7.0 per cent.

A significant policy by the NHB was the deregulation of interest rates charged by primary lending agencies on all loans above ₹ 1 lakh. The refinance rates charged by the NHB in respect of recognised and approved HFCs were revised downwards. The NHB also formulated prudential norms for income recognition and assets classification for the HFCs.

CONCLUDING OBSERVATIONS

During the period 1990–1997, as part of financial sector reforms, fundamental changes took place in banking and the financial system. While the liberalisation process commenced earlier in the mid–1980s, the reform measures gained momentum after the implementation of the report of the Narasimham Committee on the financial system. While the systemic shock due to irregularities in securities transactions jolted the financial system and the banking sector in particular, the lessons from the scam led to far-reaching reforms in market regulation and settlement practices. This also strengthened the bias towards a gradualist approach to financial sector reform and the continuation of public sector dominace in the financial system.