REPORT

OF

THE COMMITTEE

ON

BANKING SECTOR REFORMS

APRIL 1998

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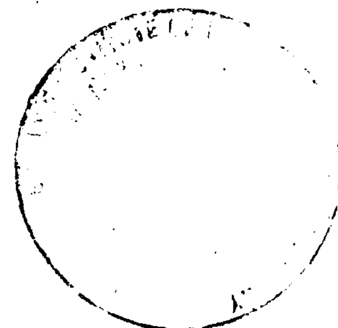
April 22, 1998



Dear Mr. Minister

I have pleasure in submitting the Report of the Committee on Banking Sector Reforms.

The Committee would like to take this opportunity of expressing its grateful appreciation to the large number of representative organisations and individuals who either sent it memoranda conveying their views on the issues before the Committee or who met the Committee personally.

As Chairman of the Committee, I would like to record my personal appreciation to each and every member of the Committee who brought to its deliberations his personal insights, expertise and experience.

The other Members of the Committee and I would like to record our appreciation of the contribution to its deliberations made by our Member Secretary, Shri C. M. Vasudev. The Committee greatly benefited from his intimate knowledge of the subject and experience in dealing with issues facing the banking sector. The Committee also places on record its deep appreciation of the considerable assistance it received from Shri M. Damodaran, Sudhir Shrivastava and K. K. Bhargava of the Banking Division of the Ministry of Finance and from Shri A Ghosh and Smt. Shyamala Gopinath of the Reserve Bank of India. The Committee also benefited from papers submitted to it by Smt. Benu Schneider of ICRIER and Dr. Urjit Patel of IDFC.

The Reserve Bank of India provided full logistic support to the Committee and, I would like to record the Committee's appreciation for this.

Shri Samuel Abraham of the Administrative Staff College once again handled the stenographic and typing work and , I would like to record my appreciation of the excellent work he put in.

With Kind regards,

Yours sincerely,

(M. Narasimham)

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SUMMARY

1. Reform of the Indian banking sector is now under way following the recommendations of the Committee on Financial System (CFS) which reported in 1991. Meanwhile, major changes have taken place in the domestic economic and institutional scene, coinciding with the movement towards global integration of financial services. These developments have reinforced the importance of building a strong and efficient financial system. ***(Chapter I, para 1.6 - 1.7)***

2. The second generation of reform could be conveniently looked at in terms of three broad inter-related issues: (i) Actions that need to be taken to strengthen the foundations of the banking system; (ii) Related to this, streamlining procedures, upgrading technology and human resource development; (iii) Structural changes in the system. These would cover aspects of banking policy, institutional, supervisory and legislative dimensions. ***(Chapter I, para 1.32)***

Measures to Strengthen the Banking System:

Capital Adequacy:

3. The Committee suggests that pending the emergence of markets in India where market risks can be covered, it would be desirable that capital adequacy requirements take into account market risks in addition to the credit risks. ***(Chapter III, para 3.10)***

4. The Committee recommends that in the next three years the entire portfolio of Government securities should be marked to market and this schedule of adjustment should be announced at the earliest. At present Government and other approved securities are subject to a zero risk weight. It would be appropriate that there should be a 5% weight for market risk for Government and approved securities. ***(Chapter III, para 3.11)***

5. The risk weight for a Government guaranteed advance should be the same as for other advances. To ensure that banks do not suddenly face difficulties in meeting the capital adequacy requirement, the new prescription on risk weight for Government guaranteed advances should be made prospective from the time the new prescription is put in place. ***(Chapter III, para 3.12)***

6. There is an additional capital requirement of 5% of the foreign exchange open position limit. Such risks should be integrated into the calculation of risk weighted assets. The Committee recommends that the foreign exchange open position limits should carry a 100% risk weight. ***(Chapter III, para 3.13)***

7. The Committee believes that it would be appropriate to go beyond the earlier norms and set new and higher norms for capital adequacy. The Committee accordingly recommends that the minimum capital to risk assets ratio be increased to 10% from its present level of 8%. It would be appropriate to phase the increase as was done on the previous occasion. Accordingly, the Committee recommends that an intermediate minimum target of 9% be achieved by the year 2000 and the ratio of 10% by 2002. The RBI should also have the authority to raise this further in respect of individual banks if in its judgement the situation with respect to their risk profile warrants such an increase. The issue of individual banks' shortfalls in the CRAR needs to be addressed in much the same way that the discipline of reserve requirements is now applied, viz., of uniformity across weak and strong banks. ***(Chapter III, para 3.15 - 3.16)***

8. In respect of PSBs, the additional capital requirement will have to come from either the Government or the market. With the many demands on the budget and the continuing imperative need for fiscal consolidation, subscription to bank capital funds cannot be regarded as a priority claim on budgetary resources. Those banks which are in a position to access the capital market at home or abroad should, therefore, be encouraged to do so. ***(Chapter III, para 3.17)***

Asset Quality, NPAs and Directed Credit:

9. The Committee recommends that an asset be classified as doubtful if it is in the substandard category for 18 months in the first instance and eventually for 12 months and loss if it has been so identified but not written off. These norms, which should be regarded as the minimum, may be brought into force in a phased manner. ***(Chapter III, para 3.18)***

10. The Committee has noted that NPA figures do not include advances covered by Government guarantees which have turned sticky and which in the absence of such guarantees would have been classified as NPAs. The Committee is of the view that for the purposes of evaluating the quality of asset portfolio such advances should be treated as NPAs. If, however, for reason of the sovereign guarantee argument such advances are excluded from the computation, the Committee would recommend that Government guaranteed advances which otherwise would have been classified as NPAs should be separately shown as an aspect of fuller disclosure and greater transparency of operations. ***(Chapter III, para 3.21)***

11. Banks and financial institutions should avoid the practice of "evergreening" by making fresh advances to their troubled constituents only with a view to settling interest dues and avoiding classification of the loans in question as NPAs. The Committee notes that the regulatory and supervisory authorities are paying particular attention to such breaches in the adherence to the spirit of the NPA definitions and are taking appropriate corrective action. At the same time, it is necessary to resist the suggestions made from time to time for a relaxation of the definition of NPAs and the norms in this regard. ***(Chapter III, para 3.22)***

12. So far, a sum of Rs 20,000 crores has been expended for recapitalisation and to the extent to which recapitalisation has enabled banks to write off losses, this is the cost which the Exchequer has had to bear for the bad debts of the banks. Recapitalisation is a costly and, in the long run, not a sustainable option. Recapitalisation involves budgetary commitments and could lead to a large measure of monetisation. The Committee urges that no further recapitalisation of banks be undertaken from the Government budget. As the authorities have already proceeded on the recapitalisation route it is perhaps not necessary to consider de novo the institution of an ARF of the type envisaged by the earlier CFS Report. The situation would perhaps have been different if the recapitalisation exercise had not been undertaken in the manner in which it has been. ***(Chapter III, para 3.24 - 3.25)***

13. The Committee believes that the objective should be to reduce the average level of net NPAs for all banks to below 5% by the year 2000 and to 3% by 2002. For those banks with an international presence the minimum objective should be to reduce gross NPAs to 5% and 3% by the year 2000 and 2002 respectively and net NPAs to 3% and 0% by these dates. These targets cannot be achieved in the absence of measures to tackle the problem of backlog of NPAs on a one time basis and the implementation of strict prudential norms and management efficiency to prevent the recurrence of this problem. ***(Chapter III, para 3.26)***

14. The Committee is of the firm view that in any effort at financial restructuring in the form of hiving off the NPA portfolio from the books of the banks or measures to mitigate the impact of a high level of NPAs must go hand in hand with operational restructuring. Cleaning up the balance sheets of banks would thus make sense only if simultaneously steps were taken to prevent or limit the re-emergence of new NPAs which could only come about through a strict application of prudential norms and managerial improvement. ***(Chapter III, para 3.27)***

15. For banks with a high NPA portfolio, the Committee suggests consideration of two alternative approaches to the problem as an alternative to the ARF proposal made by the

earlier CFS. In the first approach, all loan assets in the doubtful and loss categories - which in any case represent bulk of the hard-core NPAs in most banks - should be identified and their realisable value determined. These assets could be transferred to an Asset Reconstruction Company (ARC) which would issue to the banks NPA Swap Bonds representing the realisable value of the assets transferred, provided the stamp duties are not excessive. The ARC could be set up by one bank or a set of banks or even in the private sector. In case the banks themselves decide to set up an ARC, it would need to be ensured that the staff required by the ARC is made available to it by the banks concerned either on transfer or on deputation basis, so that staff with institutional memory on NPAs is available to ARC and there is also some rationalisation of staff in the banks whose assets are sought to be transferred to the ARC. Funding of such an ARC could be facilitated by treating it on par with venture capital for purpose of tax incentives. Some other banks may be willing to fund such assets in effect by securitising them. This approach would be worthwhile and workable if stamp duty rates are minimal and tax incentives are provided to the banks. ***(Chapter III, para 3.28)***

16. An alternative approach could be to enable the banks in difficulty to issue bonds which could form part of Tier II capital. This will help the banks to bolster capital adequacy which has been eroded because of the provisioning requirements for NPAs. As the banks in difficulty may find it difficult to attract subscribers to bonds, Government will need to guarantee these instruments which would then make them eligible for SLR investment by banks and approved instruments by LIC, GIC and Provident Funds. ***(Chapter III, para 3.29)***

17. Directed credit has a proportionately higher share in NPA portfolio of banks and has been one of the factors in erosion in the quality of bank assets. There is continuing need for banks to extend credit to agriculture and small scale sector which are important segments of the national economy, on commercial considerations and on the basis of creditworthiness. In this process, there is scope for correcting the distortions arising out of directed credit and its impact on banks' assets quality. ***(Chapter III, para 3.31)***

18. The Committee has noted the reasons why the Government could not accept the recommendation for reducing the scope of directed credit under priority sector from 40% to 10%. The Committee recognises that the small and marginal farmers and the tiny sector of industry and small businesses have problems with regard to obtaining credit and some earmarking may be necessary for this sector. Under the present dispensation, within the priority sector 10% of net bank credit is earmarked for lending to weaker sections. A major portion of this lending is on account of Government sponsored poverty alleviation and employment generation schemes. The Committee recommends that given the special needs of this sector, the current practice may continue. The Branch Managers of banks should, however, be fully responsible for the identification of beneficiaries under the Government sponsored credit linked schemes. The Committee proposes that given the importance and needs of employment oriented sectors like food processing and related service activities in agriculture, fisheries, poultry and dairying, these sectors should also be covered under the scope of priority sector lending. The Committee recommends that the interest subsidy element in credit for the priority sector should be totally eliminated and even interest rates on loans under Rs 2 lakhs should be deregulated for scheduled commercial banks as has been done in the case of Regional Rural Banks and cooperative credit institutions. The Committee believes that it is the timely and adequate availability of credit rather than its cost which is material for the intended beneficiaries. The reduction of the pre-empted portion of banks' resources through the SLR and CRR would, in any case, enlarge the ability of banks to dispense credit to these sectors. ***(Chapter III, para 3.32)***

Prudential Norms and Disclosure Requirements:

19. With regard to income recognition, in India, income stops accruing when interest or instalment of principal is not paid within 180 days. The Committee believes that we should move towards international practices in this regard and recommends the introduction of

the norm of 90 days in a phased manner by the year 2002. ***(Chapter III, para 3.35)***

20. At present, there is no requirement in India for a general provision on standard assets. In the Committee's view a general provision, say, of 1% would be appropriate and RBI should consider its introduction in a phased manner. ***(Chapter III, para 3.36)***

21. The Committee believes that in the case of all future loans, the income recognition and asset classification and provisioning norms should apply even to Government guaranteed advances in the same manner as for any other advance. For existing Government guaranteed advances, RBI Government and banks may work out a mechanism for a phased rectification of the irregularities in these accounts. ***(Chapter III, para 3.37)***

22. There is a need for disclosure, in a phased manner, of the maturity pattern of assets and liabilities, foreign currency assets and liabilities, movements in provision account, and non-performing assets. The RBI should direct banks to publish, in addition to financial statements of independent entities, a consolidated balance sheet to reveal the strength of the group. Full disclosure would also be required of connected lending and lending to sensitive sectors. Furthermore, it should also ask banks to disclose loans given to related companies in the banks' balance sheets. Full disclosure of information should not be only a regulatory requirement. It would be necessary to enable a bank's creditors, investors and rating agencies to get a true picture of its functioning - an important requirement in a market driven financial sector. ***(Chapter III, para 3.38)***

23. As an incentive to banks to make specific provisions, the Committee recommends that consideration be given to making such provisions tax deductible. ***(Chapter III, para 3.39)***

24. Banks should also pay greater attention to asset liability management to avoid mismatches and to cover, among others, liquidity and interest rate risks. ***(Chapter III, para 3.41)***

25. Banks should be encouraged to adopt statistical risk management techniques like Value-at-Risk in respect of balance sheet items which are susceptible to market price fluctuations, forex rate volatility and interest rate changes. While the Reserve Bank may, initially, prescribe certain normative models for market risk management, the ultimate objective should be that of banks building up their own models and RBI backtesting them for their validity on a periodical basis. ***(Chapter III, para 3.41 - 3.42)***

Systems and Methods in Banks:

26. Banks should bring out revised Operational Manuals and update them regularly, keeping in view the emerging needs and ensure adherence to the instructions so that these operations are conducted in the best interest of a bank and with a view to promoting good customer service. These should form the basic objective of internal control systems, the major components of which are: (1) Internal Inspection and Audit, including concurrent audit, (2) Submission of Control Returns by branches/controlling offices to higher level offices, (3) Visits by controlling officials to the field level offices, (4) Risk management systems, (5) Simplification of documentation, procedure and of inter office communication channels. ***(Chapter IV, para 4.3)***

27. An area requiring close scrutiny in the coming years would be computer audit, in view of large scale usage and reliance on information technology. ***(Chapter IV, para 4.7)***

28. There is enough International experience to show the dangers to an institution arising out of inadequate reporting to and checking by the back offices of trading transactions and positions taken. Banks should pay special attention to this aspect. ***(Chapter IV, para 4.8)***

29. There is need to institute an independent loan review mechanism especially for large borrowal accounts and systems to identify potential NPAs. It would be desirable that banks

evolve a filtering mechanism by stipulating in-house prudential limits beyond which exposures on single/group borrowers are taken keeping in view their risk profile as revealed through credit rating and other relevant factors. Further, in-house limits could be thought of to limit the concentration of large exposures and industry/sector/ geographical exposures within the Board approved exposure limits and proper overseeing of these by the senior management/boards. It would be appropriate if the management committees are reconstituted to have only whole time functionaries in it, somewhat on the pattern of Central Office Credit Committee constituted in the State Bank of India. All decisions taken by these committees could be put up to the Board of Directors for information. ***(Chapter IV, para 4.12 - 4.16)***

30. It would be appropriate to induct an additional whole time director on the board of the banks with an enabling provision for more whole time directors for bigger banks. ***(Chapter IV, para 4.17)***

31. The Committee feels that the present practice of RBI selecting the statutory auditors for banks with Board of Directors having no role in the appointment process, is not conducive to sound corporate governance. The RBI may review the existing practice in this regard. ***(Chapter IV, para 4.19)***

32. The Committee notes that public sector banks and financial institutions have yet to introduce a system of recruiting skilled manpower from the open market. The Committee believes that this delay has had an impact on the competency levels of public sector banks in some areas and they have consequently lost some ground to foreign banks and the newly set up private sector banks. The Committee urges that this aspect be given urgent consideration and in case there are any extant policy driven impediments to introducing this system, appropriate steps be taken by the authorities towards the needed deregulation. Banks have to top up their skills' base by resorting, on an ongoing basis, to lateral induction of experienced and skilled personnel, particularly for quick entry into new activity/areas. The Committee notes that there has been considerable decline in the scale of merit-based recruitment even at the entry level in many banks. The concept of direct recruitment itself has been considerably diluted by many PSBs including the State Bank of India by counting internal promotions to the trainee officers' cadre as direct recruitment. The Committee would strongly urge the managements of public sector banks to take steps to reverse this trend. The CFS had recommended that there was no need for continuing with the Banking Service Recruitment Boards insofar as recruitment of officers was concerned. This Committee, upon examination of the issue, reaffirms that recommendation. As for recruitment in the clerical cadre, the Committee recommends that a beginning be made in this regard by permitting three or four large well-performing banks, including State Bank of India, to set up their own recruitment machinery for recruiting clerical staff. If the experience under this new arrangement proves satisfactory, it could then pave the way for eventually doing away completely with the Banking Service Recruitment Boards. ***(Chapter IV, para 4.21 - 4.23)***

33. It seems apparent that there are varying levels of overmanning in public sector banks. The managements of individual banks must initiate steps to measure what adjustments in the size of their work force is necessary for the banks to remain efficient, competitive and viable. Surplus staff, where identified, would need to be redeployed on new business and activities, where necessary after suitable retraining. It is possible that even after this some of the excess staff may not be suitable for redeployment on grounds of aptitude and mobility. It will, therefore, be necessary to introduce an appropriate Voluntary Retirement Scheme with incentives. The managements of banks would need to initiate dialogue in this area with representatives of labour. ***(Chapter IV, para 4.5 & 4.24)***

34. The Committee feels that the issue of remuneration structure at managerial levels prevailing in public sector banks and financial institutions needs to be addressed. There is an urgent need to ensure that public sector banks are given flexibility to determine managerial remuneration levels taking into account market trends. The Committee

recommends that the necessary authority in this regard be given to the Boards of the banks initially in the case of profit making public sector banks which have gone public, for they would, in any case, be required to operate with an accountability to the market. The forthcoming wage negotiations provide an opportunity to review the existing pattern of industry wise negotiations and move over to bank-wise negotiations. ***(Chapter IV, para 4.26)***

35. This Committee is of the view that in today's increasingly challenging business environment, a large institution can only be led effectively by a Chief Executive who has a reasonable length of tenure, which the Committee believes should not be less than five years. Since, however, moving over to this tenure may be difficult, we suggest that in the first instance, the minimum tenure should be three years. The Committee feels that there is now a need to delink the pay scales of the Chief Executives of public sector banks and financial institutions from the Civil Service pay scales and that this should be left to be decided by the individual banks, not excluding the possibility of performance based remuneration. The Committee would like to add that these observations and recommendations also apply to the whole time Directors on the Boards of banks and financial institutions appointed by the Government. ***(Chapter IV, para 4.29 - 4.30)***

36. The Committee would urge the managements of Indian banks to review the changing training needs in individual banks keeping in mind their own business environment and to address these urgently. The Committee would suggest that they explore, wherever appropriate, the feasibility of entering into collaborative arrangements with universities and other institutions in India and abroad, offering specialised training to the financial services industry, so that there can be an arrangement in place for ongoing inflow of emerging training packages and methodologies. ***(Chapter IV, para 4.32)***

37. There may be need to redefine the scope of external vigilance and investigative agencies with regard to banking business. External agencies should have the requisite skill and expertise to take into account the commercial environment in which decisions are taken. The vigilance manual now being used has been designed mainly for use by Government Departments and public sector undertakings. It may be necessary that a separate vigilance manual which captures the special features of banking should be prepared for exercising vigilance supervision over banks. The Committee feels that this is an extremely critical area and arrangements similar to the Advisory Board for Bank Frauds be made for various levels of staff of banks. A suggestion has been received by the Committee that the banks should put in place a system where a record of all credit decisions made by an individual officer together with his successful performance is maintained. Public sector banks should consider the suggestion and try to devise a system suited to their needs. ***(Chapter IV, para 4.35 - 4.37)***

38. Globally, banking and financial systems have undergone fundamental changes because of the ongoing revolution in information and communications technology. Information technology and electronic funds transfer systems have emerged as the twin pillars of modern banking development. This phenomenon has largely bypassed the Indian banking system although most technologies that could be considered suitable for India have been introduced in some diluted form. The Committee feels that requisite success in this area has not been achieved because of the following reasons:

- Inadequate bank automation,
- not so strong commercially oriented inter-bank platform
- lack of a planned, standardised, electronic payment systems backbone,
- inadequate telecom infrastructure,
- inadequate marketing effort,

- lack of clarity and certainty on legal issues and
- lack of data warehousing network.

The Committee has tried to list out series of implementation steps for achieving rapid induction of information technology in the banking system. Further, information and control systems need to be developed in several areas like

- Better tracking of spreads, costs and NPAs for higher profitability
- Accurate and timely information for strategic decisions to Identify and promote profitable products and customers
- Risk and Asset-Liability management; and
- Efficient Treasury management ***(Chapter IV, para 4.66 & 4.70)***

Structural Issues:

39. The Committee has taken note of the twin phenomena of consolidation and convergence which the financial system is now experiencing globally. In India also banks and DFIs are moving closer to each other in the scope of their activities. The Committee is of the view that with such convergence of activities between banks and DFIs, the DFIs should, over a period of time, convert themselves to banks. There would then be only two forms of intermediaries, viz., banking companies and non-banking finance companies. If a DFI does not acquire a banking licence within a stipulated time it would be categorised as a non-banking finance company. A DFI which converts to a bank can be given some time to phase in reserve requirements in respect of its liabilities to bring it on par with the requirements relating to commercial banks. Similarly, as long as a system of directed credit is in vogue a formula should be worked out to extend this to DFIs which have become banks. ***(Chapter V, para 5.6)***

40. Mergers between banks and between banks and DFIs and NBFCs need to be based on synergies and locational and business specific complimentarities of the concerned institutions and must obviously make sound commercial sense. Mergers of public sector banks should emanate from the managements of banks with the Government as the common shareholder playing a supportive role. Such mergers, however, can be worthwhile if they lead to rationalisation of work force and branch network; otherwise the mergers of public sector banks would tie down the management with operational issues and distract attention from the real issue. It would be necessary to evolve policies aimed at "right-sizing" and redeployment of the surplus staff either by way of retraining them and giving them appropriate alternate employment or by introducing a VRS with appropriate incentives. This would necessitate the co-operation and understanding of the employees and towards this direction, managements should initiate discussions with the representatives of staff and would need to convince their employees about the intrinsic soundness of the idea, the competitive benefits that would accrue and the scope and potential for employees' own professional advancement in a larger institution. Mergers should not be seen as a means of bailing out weak banks. Mergers between strong banks/FIs would make for greater economic and commercial sense and would be a case where the whole is greater than the sum of its parts and have a "force multiplier effect". ***(Chapter V, para 5.13 - 5.15)***

41. A 'weak bank' should be one whose accumulated losses and net NPAs exceed its net worth or one whose operating profits less its income on recapitalisation bonds is negative for three consecutive years. A case by case examination of the weak banks should be undertaken to identify those which are potentially revivable with a programme of financial and operational restructuring. Such banks could be nurtured into healthy units by slowing down on expansion, eschewing high cost funds/borrowings, judicious manpower deployment, recovery initiatives, containment of expenditure etc. The future set up of such banks should also be given due consideration. Merger could be a solution to the problem

of weak banks but only after cleaning up their balance sheets. If there is no voluntary response to a take over of these banks, it may be desirable to think in terms of a Restructuring Commission for such public sector banks for considering other options including restructuring, merger amalgamation or failing these closure. Such a Commission could have terms of reference which, inter alia, should include suggestion of measures to safeguard the interest of depositors and employees and to deal with possible negative externalities. Weak banks which on a careful examination are not capable of revival over a period of three years, should be referred to the Commission. ***(Chapter V, para 5.16 - 5.18)***

42. The policy of licensing new private banks (other than local area banks) may continue. The start up capital requirements of Rs 100 crores were set in 1993 and these may be reviewed. The Committee would recommend that there should be well defined criteria and a transparent mechanism for deciding the ability of promoters to professionally manage the banks and no category should be excluded on a priori grounds. The question of a minimum threshold capital for old private banks also deserves attention and mergers could be one of the options available for reaching the required capital thresholds. The Committee would also, in this connection, suggest that as long as it is laid down (as now) that any particular promoter group cannot hold more than 40% of the equity of a bank, any further restriction or voting rights by limiting it to 10% may be done away with. ***(Chapter V, para 5.20)***

43. The Committee is of the view that foreign banks may be allowed to set up subsidiaries or joint ventures in India. Such subsidiaries or joint ventures should be treated on par with other private banks and subject to the same conditions with regard to branches and directed credit as these banks. ***(Chapter V, para 5.21)***

44. The Committee attaches the greatest importance to the issue of functional autonomy with accountability within the framework of purposive, rule bound, non-discretionary prudential regulation and supervision. Autonomy is a prerequisite for operational flexibility and for critical decision making whether in terms of strategy or day to day operations. There is also the question whether full autonomy with accountability is consistent and compatible with public ownership. Given the dynamic context in whichthebanks are operating and considering the situational experience further capital enhancement would be necessary for the larger Indian banks. Against the background of the need for fiscal consolidation and given the many demands on the budget for investment funds in areas like infrastructure and social services, it cannot be argued that subscription to the equity of public sector banks to meet their enhanced needs for capital should command priority. Public sector banks should be encouraged, therefore, to go to the market to raise capital to enhance their capital. At present, the laws stipulate that not less than 51% of the share capital of public sector banks should be vested with the Government and similarly not less than 55% of the share capital of the State Bank of India should be held by the Reserve Bank of India. The current requirement of minimum Government of India/Reserve Bank of India shareholding is likely to become a constraint for raising additional capital from the market by some of the better placed banks unless Government also decides to provide necessary budgetary resources to proportionately subscribe to the additional equity, including the necessary premium on the share price, so as to retain its minimum stipulated shareholding. The Committee believes that these minimum stipulations should be reviewed. It suggests that the minimum share holding by Government/Reserve Bank in the equity of the nationalised banks and the State Bank should be brought down to 33%. The Reserve Bank as a regulator of the monetary system should not be also the owner of a bank in view of the potential for possible conflict of interest. It would not be necessary for the Government/RBI to divest their stake in these nationalised banks and in the State Bank of India. A reduction in their shares would come about through additional subscription by the market to their enhanced capital. A proportion of upto 5 or 10% of the equity of the bank concerned may be reserved for employees of the bank with a provision at some later date for the introduction of stock options. The appointment by the Government of

Boards and top executives of banks derives from its majority holding and if, as suggested above, the majority holding itself were to be given up, the appointment of Chairmen and Managing Directors should be left to the Boards of the banks and the Boards themselves left to be elected by shareholders. Needless to say, with a significant stock holding of not less than 33%, Government would have a say in the election of Boards and indirectly of the chief executives without their being seen as administrative appointments. The reduction in the minimum holding of Government below 51% would in itself be a major and clear signal about the restoration to banks and financial institutions of autonomy in their functioning. The Committee makes this recommendation in the firm belief that this is essential for enhancing the effectiveness and efficiency of the system and not on any other consideration. ***(Chapter V, para 5.27 - 5.33)***

45. To provide the much needed flexibility in its operations, IDBI should be corporatised and converted into a Joint Stock Company under the Companies Act on the lines of ICICI, IFCI and IIBI. For providing focused attention to the work of State Financial Corporations, IDBI shareholding in them should be transferred to SIDBI which is currently providing refinance assistance to State Financial Corporations. To give it greater operational autonomy, SIDBI should also be delinked from IDBI. ***(Chapter V, para 5.34)***

46. All NBFCs are statutorily required to have a minimum net worth of Rs 25 lakhs if they are to be registered. The Committee is of the view that this minimum figure should be progressively enhanced to Rs 2 crores which is permissible now under the statute and that in the first instance it should be raised to Rs 50 lakhs. ***(Chapter V, para 5.36)***

47. Deposit insurance for NBFCs could blur the distinction between banks, which are much more closely regulated, and the non banks as far as safety of deposit is concerned and consequently lead to a serious moral hazard problem and adverse portfolio selection. The Committee would advise against any insurance of deposits with NBFCs. ***(Chapter V, para 5.38)***

48. Urban Cooperative Banks are an important link in the credit delivery system and ensuring their sound health is important. The current entry norms, specially the capital requirements are much too liberal. RBI should urgently undertake a review of these norms and prescribe revised prudent minimum capital norms for these banks. Further, with a view to achieving an integrated system of supervision over the financial system, the Committee recommends that urban cooperative banks (UCBs) should also be brought within the ambit of the Board of Financial Supervision. One of the problem areas in supervision of the UCBs is the duality in control by the State Government and the Reserve Bank of India. Though co-operation is a state subject, since UCBs are primarily credit institutions meant to be run on commercial lines, the Committee recommends that this duality in control should be dispensed with. It should be primarily the task of the Board of Financial Supervision to set up regulatory standards for UCBs and ensure compliance with these standards through the instrumentality of supervision. ***(Chapter V, para 5.39)***

49. The Committee is of the view that there is need for a reform of the deposit insurance scheme. In India, deposits are insured upto Rs 1 lakh. There is no need to increase the amount further. There is, however, need to shift away from the 'flat' rate premiums to 'risk based' or 'variable rate' premiums. Under risk based premium system all banks would not be charged a uniform premium. While there can be a minimum flat rate which will have to be paid by all banks on all their customer deposits, institutions which have riskier portfolios or which have lower ratings should pay higher premium. There would thus be a graded premium. As the Reserve Bank is now awarding CAMELS ratings to banks, these ratings could form the basis for charging deposit insurance premium. ***(Chapter V, para 5.42)***

50. The Committee is of the view that the inter-bank call and notice money market and inter-bank term money market should be strictly restricted to banks. The only exception should be the primary dealers who, in a sense, perform a key function of

equilibrating the call money market and are formally treated as banks for the purpose of their inter-bank transactions. All the other present non-bank participants in the inter-bank call money market should not be provided access to the inter-bank call money market. These institutions could be provided access to the money market through different segments. ***(Chapter V, Annexure, para A7)***

51. There must be clearly defined prudent limits beyond which banks should not be allowed to rely on the call money market. This would reduce the problem of vulnerability of chronic borrowers. Access to the call market should be essentially for meeting unforeseen swings and not as a regular means of financing banks' lending operations. ***(Chapter V, Annexure, para A8)***

52. The interest rates movements in the inter-bank call money market should be orderly and this can only be if the RBI has a presence in the market through short term Repos for as short a period as one day. The RBI support to the market should be through a Liquidity Adjustment Facility under which the RBI would periodically, if necessary daily, reset its Repo and Reverse Repo rates which would in a sense provide a reasonable corridor for market play. While there is much merit in an inter-bank reference rate like a LIBOR, such a reference rate would emerge as banks implement sound liquidity management facilities and the other suggestions made above are implemented. Such a rate cannot be anointed, as it has to earn its position in the market by being a fairly stable rate which signals small discrete interest rate changes to the rest of the system. ***(Chapter V, Annexure, para A8)***

53. Non-bank parties can be provided free access to bill rediscounts, commercial paper (CP), Certificates of Deposits (CD), Treasury Bills (TB) and Money Market Mutual Funds (MMMFs). The issue arises of the minimum period for the issue of these instruments. At present, the minimum period for bills rediscounting by scheduled commercial banks is 15 days. The minimum lock-in period for CDs, CP and MMMFs is 30 days. In the restructuring of the market, proposed by the Committee, the minimum period of fixed deposit could, in the first instance, be reduced to 15 days and all money market instruments should likewise have a similar reduced minimum duration. There is reason for keeping a minimum duration for fixed deposits as in the absence of such a minimum all current accounts would become fixed deposits and thereby greatly add to the cost of funds of banks. The question needs to be addressed of the non-bank institutions, which have funds for a duration less than the minimum period stipulated for money market instruments. At the present time, the investors in money market instruments invariably hold the instruments to maturity and as such there is no secondary market in these instruments. In the kind of structure envisaged by the Committee, there will be an active secondary market in money market instruments. The Committee is of the view that these structural changes would result in the development of a strong and stable money market with liquidity and depth. ***(Chapter V, Annexure, para A9)***

54. The Committee recommends that the RBI should totally withdraw from the primary market in 91 days Treasury Bills; the RBI could, of course, have a presence in the secondary market for 91 days Treasury Bills. If the 91 days Treasury Bill rate reflects money market conditions, the money and securities market would develop an integral link. The Committee also recommends that foreign institutional investors should be given access to the Treasury Bill market. Broadening the market by increasing the participants would provide depth to the market. ***(Chapter V, Annexure, para A10)***

55. With the progressive expansion of the forward exchange market, there should be an endeavour to integrate the forward exchange market with the spot forex market by allowing all participants in the spot forex market to participate in the forward market upto their exposures. Furthermore, the forex market, the money market and the securities should be allowed to integrate and the forward premia should reflect the interest rate differential. As instruments move in tandem in these markets the desiderative of a seamless and vibrant financial market would hopefully emerge. ***(Chapter V, Annexure, para A11)***

Rural and Small Industrial Credit

56. The Committee is of the view that the banking system should be in a position to equip itself to identify the eligible clients based on prescribed norms in the Government sponsored programmes so that the full responsibility for all aspects of the credit decision remains with it. This should also help improve the client-bank relationship instead of the present system of virtually imposed clientele and build a credit culture and discipline. ***(Chapter VI, para 6.3)***

57. The Committee also recommends that a distinction be made between NPAs arising out of client specific and institution specific reasons and general (agro climatic and environmental issues) factors. While there should be no concession in treatment of NPAs arising from client specific reasons, any decision to declare a particular crop or product or a particular region to be distress hit should be taken purely on techno-economic consideration by a technical body like NABARD. ***(Chapter VI, para 6.6)***

58. The Committee strongly urges that there should be no recourse to any scheme of debt waiver in view of its serious and deleterious impact on the culture of credit. ***(Chapter VI, para 6.7)***

59. As a measure of improving the efficiency and imparting a measure of flexibility the Committee recommends consideration of the debt-securitisation concept within the priority sector. This could enable banks which are not able to reach the priority sector target to purchase the debt from institutions which are able to lend beyond their mandated percentage. ***(Chapter VI, para 6.8)***

60. Evolution of a risk management system would provide the needed comfort to the banking system to finance agriculture. At present, under the Income Tax Act, provision for bad and doubtful debts not exceeding 5% of income and 10% of the aggregate average advances made by rural branches of a scheduled or a non scheduled bank are allowed as deduction in computing the income chargeable to tax. Consideration could be given to increasing this to 5% of income and 20% of average aggregate advances of rural branches to provide incentive to banks for lending to rural sectors. ***(Chapter VI, para 6.10)***

61. The Committee recommends that the RRBs and cooperative banks should reach a minimum of 8% capital to risk weighted assets over a period of five years. A review of the capital structure of RRBs should be undertaken with a view to enlarging public subscription and give the sponsor banks greater ownership and responsibility in the operation of RRBs. While considering the issue of salaries of employees of RRBs, the Committee strongly urges that there should be no further dilution of the basic feature of RRBs as low cost credit delivery institutions. Cooperative credit institutions also need to enhance their capital through subscription by their members and not by Government. There should be a delayering of the cooperative credit institutions with a view to reducing the intermediation cost and thus providing the benefit of cheaper NABARD credit to the ultimate borrowers. ***(Chapter VI, para 6.12)***

62. The supervisory function over rural financial institutions has been entrusted to NABARD. While this arrangement may continue for the present, over the longer term, the Committee would suggest that all regulatory and supervisory functions over rural credit institutions should vest with the Board for Financial Regulation and Supervision. ***(Chapter VI, para 6.13)***

63. The present duality of control over the cooperative credit institutions by State Government and RBI/NABARD should be eliminated and all the cooperative banking institutions should come under the discipline of Banking Regulation Act, under the aegis of RBI/NABARD/BFS. This would require amendments to the Banking Regulation Act. The control of the Registrar of Cooperative Sector over co-operatives would then be somewhat on the lines of control that Registrar of Companies has over the Banking Institutions, registered under the Companies Act. ***(Chapter VI, para 6.14)***

64. Banking policy should facilitate the evolution and growth of micro credit institutions, including LABs which focus on agriculture, tiny and small scale industries, including such specialist institutions as may be promoted by NGOs for meeting the banking needs of the poor. Third-tier banks should be promoted and strengthened to be autonomous, vibrant, effective and competitive in their operations. ***(Chapter VI, para 6.16)***

65. Banks should devise appropriate criteria suited to the small industrial sector and be responsive to its genuine credit needs but this should not be by sacrificing canons of sound banking. Borrowers also need to accept credit discipline. There is also need to review the present institutional set up of state level financial/industrial development institutions. ***(Chapter VI, para 6.19)***

Regulation and Supervision

66. The Committee recommends that to improve the soundness and stability of the Indian banking system, the regulatory authorities should make it obligatory for banks to take into account risk weights for market risks. The movement towards greater market discipline in a sense would transform the relationship between banks and the regulator. By requiring greater internal controls, transparency and market discipline, the supervisory burden itself would be relatively lighter. ***(Chapter VII, para 7.13)***

67. The Committee notes that there is insufficient awareness of the Core Principles in India and perhaps even a complacent feeling that these are being implemented. This is not the case. There is, in fact, a need for all market participants to take note of the new guidelines. It is essential to formally announce full accession to these principles, their prescription tothefinancial institutions and their full and effective implementation. ***(Chapter VII, para 7.14)***

68. Proprietorial concerns in the case of public sector banks impact on the regulatory function leading to a situation of 'regulatory capture' where the regulators tend to identify regulatory activity with banking interests and as a consequence of which the quasi fiscal impact of appropriate regulation affects the quality of regulation. ***(Chapter VII, para 7.16)***

69. The Committee recommends that the regulatory and supervisory authorities should take note of the developments taking place elsewhere in the area of devising effective regulatory norms and to apply them in India taking into account the special characteristics but not in any way diluting the rigour of the norms so that the prescriptions match the best practices abroad. It is equally important to recognise that pleas for regulatory forbearance such as waiving adherence to the regulations to enable some (weak) banks more time to overcome their deficiencies could only compound their problems for the future and further emasculate their balance sheets. ***(Chapter VII, para 7.17)***

70. An important aspect of regulatory concern should be ensuring transparency and credibility particularly as we move into a more market driven system where the market should be enabled to form its judgement about the soundness of an institution. There should be punitive penalties both for the inaccurate reporting to the supervisor or inaccurate disclosures to the public and transgressions in spirit of the regulations. ***(Chapter VII, para 7.19)***

71. The Committee is of the view that banks should be required to publish half-yearly disclosure requirements in two parts. The first should be a general disclosure, providing a summary of performance over a period of time, say 3 years, including the overall performance, capital adequacy, information on the bank's risk management systems, the credit rating and any action by the regulator/supervisor. The disclosure statement should be subject to full external audit and any falsification should invite criminal procedures. The second disclosure, which would be a brief summary aimed at the ordinary depositor/investor should provide brief information on matters such as capital adequacy ratio, non performing assets and profitability, vis-a-vis, the adherence to the stipulated norms and a comparison with the industry average. This summary should be in a language intelligible to the depositor

and be approved by the supervisors before being made fully public when soliciting deposits. Such disclosure, the Committee believes, will help the strong banks to grow faster than the weaker banks and thus lead to systemic improvement. ***(Chapter VII, para 7.20)***

72. The Committee recommends that an integrated system of regulation and supervision be put in place to regulate and supervise the activities of banks, financial institutions and non bank finance companies (NBFCs). The functions of regulation and supervision are organically linked and we propose that this agency be renamed as the Board for Financial Regulation and Supervision (BFRS) to make this combination of functions explicit. An independent regulatory supervisory system which provides for a closely coordinated monetary policy and banking supervision would be the ideal to work towards. ***(Chapter VII, para 7.24)***

73. The Board for Financial Regulation and Supervision (BFRS) should be given statutory powers and be reconstituted in such a way as to be composed of professionals. At present, the professional inputs are largely available in an advisory board which acts as a distinct entity supporting the BFS. Statutory amendment which would give the necessary powers to the BRFS should develop its own autonomous professional character. The Committee, taking note of the formation of BFS, recommends that the process of separating it from the Reserve Bank qua central bank should begin and the Board should be invested with requisite autonomy and armed with necessary powers so as to allow it to develop experience and professional expertise and to function effectively. However, with a view to retain an organic linkage with RBI, the Governor, RBI should be head of the BFRS The Committee has also set out specific measures to ensure an effective regulatory/supervisory system which are detailed in para 7.27. ***(Chapter VII, para 7.24)***

Legal and Legislative Framework

74. A legal framework that clearly defines the rights and liabilities of parties to contracts and provides for speedy resolution of disputes is essential for financial intermediation. The evolution of the legal framework has not kept pace with the changing commercial practices and with the financial sector reforms. The Transfer of Property Act enacted in 1882 is a case in point. ***(Chapter VIII, para 8.1)***

75. Given the unsatisfactory state of the law of mortgage, the response has been to vest through special statute the power of sale in certain institutions like Land Development Banks and State Finance Corporations. This approach could be extended to other financial institutions and, if possible, to banks. The other approach is to set up special tribunals for recovery of dues to banks and financial institutions. These Tribunals need to have powers of attachment before judgement, for appointment of receivers and for ordering preservation of property. For this purpose, an amendment to the concerned legislation may be necessary. The Committee would like to emphasise the importance of having in place a dedicated and effective machinery for debt recovery for banks and financial institutions. ***(Chapter VIII, para 8.2 - 8.4)***

76. Securitisation of mortgages is also critically dependent on the ease of enforcement and the costs associated with transfer of mortgages. The power of sale without judicial intervention is not available to any class of mortgages except where the mortgagee is the Government or the mortgage agreement so provides and the mortgaged property is situated in Mumbai, Chennai and Calcutta and other towns so notified. Even if the power of sale without judicial intervention were available there would need to be measures to put the buyer in possession. ***(Chapter VIII, para 8.5 - 8.6)***

77. The question of stamp duties and registration fees also requires review. There is a case for reducing stamp duties and registration fees substantially. ***(Chapter VIII, para 8.7)***

78. In view of the recent amendments to Section 28 of Indian Contract Act, banks have expressed a fear that they can no longer limit their liabilities under bank guarantees to a specified period and that they would have to carry such guarantee commitments for long

periods as outstanding obligations. Government departments do not generally return the original guarantee papers even after the purpose is served. This whole issue needs to be re-examined and bank guarantees exempted from the purview of the recent amendment to Section 28 of the Indian Contract Act. The issue of enforcing securities in the form of book debts also calls for review. The Committee also agrees with the proposal to amend the Sick Industrial Companies Act, seeking to trigger off the remedial mechanism on the sight of incipient sickness. ***(Chapter VIII, para 8.9 - 8.14)***

79. With the advent of computerisation there is need for clarity in the law regarding the evidentiary value of computer generated documents. The Shere Committee had made some recommendations in this regard and the Committee notes that the Government is having consultations with public sector banks in this matter. With electronic funds transfer several issues regarding authentication of payment instruments, etc., require to be clarified. The Committee recommends that a group be constituted by the Reserve Bank to work out the detailed proposals in this regard and implement them in a time bound manner. ***(Chapter VIII, para 8.15 - 8.16)***

80. Certain legislative requirements would also be needed to implement some of the Committee's recommendations regarding the structure of the banking system and matters pertaining to regulation and supervision.. The Banking Regulation Act is structured on the premise that bank supervision is essentially a Government function and that the Reserve Bank of India's position is somewhat on the lines of an agent. The Act also provides appellate powers to Government over the decisions of the RBI in this regard. It also provides original powers in certain instances. The Committee feels that these provisions should be reviewed. ***(Chapter VIII, para 8.17)***

81. With respect to recommendations regarding constitution of a Board for Financial Regulation and Supervision, it would be necessary for amendments in the Banking Regulation Act and Reserve Bank of India Act. Amendments would also be needed in the Bank Nationalisation Acts to enable grant of greater managerial autonomy to public sector banks, for lowering the minimum requirements of 51% Government ownership and as regards the constitution of Boards of Directors and of the Management Committees. The provisions relating to prior approval of Government for regulations framed under the Act would also need to be reviewed. In line with the above, amendments would also be needed in the State Bank of India Act with regard to shareholding of the RBI and constitution of its Central Board. ***(Chapter VIII, para 8.19 - 8.20)***

82. These suggestions are not exhaustive and we would recommend that the legal implications with reference to each of these recommendations be examined and detailed legislative steps identified by the Ministry of Finance, Banking Division in consultation with the Ministry of Law. In view or the wide-ranging changes needed in the legal framework the Committee recommends setting up of an expert committee comprising among others, representatives from the Ministry of Law, Banking Division, Ministry of Finance, RBI and some outside experts to formulate specific legislative proposals to give effect to the suggestions made above. ***(Chapter VIII, para 8.22 - 8.23)***

Chapter I

Introduction : The Issues

1.1. A strong and efficient financial system, functionally diverse and geographically widespread, is critical to the attainment of our objectives of creating a market-driven, productive and competitive economy and to support higher investment levels and accentuate growth. The creation of such a system has been the objective that has inspired the process of financial sector reform since 1992 as part of the broader programme of structural economic reform.

1.2. As part of this process, reform of the banking sector is now under way. The banking system is, by far, the most dominant segment of the financial sector, accounting as it does for over 80% of the funds flowing through the financial sector and it is appropriate that reform in this sector has been receiving major emphasis. The reform measures taken in this area have followed the recommendations of the Committee on the Financial System (CFS), which reported in November 1991. That Report had made a number of recommendations aimed at improving the productivity, efficiency and profitability of the banking system on the one hand and providing it greater operational flexibility and functional autonomy in decision making on the other. It covered policy aspects, accounting practices, institutional and structural issues and matters relating to organisational development. The Report itself was conceived as a holistic exercise and its recommendations were accordingly symbiotically related to each other.

1.3. Since the submission of the Report several measures have been instituted in line with its recommendations. Accounting practices have been prescribed more in consonance with internationally accepted standards in this regard with the major objective of enhancing transparency and credibility and ensuring accuracy of financial statements.

1.4. Asset classification criteria have been prescribed and principles governing income recognition have been laid down with the aim of removing subjectivity in this regard and providing for measurable objectivity. Prudential norms have also been prescribed, most importantly, with respect to provisioning for various categories of market related and substandard assets. Capital adequacy requirements have also been laid down, directed towards enhancing the inherent strength of banking institutions. With regard to policy measures, the significant changes that have been effected in line with the recommendations of the CFS have been the progressive reduction of the Statutory Liquidity Ratio (SLR) and the Cash Reserve Ratio (CRR) requirements as an aspect of correcting the impact of the high proportion of directed investments on profitability and operational flexibility. Another major step has been, as suggested by the CFS, the progressive deregulation of the bewilderingly complex and detailed administered interest rate structure and to move interest rates more closely to a market-determined basis and to restore to the Bank rate its function of being an anchor or reference rate.

1.5. These have been very major and significant changes but it would be observed that while the "arithmeticals" of the CFS recommendations in relation to various ratios, rates and accounting have been accepted and put through, the same measure of progress has not been made with regard to structural and systemic aspects of the reform agenda outlined by the CFS. Even with regard to 'arithmeticals', an important recommendation relating to directed credit has not been accepted. In some cases, as for instance, in respect of the ways to handle the problem of non performing assets (NPAs), while the problem has been recognised the approach adopted has differed.

1.6. Even as these measures are making their impact, there have been major changes in the macro economic environment and policy and institutional developments. These may call for an examination of the problem issues anew and possibly for a review of some of the recommendations made earlier to see whether they continue to have the same relevance in the changed context. The most important change in the domestic macro environment has been the greater focus on the containment of the fiscal deficit, the subsidence of inflationary pressures and the restoration to monetary policy of its defining function of regulating money and credit in the pursuit of its central objectives of price and exchange rate stability. For monetary policy itself to be effective we need

a well knit and integrated financial system and active money and capital markets. The greater reliance on market instruments of monetary regulation and especially on the interest rate has implications for the banking system in terms of expanding the scope and range of the risk management function especially as marking assets to market prices comes, as it should, increasingly into vogue. Apart from the traditional concerns with credit risk, banks will thus increasingly need to manage market and liquidity risks and to develop the skills for this. The other development has been the much greater flexibility now available to banks and financial institutions with respect to foreign exchange transactions. Indian banks are participating in growing measure in the foreign exchange markets both in India and abroad with all the opportunities and risks that this entails. We could also expect derivative trading to play an increasing role with appropriate forms of risk management.

1.7. These changes in the domestic economic and institutional scene have coincided with the movement towards global integration of financial services. Financial autarky is not a viable or even a possible option. Global financial integration would call for a greater measure of competitive efficiency in our financial system if it is to be able to face successfully the challenge of increasing competition from abroad. This is more so in the context of our objective of moving in a phased manner towards a more liberal capital account regime. An open capital account would result in larger inflows and outflows with attendant implications for the management of the exchange rate and domestic liquidity. For the system to be able to handle such problems it would need to be strong and resilient. The recent developments in East and South East Asia have only underscored the importance of a strong domestic financial system. This experience has shown that despite strong economic fundamentals, such as a high savings rate and prudent fiscal policies, weak banking policies and practices and the consequent fragility of the financial system can have a serious destabilising influence.

1.8. Recent developments have thus served to reinforce the point that a strong and efficient financial system is necessary both to strengthen the domestic economy and make it more efficient and also to enable it to meet the challenges posed by financial globalisation. Building such a system constitutes the unfinished agenda of banking and financial sector reform.

1.9. Action on strengthening the foundations of the system would necessarily involve improving the quality of bank assets. Nothing is more indicative of the quality of assets than the quantum and incidence of NPAs in relation to the total portfolio. The causes for a high proportion of NPAs are varied. Poor credit decisions by bank managements, difficult recovery environment and changes both cyclical and structural in the larger economic environment represent some of the micro and macro aspects of this. This is not all. Often, as international experience has shown, a high incidence of NPAs could be traced to policies of directed credit, not to speak of cruder forms of behest lending. In our own country, the 'contamination coefficient' of directed credit has been shown to have a value above unity as the figure of NPAs emanating from priority sector credit testify. There is nothing inherently wrong in setting out social priorities for bank lending. Social banking need not conflict with canons of sound banking but when banks are required by directive to meet specific quantitative targets, there is, as our own experience has shown, the danger of erosion of the quality of the loan portfolio.

1.10. In the last few years the overall proportion of net NPAs to the total portfolio has come down. Gross NPAs amounted to a little under twice the proportion of net NPAs. The reduction in the level of NPAs partly reflects banks' efforts at recovery and the write-offs of losses and provisioning for non performing loans which banks were enabled to do as a result of infusion of Government funds as part of a recapitalisation programme. The figure of NPAs, however, remains uncomfortably high as an average even as it conceals wide individual variations with the position of some banks being quite disconcerting. The NPA figures incidentally do not include advances covered by Government guarantees which have turned sticky. It is also important to ensure that the classificatory norms for NPAs are strictly adhered to in letter and spirit and to see that the phenomenon of 'ever greening' does not mask the true situation.

1.11. An important aspect of the continuing reform process is thus to reduce further the high level of NPAs as a means of institutional strengthening. While there is reason to expect that with

a combination of policy and institutional development, new NPAs could in future be lower than hitherto, the problem remains of the huge backlog of existing NPAs which impinges severely on banks' performance and their profitability. Several approaches are possible. The earlier Committee had suggested the creation of an Assets Reconstruction Fund (ARF) to take these assets off banks' books at a discount. Recapitalisation through infusion of capital is another approach and has been used in the case of some banks. In the last six years, massive budgetary funds have been used for recapitalisation of public sector banks. This is a costly and, over time, not a sustainable option. The problem, however, remains and consideration would need to be given to revisiting the concept of an ARF.

1.12. Another measure intended to enhance the inherent financial strength of the system is the enhancement of capital funds of banks. At the time the earlier Committee reported the desirable and feasible target for capital adequacy seemed to be the level set by the Basle Committee of the BIS. Several developments have taken place since. We now have a better idea of the nature and volume of risk weighted assets. As observed earlier, with greater volatility in exchange markets and the greater use of interest rate variations as instruments of monetary policy the market or asset price risk of both foreign assets and domestic investments is now quite considerable. Banks have also been getting more exposed to off balance sheet risks. Banking is essentially an exercise in risk management. All these considerations suggest the need to review anew the minimum prescriptions for capital adequacy with a view to their possible enhancement.

1.13. Another important measure of the strength of the system is its profitability levels. The high level of NPAs has been a proximate cause for the low profitability levels of our public sector banks. Other factors have been the large number of unremunerative branches, low productivity, overmanning and arcane methods of operations, apart from the impact of directed credit and high pre-emptions of funds. Spreads in the Indian banking system remain high and yet profitability levels are low. There has been some improvement in recent years in net profits for Public Sector Banks (PSBs) as a group (partly as a result of some recapitalisation in some of them). With increasing competition from foreign and private banks, margins will come under further pressure and issues of customer orientation, productivity and efficiency in relation to profitability will come to the fore.

1.14. Action on strengthening the foundations of the system by improving asset quality, enhancing capital and improving profitability would need to go along with structural changes in the system. One of the more important developments that has been taking place in international banking is the revival of the phenomenon of universal banking in terms of which the distinction between commercial, investment and development banking is getting blurred. In this country also we are moving towards this concept. Commercial banks have been making, in larger measure than before, term finance to industry and providing investment banking services apart from setting up subsidiaries in such diverse areas as mutual funds, securities trading and factoring. At the other end of the spectrum the development finance institutions (DFIs) are increasingly getting into the area of working capital finance and have also set up banking and mutual fund subsidiaries. The financing requirements of Indian corporates, whether from the DFIs or from the banks, are now being seen as an integrated operation. Non-banking financial companies (NBFCs) have proliferated in India in areas like consumer finance, hire purchase, equipment leasing and housing finance. How their activities should be integrated into the financial system and regulated is an issue which needs to be examined.

1.15. The financial structure is thus evolving towards a continuum of institutions rather than discrete specialisation and the facilities that are being provided are to be seen as aspects of a spectrum of financial services in keeping with 'relationship' banking. Universal banking in fact provides for a cafeteria approach or, if one were to vary the metaphor, it would take on the role of a one stop financial supermarket. These developments also have implications for the framework and content of regulation.

1.16. With regard to the structural framework of the banking system, there is a need to help move towards a structure, as the CFS suggested, with a few large Indian banks with an international character, some large national banks and the rest consisting basically of regional/

local banks. There is also a need to impart greater competition as between public sector banks and private sector banks.

1.17. In recent years, there have been a large number of mergers in international banking and in the process large institutions have become even larger as a response to the challenges of competition and as an aspect of synergising operations and achieving scale economics. Mergers should, in the normal course, be driven by business needs and should lead to the growth of larger banks both in public and private sector. There is general recognition now that size is an important determinant of banking strength. Mergers amongst strong units can be both a means of strengthening them as also providing for greater opportunities for competition.

1.18. A merger of strong units would indeed have, to borrow a phrase from another discipline, a force multiplier effect. It is sometimes argued that mergers could provide for a strong bank taking over a weak one. On the other hand, such mergers could well result in an adverse impact on the asset quality of the stronger unit as a result of acquiring the contaminated portfolio of the weaker unit in the absence of any system of writing off the NPAs of the latter before the merger.

1.19. It needs, however, to be recognised that mergers to be meaningful and useful should not be a mere arithmetical merger of balance sheets and staff of the banks but should yield benefits in terms of staff and branch network rationalisation. Unless these benefits can become available, mergers of public sector banks would tie down managements with operational issues and merely distract attention from the real issues without giving any commensurate benefits.

1.20. The problem of the weak banks is a separate and important issue and needs to be addressed squarely. As a working definition, a weak bank could be regarded as one whose accumulated losses and net NPAs exceed its capital funds or in respect of PSBs whose operating results less income from recapitalisation bonds reveal losses for three consecutive years. Some public sector banks fall in this category and, if the depositors' funds are not at risk (as they would otherwise have been) it is because of the implicit guarantee provided by State ownership of the institutions. There could be some weak banks which are potentially viable with some corrective measures being applied even as there would be those whose affairs are not capable of early or complete correction. In the latter case, the costs and implications of various alternative approaches, not excluding closure in some cases, would need to be carefully examined. In this connection, the concept of narrow banks has been suggested as a possible solution for the short term. Narrow banks could be allowed as an opportunity to facilitate their rehabilitation. The strategic revival plans formulated by some weak banks and approved by Government and Reserve Bank of India (RBI) as well as the Memoranda of Undertaking (MoUs) entered into by Management and Staff Unions is indicative of this approach. The issue of closure would need to be examined if it were concluded that the narrow banks approach does not enable rehabilitation of some banks.

1.21. One of the more significant measures instituted since 1991 has been the permission for new private banks to be set up, and the more liberal approach towards foreign bank offices being opened in India. These steps have enhanced the competitive framework for banking — the more so as the new private and foreign banks have higher productivity levels based on newer technology and lower levels of manning. The increasing share in total banking business of the foreign and private banks in the last few years is reflective of their competitive edge and their potential.

1.22. While two or three banks with an international orientation and 8 to 10 large national banks should take care of the needs of the large and medium corporate sector and the larger of the small enterprises; there will still be need for a large number of local banks. This third tier banks should appropriately be confined to smaller geographical regions, namely states, or cluster of districts and it is this class of banks that should appropriately serve the needs of local trade, small industry and agriculture with strong correspondent relationships with larger national and international Indian banks. A measure of specialisation by size and regional character would be in keeping with experience abroad and is particularly appropriate in a country as large and diverse as ours. The issue of evolving a viable and efficient framework for rural credit has defied solution despite our long experience of the felt needs for rural credit and an examination of this issue by several committees and experimentation with various policies and institutions. One of the major

issues before this Committee is to attempt an integration and linkage of rural credit facilities with the other constituents of the financial system and more particularly the banking sector.

1.23. The next set of issues before the Committee relate to streamlining the procedures and operational methods in banks. Modern banking abroad rests on the twin pillars of information technology and instant electronic funds transfer systems. Neither of these has made any worthwhile impact in our country though some small beginnings have been made. We cannot, afford to neglect these aspects if Indian banking has to face the challenges of not only increasing global competition but of serving our domestic economy better. Technological upgradation, both at the level of central offices and even more so through branch networking and in respect of retail banking services has to be given high priority. The programme of branch computerisation has been making slow progress and clearly needs to be speeded up. Priority would need to be given to the needs of the larger banks in this area and over time such technological upgradation must cover all the constituents of the banking system. Upgradation of technology through widespread computerisation would obviously enhance the productivity and efficiency of the system, reduce costs and improve customer service. Banking is first and foremost a service industry and the international trend is towards what has been termed "relationship banking" suggesting a customer and client specific orientation to provision of services. Electronic banking is increasingly replacing conventional banking instruments abroad. Digital cash has also made its appearance. The implications for our banks of these developments will need attention. The possibility of outsourcing some services which lend themselves to computerisation needs also to be explored.

1.24. As regards modernisation and technology upgradation, the pace and reach of computerisation will need to be accelerated. In these endeavours, there is no reason to expect that employees will not agree to cooperate or welcome efforts in enhancing the productivity and efficiency of banks. The earlier Committee had drawn particular attention to the aspect of enhancing professional skills and the need for professional competence at the executive and decision making levels. As banking gets more technology intensive the type of skills that would be required particularly in those banks which could increasingly face internal and global competition would be of a different order emphasising new forms of risk identification and management, liquidity and credit appraisal in areas like infrastructural finance, to give an example, and Treasury management, avoidance of asset-liability mismatch in terms of maturity, currency and value as well as developing expertise in derivative trading and associated risk management. These specialist requirements and indeed the need to elevate the general level of professional skills will call for a review of recruitment procedures and training and remuneration policies in bank, especially in the PSBs.

1.25. An aspect of human resource management in banks is the perception of low morale amongst banking personnel as a result of actual or perceived threat of action by vigilance and other investigative authorities in respect of what should normally be regarded as commercial decisions. This may have led to some risk aversion with its impact of a denial in some case of legitimate productive credit. This an issue which the Committee has sought to address.

1.26. Fundamental to the reform process is the issue of ensuring greater operational flexibility to the public sector banks. This is also closely related to their functional autonomy. The CFS laid great store by this and took the view that restoration of functional autonomy was not inconsistent with public ownership and that the productive efficiency and profitability of the system was ownership neutral as long as Government's role was only that of an investor and banks were given freedom of action within a well devised framework of regulation and prudential norms. Autonomy has its corollary in accountability and even as autonomy is sought and given, we need to evolve transparent procedures to fix accountability for non performance. The dichotomy between ownership and management is regarded as the hallmark of modern corporate organisation and though in theory functional autonomy could be ownership neutral as indicated by the CFS, the major rider it added, viz., the requirement that for this to be so the owner should allow the management to function with flexibility and autonomy has not been totally fulfilled. The more general case is where ownership has itself become an instrument of management. Such micro management of banks is not calculated to enhance autonomy and flexibility. Indeed the wider question whether real autonomy is consistent with public ownership needs to be re-examined in the light of experience in the last few years.

1.27. One of the more significant recommendations aimed at improving the flexibility and autonomy of banks was that relating to the depoliticisation of appointments to the Boards of banks and of their Chairmen. Such a depoliticisation would be a corollary to encouraging professionalism in bank management and board appointments. The issue of depoliticisation is obviously linked to the question of autonomy in decision making. A measure of depoliticisation has been effected with respect to appointments of Chairmen and Managing Directors and Executive Directors of public sector banks. Though the appointing authority is the Government, the decisions regarding appointments are based on the recommendations of a separate Appointments Board headed by the Governor of RBI. The same is not the case with appointments of non-official directors on the Boards and this is an aspect which needs correction.

1.28. A high degree of professionalism needs to be introduced as much at the Board level as in Management. The composition of the boards should reflect this. The respective functions of the boards and the management require to be reviewed so that the boards remain responsible for enhancing shareholder value through formulation of corporate strategy and not get involved in credit decision making and other aspects of day-to-day management which should be the concern of a Committee of Executives.

1.29. Efforts have been made by banks in the direction of strengthening internal controls. In view of the more open environment in which the banks would now be required to function and the attendant proliferation of risks banks would have to put in place appropriate systems for asset-liability and risk management.

1.30. Another major issue for consideration is that related to the arrangements for regulation and supervision. Regulation should appropriately be concerned with the formulation of policy with regard to prudential norms, capital adequacy and the like, while the function of supervision should be regarded as the instrumentality for ensuring that the regulatory norms are complied with. This could take the form of either both off-site oversight by scrutiny of periodical returns and on-site inspection. A Board for Financial Supervision has been established and one of the critical issues here is whether the Board should be an autonomous body, as recommended by the CFS, or, as is the case now, a part of the Reserve Bank of India. Regulation and associated supervision, whether off-site or on-site, should be concerned with laying down prudential and disclosure norms and sound procedures and ensure adherence to these and not get involved in aspects of day-to-day management of banks. Regulation and supervision of DFIs and NBFCs is appropriately now the responsibility of the agency charged with exercising this function over banks. In discussing issues of regulation and supervision, the new 'core principles' set out by the BIS in this regard would need to be kept in view, especially in respect of surveillance of cross border transactions.

1.31. There has been a perception, and not without reason, that our legal system have not kept pace with measures of financial sector reform and indeed economic reforms more generally. As far as the banking sector is concerned, there is continuing need for an appropriate legal framework to help enforce contracts and protect the interests of secured creditors especially in bankruptcy proceedings. Some of our laws are outdated and legal procedures are cumbersome and time consuming. Even where Court decrees are obtained, their enforcement has been marked by delays. Our experience with the Debt Recovery Tribunals has not been altogether satisfactory in view of the legal issues that have been raised. Our laws indeed seem marked by a basic asymmetry in their protection of creditors as distinct from borrowers which comes in the way of the proper and smooth functioning of banking and credit systems. There are also a host of Banking Sector Laws like the RBI Act, Banking Regulation Act, Nationalisation Acts, State Bank of India Act and so on which are in urgent need of review and amendments to bring some of the provisions in line with the current needs of the banking industry in the country. The Sick Industrial Undertakings (Special Provisions) Act or the Bankers' Book Evidence Act also need to be reviewed.

1.32. As we move into the second phase of financial and banking sector reform, the emphasis would thus increasingly have to be on enhancing the inherent strength of banks, review the structure of the system, the internal organisation of banks and streamlining their procedures, taking into account institutional and technological dimensions. It would also call for an analysis of banking

policy in the new milieu. The second generation of reform, therefore, could be conveniently looked at in terms of three broad inter-related issues:-

- Actions that need to be taken to strengthen the foundations of the banking system;
- Related to the above, streamlining procedures, upgrading technology and human resource development; and
- Structural changes in the system.

1.33. These would cover aspects of banking policy, institutional, supervisory and legislative dimensions.

1.34. The foregoing paragraphs set out the broad issues that the Committee has addressed itself to. Underlying its approach is the same vision that guided the earlier Committee, namely, of a healthy, competitive, market-oriented, efficient and professionally managed financial system, which would make its distinctive contribution to the growth of the Indian economy and its closer integration with the international economy in the challenging decades ahead.

Chapter II

Review of the Action Taken on the Recommendations of the Committee on Financial System

2.1. The Committee on the Financial System had approached the task of financial sector reform by placing emphasis on the steps needed to improve the financial health of banks and development financial institutions to make them viable and efficient in order to serve the emerging needs and enhance the competitive efficiency of the real sector. The Committee suggested several policy and structural changes designed to enhance competitive efficiency, productivity and profitability of the financial system and enhance flexibility and autonomy in the functioning of banks and DFIs. The Report covered policy aspects, accounting standards, institutional and structural issues and organisational development.

2.2. Many of the recommendations of the Report have been accepted and implemented. Some have not been accepted and some implemented in a manner somewhat different from what was recommended.

2.3. The following indicates the various actions taken on the Report of the CFS.

2.4. ***Statutory Liquidity Ratio (SLR) :*** The Committee had recommended that the SLR be viewed as a prudential requirement and brought down in a phased manner to 25% over a period of about five years. This recommendation has been implemented and the SLR has been brought down to 25% in a phased manner and stands at 25% of demand and time liabilities from the fortnight ended October 22, 1997.

2.5. ***Cash Reserve Ratio (CRR) :*** The Committee was of the view that RBI should have the flexibility to operate this instrument to serve its monetary policy objectives. The Committee however added that with Government's resolve to reduce the fiscal deficit and with deregulation of interest rates, there would be more scope for use of Open market operations with perhaps less emphasis on variations in the CRR. It therefore suggested that the RBI should consider progressively reducing the cash reserve ratio from the then prevalent high level. The average CRR was brought down in stages from 15% in 1989 to 9.5% in November 1997. It was hiked to 10% in December 1997 and to 10.5% in January 1998 in view of the situation prevailing in financial and foreign exchange markets and international developments. The CRR was however reduced to 10.25% from 28.3.98 and to 10% with effect from 11.4.98. RBI has also been using open market operations for monetary policy reasons.

2.6. ***Interest rates on CRR balances :*** The Committee had recommended that RBI should pay interest rates on CRR deposits above the basic minimum related to banks' average cost of deposits. During the regime of administered interest rates the rate may be fixed at the level of banks' one year deposit rate. Till October, 1997, under the two-tier formula, interest was paid at the rate of 10.5 percent on eligible cash balances based on their Net Demand and Time Liabilities (NDTL) as on March 23, 1990 and no interest was paid on the increase in eligible cash balances (based on the increase in NDTL over the level as on March 23, 1990), maintained with RBI. Thus, the effective rate of interest on the entire eligible cash balance worked out to about 3.5% per annum. Consequent on the latest busy season credit policy announcements, interest on eligible cash balances i.e. above the basic minimum, is now being paid to all scheduled commercial banks at the rate of 4 per cent per annum from the fortnight beginning October 25, 1997. Eligible cash balances are defined as cash balances above the basic minimum of 3%.

2.7. ***Directed Credit :*** The Committee had recommended that directed credit programmes should be phased out. It recognised that it would be necessary for a measure of special credit support through direction to a redefined priority sector for which the suggested rates should be fixed at 10 per cent of aggregate credit. A review could be undertaken at the end of three years to see if directed credit programmes needed to be continued. As regards credit to the target group which would not be included in the new definition, RBI and other refinance agencies may institute a preferential refinance scheme to cover incremental credit to these sectors.

2.8. According to the assessment made by RBI the redefined priority sector accounts for a little less than 30% of net bank credit. It was therefore decided to continue the existing targets for priority sector lending. Concessional finance is however now limited to small loans below Rs. 2 lakhs and for DRI advances. For advances above Rs. 2 lakhs, the banks are free to charge interest rate linked to PLR. The scope of priority sector lending has been enlarged to include finance to SIDC/SFC, refinance to RRBs by sponsor banks, investments in bonds issued by certain specified institutions etc.

2.9. ***Interest rates structure :*** The Committee recommended the deregulation of interest rates in a phased manner in line with macro economic conditions. The interest rates on bank deposits could continue to be regulated, the ceilings on such rates being raised as the SLR is reduced progressively. The interest rate on Government borrowing could also be gradually brought in line with market determined rates which should be facilitated by the reduction of SLR. Meanwhile concessional interest rates should be phased out. The structure of interest rates should bear a broad relationship to the Bank Rate which should be used as an anchor to signal the RBI's monetary policy. A Prime rate may be set which would act as a floor for the lending rates of banks and DFIs. The spreads between the Bank Rate, the bank deposit rates, the Government borrowing rates and the prime rate may be determined by RBI broadly in accordance with the criteria suggested by the Chakravarty Committee so as to ensure that real rates of interest remain positive.

2.10. These recommendations have since been implemented. Except lending to small borrowers and a part of export finance, all lending rates have been deregulated. Interest rates on deposits are now free except for prescription in respect of savings deposits. The interest rate on Government borrowings is also now market determined. Concessionality in interest rates in lending has also been phased out to a great extent. Interest rates are presently prescribed for borrowers covered under the Differential Rate of Interest (DRI) Scheme at 4 per cent per annum and small borrowers for credit limits upto Rs. 2 lakh. It should be added that this sector to which concessional rates apply account for a significant portion of the priority sector credit. The Bank Rate has been reactivated as per the Monetary and Credit Policy announced in April 1997, by linking interest rates of significance (e.g., refinance from RBI, penal interest on shortfall in reserve requirements, etc.) to it. Since October 1994, a system of Prime Lending Rate (PLR) has been put in place under which banks and FIs are setting out, with approval of their Boards, their PLR which is the minimum lending rate for non concessional lending (i.e., credit limits above Rs. 2 lakh) The relationship between the Bank Rate, the Government borrowing rate, bank deposit rates and the PLRs of banks are determined by market forces and developments in the economy like expected inflation rate, etc.

2.11. ***Capital adequacy :*** The Committee had recommended that BIS norms on capital adequacy should be achieved over a period of 3 years by March 1996, the period being accelerated for banks with an international presence. Profitable banks could straightaway approach the capital market for enhancement of their capital and in respect of other-banks Government could meet the shortfall either by direct subscription to equity or by providing a loan which could be treated as subordinated debt.

2.12. These norms were implemented by RBI. Banks with international presence were directed to achieve these norms by March 1995 and other banks in two stages by March 1996. Eight banks could not achieve the prescribed norm as on 31.3.1996. As on 31.3.1997 only two banks have not been able to achieve the 8% norm.

2.13. Five nationalised banks, SBI and two subsidiaries of SBI successfully raised capital from the market since 1993 for a total of Rs. 6034.75 crores (including the premium on the issue prices). Government has also directly subscribed to the capital of nationalised banks to the extent of Rs.20046.00 crores upto 28.2.1998.

2.14. ***Income recognition, asset classification and provisioning norms:*** The Committee defined the term non-performing asset (NPA) and recommended that no interest should accrue in respect of NPAs. The income recognition norms were to be phased 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.

2.15. The norms have been introduced since 1992 in phases as recommended by the Committee. Banks were directed that income from Non Performing Assets (NPAs) could not be taken to Profit and Loss Account unless income had been realised. NPA has been defined as a credit facility in respect of which interest has remained "past due" for a period of four/three/two quarters as on 31 March 1993, 31 March 1994, 31 March 1995 respectively. A credit facility is "past due" when the instalment has not been paid within 30 days from the due date. Similarly, banks were required to classify assets, based on their status, as NPA into sub-standard, doubtful and loss assets and make appropriate provisions. These norms have been applied to DFIs except that in case of DFIs an advance becomes NPA if interest remains overdue for more than 180 days and/or instalment of principal remains overdue for more than 365 days.

2.16. ***Transparency of financial statements:*** The Committee recommended that the transparency and disclosure standards recommended in the International Accounting Standards may be implemented in a phased manner.

2.17. RBI modified the format of balance sheets of banks with a view to introducing greater transparency and disclosures in 1992. In their 1996 accounts banks were required to disclose the capital adequacy ratios and in the 1997 accounts, further disclosure requirements were introduced; more significant being 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 have been directed to disclose seven critical ratios relating to productivity and profitability.

2.18. ***Tax treatment of provisions:*** The Committee recommended that income recognition norms as suggested by it may be implemented by RBI. The specific provisions 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% of the aggregate average non-agricultural advances and 2% of the aggregate average advances by rural branches to all banks including those having overseas operations.

2.19. While the income recognition norms have been implemented as proposed, in respect of specific provisions made by banks against classified assets, these are not considered as tax-deductible unless the amount is written off. RBI has taken up the matter with Government. As regards general provisions, the limit of admissible deductions has been enhanced to 5% of the income and 10% of average aggregate advances of rural branches.

2.20. ***Debt Recovery Tribunals:*** The Committee's recommendations for setting up of Special Tribunals to speed up the process of recovery by specific legislation has been implemented with the passage of the Recovery of Debts due to Banks and Financial Institutions Act 1993 in August 1993. So far 8 debt recovery tribunals have been established covering 20 states and 4 Union Territories. An Appellate Tribunal has also been established in Mumbai.

2.21. ***Asset Reconstruction Fund:*** The Committee recommended setting up of an Asset Reconstruction Fund to take over bad and doubtful assets off the balance sheets of banks and FIs so that banks could recycle the funds realised through this process into new productive assets. The ARF should be provided with broader powers for recovery and should be funded by Government of India, RBI, public sector banks and financial institutions. The Committee also suggested the manner in which assets could be transferred.
This set of recommendations has not been implemented.

2.22. ***Structure of the banking system:*** The Committee had indicated a broad structural pattern 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 would be generally confined to a specific region and rural banks whose operations would be confined to rural areas. The move towards this structure should be market driven and based on profitability considerations and brought about through a process of mergers and acquisitions.

2.23. Except for merger of a weak public sector bank with another public sector bank, there has been no restructuring of the public sector banking system. Four weak private sector banks were closed/merged during this period.

2.24. ***Regional Rural Banks:*** The Committee's recommendations that each public sector bank 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 has not been accepted. The approach instead has been to strengthen and restructure Regional Rural Banks on a 'stand alone' basis.

2.25. ***Entry of private sector banks:*** The Committee's recommendation to allow entry of new private banks has been implemented with ten new private banks having commenced business.

2.26. ***Branch licensing:*** The Committee recommended that branch licensing be abolished and the matter of opening branches or closing of branches (other than rural branches for the present) be left to the commercial judgement of the individual banks. While branch licensing policy has not been abolished, greater operational freedom has been given to banks to open certain specialised branches, off-site ATMs and other non-branch offices. Banks have also been given freedom to close branches in urban, semi-urban and metropolitan centres and for conversion of rural branches into satellite offices. In 1994 it was decided to give freedom to open branches to banks fulfilling certain criteria viz. net owned funds of Rs.100 crore, three year track record of net profits, 8% Capital adequacy ratio and percentage of gross NPAs to total advances not exceeding 15%.

2.27. ***Foreign banks:*** The Committee recommended a liberal approach in permitting foreign banks to open either branches or subsidiaries as RBI considered appropriate subject to minimum assigned capital and reciprocity. Joint ventures between foreign banks and local banks could also be permitted.

2.28. The RBI has allowed entry of foreign banks as branches subject to reciprocity and other prudential considerations. Foreign banks/finance companies are also permitted to invest upto 20% as a technical collaborator (within the overall 40% ceiling) in a new private sector bank, subject to Government approval, provided the foreign bank does not have presence in India. Foreign equity in new Indian private banks has also been allowed. Joint ventures between foreign and local banks in non-banking financial services are also allowed in accordance with the foreign investment policy. Since January 1992, 19 new foreign banks with a total of 47 branches have been allowed.

2.29. The Committee had recommended that the foreign banks should be subject to same requirements as are applicable to domestic banks and, in case of constraints, if the foreign banks are unable to fulfil certain requirements such as targeted credit the Reserve Bank should work out alternative methods. It had accordingly been made mandatory for the foreign banks in April 1993 to achieve the minimum target of 32% of net bank credit for priority sector lending, by March 1994. Within the target of 32%, two subtargets in respect of advances (a) to small scale sector (minimum of 10%), and (b) exports (minimum of 12%) have been fixed. They are exempted from targeted credit in respect of agricultural advances.

2.30. ***Foreign operations of Indian banks:*** The Committee had recommended rationalisation of foreign operations of Indian banks. While the SBI's international operations could continue and even be strengthened, other Indian banks with the largest presence abroad could jointly set up one or more subsidiaries to take over their existing branches abroad. It had also suggested that larger Indian banks could be permitted to acquire smaller banks abroad to increase their presence. This recommendation has not been implemented.

2.31. ***Autonomy Measures - Recruitment and Creation of Posts:*** The Committee had recommended that individual banks should be free to make their own recruitment of officers and wherever appropriate, banks could voluntarily come together to have a joint recruitment system for officers. As regards clerical cadres, the present system of Banking Services Recruitment Boards

(BSRBs) could continue. It had also recommended that guidelines which relate to matters of internal administration such as creation and categorisation of posts, promotion procedures and similar matters should be rescinded.

2.32. Government of India announced in 1997 a package of autonomy to public sector banks fulfilling certain criteria viz. capital adequacy of more than 8%, net profit during the last three years, net NPA level below 9%, minimum owned funds of Rs.100 crores. In terms of this package banks fulfilling the criteria would be allowed to recruit specialised officers and also undertake campus recruitment for partly meeting their requirements of probationary officers. The boards of banks have been given powers to decide their own policy in respect of creation, abolition, upgradation/ modification of posts upto the level of DGMs.

2.33. ***Supervisory Authority:*** The Committee had recommended that duality of control over the banking system, between 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 function over banks and financial institutions should however be hived off to a separate authority to operate as quasi autonomous body under the aegis of Reserve Bank but which should be separate from other central banking functions of the Reserve Bank.

2.34. This recommendation has been implemented in a somewhat different manner. The Board for Financial Supervision (BFS) under the aegis of the Reserve Bank with four members drawn from the Reserve Bank Board and serviced by a separate Department of Banking Supervision has been constituted. An Expert Advisory Council has been set up to advise the BFS on various policy matters.

2.35. ***Appointment of CEOs/Board Members:*** Laying stress on the depoliticisation of appointments for the post of CEOs and Board membership of public sector banks and financial institutions, the Committee had recommended that such appointments could be based on a convention of the Government accepting the recommendations of a group of eminent persons who could be invited by the Governor of the Reserve Bank of India to make recommendations for appointments of CMDs of banks and Board members of banks.

2.36. Government of India have set up an Appointments Board for board level appointments in public sector banks. This Board which is chaired by the Governor, Reserve Bank of India makes recommendations to the Government for appointment of Chief Executives and Executive Directors in nationalised banks and the Chief Executives of financial institutions. The selection by the board is based on professional experience and expertise in the relevant fields. The other members of the Board are Finance Secretary, Deputy Governor, Reserve Bank of India, a management expert and a banking expert, Special Secretary (Banking)/Additional Secretary (Banking) is the member Secretary.

2.37. ***Development Financial Institutions:*** The Committee had recommended that the system recommended for commercial banks in the matter of appointment of Chief Executive Officer and the Board should apply to DFIs also. The present system of consortium lending should be dispensed with and in its place a system of syndication or participation in lending should be introduced. The Committee had recommended that commercial banks should be encouraged to provide term finance to industries while DFIs should increasingly engage in core working capital. The system of cross holding of equity and cross representation on the Boards of DFIs should be done away with. The Committee had recommended that IDBI should retain only its apex refinancing role and its direct lending function should be hived off to a separate entity. The infected portion of DFIs portfolio should be handed over to ARF.

2.38. With regard to appointment of Chairmen & Managing Directors (CMDs) of DFIs, an Appointment Board with the Governor, RBI as Chairman has been constituted (vide paragraph 16 above). The stipulation relating to formulation of compulsory consortium has been abolished. DFIs are resorting to syndication/participation in lending. As regards DFIs providing core working capital and commercial banks participating in term finance, a gradual shift is taking place in the lending pattern of DFIs and banks as envisaged by the Committee. The ceiling imposed on the

Banking system for grant of term loans for any single project was removed in September, 1997. Banks are now free to sanction term loans to all projects within the overall ceiling of prudential exposure norms. As regards the recommendation regarding cross holding of equity and cross representation on Boards of DFIs., there has been no change in the absolute amount of equity held by Industrial Development Bank of India (IDBI) in Industrial Finance Corporation of India Ltd. (IFCI). However, after the equity of IFCI went up in 1993, the percentage share of equity held by IDBI has come down to below 30 % as against 50 % earlier. IDBI continues to appoint its nominees on the Board of IFCI. IDBI is also represented on the Board of Export Import Bank of India (Exim Bank). Similarly the recommendation relating to transfer of the infected portfolio of DFI to ARF has not been implemented as ARF has not been set up.

2.39. It was recommended that State Level Institutions should maintain distance from State Governments; an action plan to ensure that they function on business principle, prudential norms, etc. be implemented in 3 years.

This has not been implemented totally. However, State Level Financial Institutions have since been subjected to prudential norms by IDBI.

2.40. It was recommended that DFIs should extend support to existing management with good track record in cases of attempted corporate take-overs. Institutions should exercise their individual professional management.

The DFIs are generally following the practice suggested by the Committee.

2.41. It was recommended that DFIs should seek to obtain resources from market at competitive rates.

2.42. As of now bonds issued by DFIs are no longer eligible to be considered as SLR asset for bank. DFIs are therefore meeting almost their entire requirements of funds at market related interest rates. Concessional assistance from RBI (LTO) Fund is now available only to Small Industries Development Bank of India (SIDBI) out of repayments being made by IDBI. Government guaranteed bond facility is now available only to Industrial Investment Bank of India Ltd. (IIBI) (formerly Industrial Reconstruction Bank of India (IRBI) and SIDBI besides, National Bank for Agriculture and Rural Development (NABARD) and National Housing Bank (NHB).

2.43. ***Capital Markets Regulation:*** The recommendations relating to capital markets have been almost entirely implemented. Securities and Exchange Board of India (SEBI) has been vested with powers under the SEBI Act 1992. The focus of the Regulations by SEBI has been on orderly development of the capital market. The norms relating to issue of shares by corporates has been rationalised subject to compliance with disclosure norms and investor protection guidelines formulated by SEBI. Under the powers vested with SEBI under the SEBI Act, it has formulated guidelines on disclosure requirements and investor protection and due diligence norms for merchant banks, portfolio management, regulations for mutual funds, etc. The capital market has also been opened for portfolio management by Foreign Institutional Investors (FIIs).

2.44. ***Supervision of new institutions like merchant banks, mutual funds, etc.:*** The recommendations in this regard have been accepted. Under the power vested with SEBI under the SEBI Act 1992, SEBI has formulated guidelines on merchant banks, mutual funds, venture capital companies, etc. With a view to bringing non banking financial companies under an effective supervisory frame work, the RBI Act has been amended in 1997 and the RBI has recently formulated a fresh set of comprehensive guidelines for regulations/supervision of Non Banking Finance Companies (NBFCs).

2.45. With a view to giving sharper focus to supervision over these companies, the RBI has set up a separate department viz. Department of Non-banking Supervision, which would undertake both on site and off site surveillance over these institutions.

2.46. ***Sequencing of reforms :*** This recommendation, that the reforms should be properly sequenced has been accepted. Deregulation of interest rates undertaken during the last 5-6 years have been phased in such a manner keeping in view the Committee's recommendations. Other

recommendations such as with regard to prudential norms have also been implemented in a sequenced manner.

2.47. ***Overall assessment:*** It is perhaps somewhat early to assess the impact of the reforms, considering that the process was initiated only in 1992 and has been implemented in phases. Yet even at this early stage one can discern some positive developments .

2.48. One of the significant areas of improvement has been the greater accuracy and transparency in respect of banks' financial statements. 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 have rendered financial statements of banks more credible and transparent. The refinement of accounting practices and disclosure requirements to bring them fully in line with internationally accepted norms in this regard has to be an on-going process.

2.49. All but two public sector banks as on March 31, 1997 met the enhanced minimum capital adequacy ratios. This contrasts with the position in March 1993 when as many as 26 public sector banks had not attained the prescribed minimum CRAR of 8% . Only 4 Indian private sector banks out of 34 were still to meet the target in March 1997. All the new private sector banks as well as foreign banks have fully complied with the minimum ratios.

2.50. The application of prudential norms on income recognition, stricter definition of NPAs and the revised format for classification and related provisioning since 1992-93 have had the result of some banks showing net losses and consequent erosion in their net worth in the earlier years. This is not so much because of an actual deterioration in the quality of their operations in the period but a reflection of the true state of affairs as a result of strict accounting and provisioning norms. Losses which were not being revealed earlier because of the absence of strict requirements relating to accounting and provisioning norms have now been brought out. The definition of NPAs has been made progressively more stringent. Despite this, gross NPAs of the public sector banks in absolute amounts have not shown much change, rising from somewhat over Rs.39,000 crores at the end of March 1993 to around Rs.43,500 crores in March 1997 with the proportion to total advance coming down in this period from 23.2% to 17.8%. Provisioning requirements against the substandard assets have also been progressively applied since 1994 and as a consequence the net NPA figure has declined from 14.5%in March 1994 to 9.2% in March 1997. More interestingly, a frequency distribution of net NPAs of banks indicates that those public sector banks having net NPAs of above 15% of their loan portfolio declined sharply from 10 to 1 in this period while the number of banks with net NPAs below 10% has increased to 17 in March 1997 as against 6 in March 1994.

2.51. These developments are also reflected in profitability trends. During the reform period, gross profits to total assets have risen for the public sector banks in the aggregate. The State Bank Group has improved its profitability ratio (gross profit as a percentage to total assets) from 1.8% during 1992 -93 to 2.18% during 1996-97. In the case of nationalised banks, the corresponding percentages are 0.42 and 1.26. The profitability levels are also related to the interest income spread with the percentage for all scheduled banks going up between 1992-93 and 1996-97 from 2.5 to 3.22. The performance of the State Bank Group is particularly significant, followed by that of the new Indian private sector banks. However, intermediation costs as percentage of total assets still remain high. In the Indian banking system, a major component of this being the wage bill. The need for enhanced provisions has also resulted in an increase in the intermediation costs. High intermediation costs have to be considered also in relation to movement in productivity per employee. This still remains low particularly for the public sector banks. This is an area which continues to call for attention. The emphasis on efficiency and productivity is necessary for effecting cost economies and needs to be. continued so as to give Indian banks, particularly the public sector banks, greater ability in meeting the competitive challenges from newer Indian banks and foreign banks.

2.52. The strength of these competitive challenges facing the Indian banks is reflected also in a measure of banking disintermediation that has marked developments in the last five years. The

rate of growth of aggregate deposits of scheduled commercial banks declined from 19.8% in 1991-92 to 16.5% in the year ended March 1997. Even abstracting from the impact of some slowing down of overall monetary aggregates, the differential performance in deposit mobilisation by the banks on the one hand and by non banking finance companies and other non bank financial intermediaries like mutual funds is significant and suggests the need to persist with efforts at cost reduction so as to be able to meet competitive pressures.

The Committee on the Financial System - Status of implementation of the Recommendations

Sr. No.	Recommendations	Comments
1.	SLR to be brought down to 25% over a period of five years.	Brought down to 25% of demand and time liabilities w.e.f. 22 October, 1997.
2.	RBI must progressively reduce CRR from its present level.	CRR has been progressively reduced from 15% to 9.5%. Recently, it was increased to 10.5% in two stages but has since been brought down again to 10.0%.
3.	Capital adequacy norms to be evolved to be achieved over a period of 3 years, that is by March 1996.	Implemented.
4.	Good banks should approach the capital market straightway.	Five nationalised banks, State Bank of India and two subsidiaries of State Bank of India have accessed capital market.
5.	Prudential and uniform accounting practices should be introduced.	Implemented.
6.	No income should be recognised on non-performing assets.	Implemented.
7.	Advances to be categorized into standard, sub-standard, doubtful and loss assets. Provisioning norms to be category related.	Implemented.
8.	There should be no bar to entry of new banks	Implemented. Ten new banks in the private sector have been set up.
9.	There is urgent need for a far greater use of computerised systems than at present, as recommended by Rangarajan Committee.	Progress slow but efforts continue.
10.	There has to be recognition on the part of managements and trade unions that the banking system cannot be competitive unless there is a radical change in work technology and culture and greater flexibility in personnel policies.	Given more autonomy to banks which satisfy certain prudential criteria.
11.	Internal guidelines/ directives issued by Government/ Reserve Bank of India should be reviewed to examine their continuing relevance. Such guidelines relating to internal administration should be rescinded.	Largely implemented. Further deregulation in this direction is in progress.
12.	Indian banking system is over regulated and over administered. Focus of supervision should be shifted from administrative and other aspects of bank	Largely implemented.

Sr. No.	Recommendations	Comments
	organisation to adherence to prudential norms. Internal inspection/ audit should be given greater emphasis by supervisory authorities.	
13.	(a) The system recommended for banks in respect of appointment of CMDs and boards should be applicable in the case of DFIs also.	Implemented.
	(b) Participative lending should be encouraged instead of consortium lending.	Consortium financing is not mandatory.
	(c) DFIs should provide core working capital and commercial banks should increase their term lending to industry.	Being done at present.
	(d) Cross holding of equity and cross representation on boards should be done away with.	IDBI's shareholding in IFCI stands at 28.63% as against 50% earlier. IDBI is represented on the Boards of IFCI and EXIM Bank.
14.	State level institutions should maintain distance from State Government. An action plan to ensure that they function on business principles, prudential norms and suitable management set up be implemented in three years.	State level financial institutions have since been subjected to the prudential norms by IDBI.
15.	DFIs should extend support to existing managements with proper track record in the event of attempts to take over.	Generally, FIs have been following the system as envisaged by the Committee.
16.	DFI should seek to obtain resources from market at competitive rates.	Implemented. Concessional assistance from LTO fund is now available only to SIDBI out of repayments being made by IDBI.
17.	(a) Committee favours speedy liberalisation of capital market.	The recommendations have been accepted.
	(b) Prior approval of any agency for any new issue in the capital market should be dispensed with.	Implemented.
	(c) SEBI should not be a substitute for CCI, but a market regulator.	Implemented.
	(d) Capital market should be gradually opened up for foreign portfolio investment.	Implemented.
	(e) The depth of the market should be increased by introducing new types of instruments, with appropriate amendment to Stamp Act.	New instruments introduced in the capital market but Stamp Act is yet to be amended.
18.	The entire financial sector comprising banks, DFIs, Finance Companies, merchant banks, H P companies etc.	Commercial Banks, NBFC and AIFIs have been brought under the supervisory jurisdiction of BFS.

Sr. No.	Recommendations	Comments
	should be brought under one supervisory agency under the aegis of RBI.	
19.	Prudential norms in respect of capital adequacy, debt/ equity ratio provisioning etc. should be laid down for all segments of the financial sector. Eligibility criteria for entry/ exit also should be laid down.	Implemented.
20.	Proper sequencing of reforms is essential	Accepted.
21.	Amendments in laws necessary for implementation of recommendation should be undertaken by Government expeditiously.	Necessary amendments have been made to the SBI Act, 1995, the Bank Nationalisation Acts, 1970/ 1980 and the B.R. Act, 1949 to enable public sector banks to raise capital from the market and to facilitate setting up of new banks in the private sector.
22.	To nurture a healthy, competitive and vibrant financial sector, it will be essential to depoliticise appointments, distancing by Governments from the internal decision making by banks/ financial institutions.	An Appointment Board has been set up for top level appointments in nationalised banks.

Chapter III

Strengthening the Banking System

General Observations:

3.1. A strong financial system, it bears repetition, is central to the objective of strengthening the real economy and for its healthy and orderly growth. The obverse of this is also true in that a weak and fragile financial system can seriously disrupt the functioning of an economy in view of the externalities and social costs involved, as the recent developments in East and South East Asia bear witness to. Surveying the scene in 1991, the CFS had stressed the importance of enhancing the strength of the banking system by arresting the deterioration in the quality of its assets portfolio and improving standards of efficiency. Accordingly, it laid emphasis on building the system's inherent strength through enhancing the capital base and improving performance through measures aimed at greater operational flexibility to help improve returns on its assets and raise levels of productivity and, in the final analysis, of profitability. Net profitability levels of the system are a time tested indicator of financial strength. If capital funds represent the "stock" aspect of strength, profitability is a measure of strength in terms of "flows".

3.2. In the last few years, the performance of the Indian banking system and especially of our public sector banks has shown a measure of improvement judged by the parameter of operating profits along with other indicators of soundness, such as enhancement of capital funds and a reduction in the percentage level of non performing assets.

3.3. This improvement has arrested the deterioration in these parameters that had marked the functioning of the system earlier. There is still, however, a considerable distance to traverse. The process of strengthening the banking system has to be viewed as a continuing one. There is no finite end to improving the levels of efficiency and profitability. In fact, the situation is one where the system has to cope constantly with changes in the broader environment in which it functions and face new challenges that these developments impose on it. Major changes have been taking place in both the domestic and external macro environment and in the policy and institutional framework which are likely to have far reaching implications for the operations of the banking and financial systems. We are still in the midst of these changes. Amongst the domestic macro environmental changes, clearly the most significant is that the economy is now on a higher growth trajectory which in turn calls for a substantial step up in our savings and investment levels. The mobilisation of savings and their economic and efficient allocation is the responsibility of the financial sector and notably of the banking system. In the earlier phase of quantitative expansion the banking system played a commendably significant role in widening and deepening the process of financial intermediation. This task must continue even while the qualitative dimension of its services will need to improve.

3.4. The higher GDP growth rate in the last few years has coincided with the marked subsidence of inflation reinforcing the axiom that a measure of price stability is basic to the enhancement of growth through, among others, its beneficial impact on saving. This period has also seen an enhanced role being assigned to the private sector in the furtherance of our investment and growth objectives and, the greater reliance on market forces and on competitive efficiency which in turn widens the scope for the operations of the financial system even as it places greater responsibility on it to discharge its functions better. In terms of policy, by far, the most significant development is the gradual reduction in the fiscal deficit in relation to GDP and restoration to monetary policy of its role in determining the availability and cost of money. In the framework of the complex inter-relationships between money, income and prices, monetary targeting and the cost of money have become important instruments of regulation. Accordingly, open market operations, action on reserve requirements and access rights to the central bank have been the principal means of controlling the monetary base even as interest rates are also increasingly coming into play to control the cost and, at one remove, the availability of money. For the banking system, the implications of a greater reliance on acting on the monetary base and on the interest rate instrument have significant implications for management of liquidity and associated risks. Banks and financial institutions will increasingly have to contend both with market

risks in terms of asset price variations as well as income risk as a result of interest rate variability. The greater flexibility now being afforded to the financial system with respect to foreign exchange transactions as part of our effort at opening up the economy also places on banks a greater measure of responsibility for managing risks associated with foreign exchange transactions especially at a time when we are moving in a phased manner towards a more open capital account. Globalisation of finance and integration of international financial markets imply that the dichotomy between the savings and investment function that is the hallmark of financial intermediation is no longer confined to national markets. There is also now an almost symbiotic relationship between movements in international interest rates and exchange rates. Globally, banks have had to come to terms with this phenomenon of uncertainty in interest rates and a measure of volatility in exchange rates by devising and employing a wide variety of risk management instruments revolving round hedging transactions. Banks in India, even at our present low level of international exposure, have also been getting involved in such risk management procedures but as their exposure expands, as it undoubtedly will, banks would need much greater expertise and experience to handle this.

3.5. While banks still remain by far the predominant sector of the financial system, there is enough evidence in the last few years of the growth of other financial institutions such as Non Banking Financial Companies (NBFCs) and Development Financial Institutions (DFIs) in areas traditionally served by commercial banks in both the deposit and credit markets as well as recourse by the corporate sector to either the Indian capital market or to the equity and debt markets abroad rather than to the Indian banking system. The process of banking disintermediation may not have reached significant proportions as yet but the experience of the last few years is sufficient indication of the competitive threat which banks would be facing in an increasingly diversified and sophisticated financial sector and the consequent need for banks to gear up their operations to meet the standards of competitive efficiency which other financial institutions here or institutions from abroad would be in a position to offer. Competitive efficiency, in turn, is a function of productivity. Transaction costs in the Indian banking system and especially in the public sector banking system still remain much too high and it is the community at large that is now bearing the cost of the high spreads. Our public sector banks can maintain these spreads only at the cost of losing business to the new private sector banks whose efficiency levels are higher or to the new foreign banks that have come in recently and more of whom are likely to come.

3.6. Any strengthening of the banking system in this competitive situation must thus address itself both to enhancing the inherent strength of the banks as measured by their capital funds ratios and in ensuring profitability of operations through providing more efficient and less costly services and in the process increase their profitability. A framework for the evaluation of the current strength of the system and of the operations and performance of banks and the future directions in which they must proceed is provided by the Reserve Bank's measuring rod of "CAMELS", the acronym which stands for Capital adequacy, Asset quality, Management, Earnings, Liquidity and internal control Systems.

Capital Adequacy :

3.7. Adequacy of capital has traditionally been regarded as a sign of banking strength irrespective of whether the institution is owned by Government or otherwise. We endorse the statement of the Reserve Bank that "Just because banks are owned by Government does not mean that the intrinsic commercial element is to be ignored". These traditional concerns received considerable impetus in the last couple of decades when following on the recommendations of the Basle Committee of the Bank for International Settlements (BIS) a set of capital adequacy norms were laid down for international banks. The CFS while appreciating the importance of setting out minimum capital adequacy norms, suggested that Indian banks should reach the Basle standards in a phased manner. At that time, the 8% capital adequacy minimum norm appeared a desirable and feasible target, considering that the average for the system was way below that. Following on the Report, the RBI has introduced minimum capital to risk assets ratio (CRAR). All the public sector banks barring two have since reached the target though the process has been somewhat longer than what the Committee had recommended. As of March 1997, one public sector bank has a ratio less than half of the norm while in another it was in fact negative. It should

also be added that some banks have gone well above the target. While most of the additional infusion of capital for our public sector banks has come from Government, a few of them have raised capital from the capital market in India and in one case also through the GDR route. Government subscription to capital has been accompanied by the requirement that the concerned bank invest these capital funds in Government securities. Even though it might be argued that consequently the transaction is "budget neutral" at least as far as the capital account is concerned in the sense that the additional capital funds are invested in Government securities there would still be a revenue impact represented by the cost of servicing the loan. The impact of monetisation apart, the question could be posed as to whether an exercise of this kind could be regarded as a form of window dressing. Some have even argued that this is a case of "purposeless tokenism" and that it is perhaps not in line with the basic objectives of enhancing capital which is to provide an effective cushion to the operations of banks. From this point of view the better course would be to access the market where feasible.

3.8. Since the CFS Report was submitted, several developments have taken place which have a bearing on the issue of capital adequacy. We now have a better idea of the nature and volume of risk weighted assets. As mentioned earlier, the various changes in the macro environment and the greater exposure of our banks to international finance have the potential for increasing the risks associated with banking business. International experience has shown that in several developing countries due to economic factors like the greater volatility and consequently higher risk in the environment in which they operate and because of institutional factors such as legal impediments to loan recoveries and weaknesses in accounting practices, capital adequacy ratios need to be set at higher levels than the ratios prevailing in developed economies even as the definition of capital adequacy has to be more exacting and risk weights are set at higher levels. In discussing the capital adequacy ratio in India the Reserve Bank in its latest Trend and Progress Report states that "it is true that the eight per cent norm cannot be operated like a 'one size fits all' formula." The asset quality, risk profile and concentration ratios may and do vary from bank to bank and as indicated in the recently formulated principles for banks' supervision by the BIS, may require higher than the minimum standards.

3.9. At present, the calculation of risk weighted assets is done in a manner whereby, barring investments in Government and approved securities which are reckoned as zero risk assets, the weights attached to the credit portfolio is on a 100% risk basis. It has been pointed out that the uniform weight does not make any distinction based on the quality of the credit and could lead to a "perverse portfolio selection". The Committee considered whether in assessing the riskiness of assets, consideration should be given to relating it to the four-way classification of assets but on balance felt that the present assignment of 100% risk to the entire credit portfolio (other than Government guaranteed advances) was appropriate as an aspect of prudence.

3.10. With new and complex financial products becoming increasingly important, market risk, defined as the risk of losses with respect to on and off balance sheet positions arising from movements in market prices, needs to be given greater attention. The Amendment to the Basle capital adequacy norms has suggested two approaches: (a) standard measurement method which uses a building block approach in which specific risk and general market risk arising from debt and equity positions are calculated separately or (b) risk measures derived from banks' own internal risk management models which focuses on a bank's general market risk exposure leaving the specific risk to be measured through separate credit risk measurement systems. The Committee suggests that the RBI work towards implementing the Amendment to the Basle norms. Meanwhile, and pending the emergence of markets in India where market risks can be covered, it would be desirable that capital adequacy requirements take into account market risks in addition to the credit risks. In our case, it would seem that in calculating the capital requirements in respect of market risk at least initially we could adopt the first of the two alternative approaches mentioned above.

3.11. Investments in Government and other approved securities are being valued on a marking to market basis in a phased manner. As at the end of March, 1998, 60% of the investments are required to be marked to market and the Committee recommends that this process should be expedited so that in the next 3 years the entire investment portfolio is marked to market and this schedule of adjustments should be announced at the earliest. Several banks, in any case, have

already gone beyond 60% and a few have either reached or will be reaching 100% marking to market. At present Government and other approved securities are subject to a zero risk weight. This may have had the unintended effect of banks investing more than they are required to do (in terms of SLR ratios) in Government securities and shying away from credit operations. The presumption of risklessness of Government securities is, however, open to question. There is a significant element of price risk in as much as a small variation in the yield can have a sizable impact on prices. Illustratively, for a ten year bond with a coupon rate of 12%, a 0.25% increase in the yield would reduce the price by 1.4%. In the Committee's view, it would be appropriate that there should be a 5% weight for market risk for Government and approved securities and recommends that this be done.

3.12. There is also the need to reconsider the issue of Government guarantees. The overall objective should be to ensure that Government guarantees should not be a substitute for proper appraisal of a loan. As such, the risk weight for a Government guaranteed advance should be the same as for other advances. To ensure that banks do not suddenly face difficulties in meeting the capital adequacy requirement, the new prescription on risk weight for Government guaranteed advances should be made prospective from the time the new prescription is put in place.

3.13. Again, at present, there is an additional capital requirement of 5% of the foreign exchange open position limit. This is an ad hoc prescription which is not the normal practice in international banking. Such risks should be integrated into the calculation of risk weighted assets. Accordingly, the Committee recommends that the foreign exchange open position limits should carry a 100% risk weight.

3.14. It is now generally recognised that capital adequacy has to be related to the items not only on the balance sheet but also to off balance sheet items. Indian banks are already engaged in some degree in taking on contingent liabilities in terms of various types of swap and hedging operations. With increasing recourse to trading in derivatives not only in respect of their international operations but also in the area of domestic activities it would be necessary to relate capital adequacy norms to banks' exposure in the form of items off their balance sheets. The Committee notes that this salutary practice is being followed in India.

3.15. Taking all these factors into account the Committee believes that it would be appropriate to go beyond the earlier norms and set new and higher norms for capital adequacy. The Committee accordingly recommends that the minimum capital to risk assets ratio be increased to 10% from its present level of 8%. It would be appropriate to phase the increase as was done on the previous occasion. Accordingly, we recommend that an intermediate minimum target of 9% be achieved by the year 2000 and the ratio of 10% by 2002. The RBI should also have the authority to raise this further in respect of individual banks if in its judgement the situation with respect to their risk profile warrants such an increase.

3.16. It is estimated that the impact of the proposed increase in CRAR to 10% would mean that the system as a whole will require an additional capital of Rs 13,500 crore between 1998 and the year 2000 but of this, Rs 8.000 crore would be attributable to the increase in risk weighted assets even with an unchanged 8% CRAR prescription on the basis of a normal increase of around 15% annually in the assets portfolio. As of March 31, 1997, the excess capital over the requirement for the system was Rs 7,500 crore. It should be emphasised that these overall figures do not fully reflect the additional demands that some banks would need to meet. The 'excess' over the norm in the case of some banks is not also transferable. The enhanced CRAR would thus cause strains at the level of some individual banks but then that is perhaps unavoidable. Banks that are inadequately capitalised must necessarily grow at a slower pace than others. The issue of individual banks' shortfalls in the CRAR needs to be addressed in much the same way that the discipline of reserve requirements is now applied, viz., of uniformity across weak and strong banks and like in the case of reserve requirements, there should be penal provisions for banks that do not maintain the CRAR. In the absence of penal provisions there would be no incentive to reach and maintain

** NPAs are defined as an advance where on the date of the balance sheet an amount to be paid to the bank (interest or instalment of principal) is past due for a period of 180 days. An amount is considered past due when it remains outstanding for 30 days beyond due date.*

the CRAR. If the owners on a consideration of all relevant issues are unable or unwilling to put in more capital the implication is that these banks would be required to reduce the scale of their operations.

3.17. In respect of our PSBs, the additional capital requirement will have to come from either the Government or the market. Ideally the accretion to net worth should come from internal accruals by way of addition to reserves. This is not feasible in our context in the time frame needed given the levels of profitability in our PSBs. The two sources for capital infusion would have to be Government subscriptions to capital and accessing the market. With the many demands on the budget and the continuing imperative need for fiscal consolidation, subscription to bank capital funds cannot be regarded as a priority claim on budgetary resources. Those banks which are in a position to access the capital market at home or abroad should, therefore, be encouraged to do so. There could, however, be a constraint to banks approaching the market in view of the present stipulations on the minimum level of Government/RBI holding in the nationalised banks and the State Bank of India respectively. This raises the larger issue of reducing Government/ RBI holding in the public sector banks below the present stipulated minimum levels and is discussed in a subsequent chapter.

Asset Quality, NPAs and Directed Credit:

3.18. A strong capital ratio by itself may not ensure future profitability which depends significantly on the quality of assets. Capital adequacy related to risk assets is no substitute for the need to improve asset quality. An improvement in asset quality is fundamental to strengthening the working of banks and improving their financial viability. Assets are now classified as standard, substandard, doubtful and loss assets. The length of delinquency in payment is the determining factor. An asset is downgraded to substandard if it is 6 months past due and to the doubtful category if it is past due for 30 months or remains in substandard category for 24 months. Indian norms in this regard are somewhat more liberal than those of some other Asian developing countries. While there may have been some justification for a measure of liberalism while phasing in the system, with the experience of the last few years, the time is perhaps right for moving closer to international practices. While the categorisation of substandard may remain as at present, the Committee would recommend that an asset be classified as doubtful if it is in the substandard category for 18 months in the first instance and subsequently for 12 months and loss if it has been so identified but not written off. These norms which should be regarded as the minimum may be brought into force in a phased manner over a three year period.

3.19. No other single indicator reflects the status of quality of assets and its impact on banks' viability than the figure of net non performing assets in relation to advances (NPAs). In fact, a number of banks have remained weak despite their satisfying capital adequacy norms because of the high NPA proportion in their assets portfolio. It is appropriate to measure NPAs in relation to credit*. The causes for a high level of NPAs are varied and range from poor credit appraisal, inadequate post credit monitoring and, as will be discussed later, policy directions. Delays in our legal system have also come in the way of debt recovery. The corrections of the accrual of NPAs must, therefore, encompass better credit management practices in banks, a review of policy directions and reduction in legal delays.

3.20. NPAs in 1992 were uncomfortably high for most of our public sector banks and for some, high enough to warrant concern especially where the ratio of NPAs to capital funds was disturbingly high and in some cases exceeded net worth and undermined solvency. If the depositor's money in such cases was not at risk, as it strictly would otherwise have been, it is because of the implicit guarantee provided by state ownership of these banks. Since 1992, there has been some improvement even with a progressive tightening of the definition in the level of non performing assets of public sector banks as a group. In spite of some write offs of loss accounts in this period, gross NPAs, which perhaps reflects the true extent of contamination of the portfolio, were as high as 23.2% of total advances in March 1993 but have since come down to 17.8% in March though

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* *The difference between gross and net NPAs is accounted for in large part by the total provisions held. It is also made up of interest due but not received and kept in suspense account, part payment of interest kept in suspense account and claims received from ECGC/DICGC and kept in suspense account.*

in absolute amounts there has been an increase of nearly 10% in the total to a figure of over Rs 43,000 crores. This average, of course, conceals wide individual variations and amongst the public sector banks, while some have gross NPAs of 7.4% there are others even now with NPAs of as much as 39.1%. The situation with regard to net NPAs follows a similar pattern*. While for the public sector banks as a group the proportionate figure has come down from 14.5% in March 1994 to around Rs 20,000 crores or 9.2% in March 1997.

3.21. The Committee has noted that these NPA figures do not include Government guaranteed advances which have turned sticky and which in the absence of such guarantees would have been classified as NPAs. If these had been added, the average gross NPAs for our public sector banks would have increased by somewhat over 1% of advances. The Committee is of the view that for the purposes of evaluating the quality of asset portfolio such advances should be treated as NPAs. If, however, for reason of sovereign guarantee argument such advances are excluded from the computation, the Committee would recommend that Government guaranteed advances which otherwise would have been classified as NPAs should be separately shown as an aspect of fuller disclosure and greater transparency of operations.

3.22. This also raises the question of strict adherence to the definition of NPAs. Such a strict adherence should be not merely in letter but also in spirit. Banks and financial institutions should avoid the practice of "ever-greening" by making fresh advances to their troubled constituents only with a view to settling interest dues and avoiding classification of the loans in question as NPAs. Such a practice would be contrary to the spirit of the definition as it tends to understate the figure of NPAs and the need for provisioning against them. The Committee notes that the regulatory and supervisory authorities are paying particular attention to such breaches in the adherence to the spirit of the NPA definitions and are taking appropriate corrective action. At the same time, it is necessary to resist the suggestions made from time to time for a relaxation of the definition of NPAs and the norms in this regard.

3.23. An important aspect of the continuing reform process is to reduce further the level of NPAs as a means of strengthening the banks. While there is reason to expect that with a combination of policy and institutional development, new NPAs would be lower, the problem remains of the huge backlog of NPAs which impinges severely on banks' performance and their profitability. The large backlog suggests, based on the classification related to age of delinquency, that a large portion of the NPAs fall within the doubtful and loss assets category. Banks continue to carry these loss assets on their books due to their inability to enter into timely compromise settlements.

3.24. Several alternative approaches are possible to tackle the problem of the NPAs overhang from the past. The CFS had suggested the institution of an Asset Reconstruction Fund and the logic for this was spelt out in detail in its Report. International experience also indicates the potential and possibilities of this type of approach to the problem of bad debts. For various reasons the ARF proposal was not accepted. The non acceptance of the recommendation about clearing the backlog of NPAs through the institution of an ARF or a variant of it has led to the necessity for the Government injecting massive funds as capital in the case of those public sector banks which were under-capitalised in any case and those whose net worth had been eroded by the weight of the NPAs and the need, in some cases, to write off losses. So far a sum of nearly Rs. 20,000 crores has been expended for such recapitalisation and to the extent to which recapitalisation has enabled banks to write off losses, this is the cost which the Exchequer has had to bear for the bad debts of the banks. Even in countries where the banking system is in private hands the Government has provided funds as a measure of rehabilitation of banks. Recapitalisation, as mentioned earlier, is a costly and, in the long run, not a sustainable option. Recapitalisation involves budgetary commitments and could lead to a large measure of monetisation. The Committee urges that no further recapitalisation of banks be undertaken from the Government budget.

3.25. As the authorities have already proceeded on the recapitalisation route it is perhaps not necessary to consider de novo the institution of an ARF of the type envisaged by the earlier CFS Report. The situation would perhaps have been different if the recapitalisation exercise had not been undertaken in the manner in which it has been.

3.26. A high level of NPAs represents a continuing potential threat to the viability of the system. The Committee believes that the objective should be to reduce the average level of net NPAs for all banks to below 5% by the year 2000 and to 3% by 2002. For those banks with an international presence the minimum objective should be to reduce gross NPAs to 5% and 3% by the year 2000 and 2002 respectively and net NPAs to 3% and 0% by these dates. These targets cannot be achieved in the absence of measures to tackle the problem of backlog of NPAs on the one hand on a one time basis and the implementation of strict prudential norms and management efficiency to prevent the recurrence of this problem.

3.27. The Committee is of the firm view that in any effort at financial restructuring in the form of hiving off the NPA portfolio from the books of the banks or measures to mitigate the impact of a high level of NPAs must go hand in hand with operational restructuring. There would be little point in a one time exercise if the same managerial weaknesses were to reappear and new NPAs generated. Operational restructuring would have to cover areas of revamping management, staff rationalisation and branch rationalisation somewhat on the lines of the strategic revival plans formulated by some weak banks and approved by Government and RBI and MoUs entered into between Management and staff unions. Cleaning up the balance sheets of banks would thus make sense only if simultaneously steps were taken to prevent or limit the re-emergence of new NPAs which could only come about through a strict application of prudential norms and managerial improvement.

3.28. It is accepted that financial restructuring has to be part of an overall package of strengthening banks. For banks with a high NPA portfolio, the Committee suggests consideration of two alternative approaches to the problem as an alternative to the ARF proposal made by the earlier CFS. In the first approach, all loan assets in the doubtful and loss categories - which in any case represent bulk of the hard-core NPAs in most banks - should be identified and their realisable value determined. These assets could be transferred to an Asset Reconstruction Company (ARC) which would issue to the banks NPA Swap Bonds representing the realisable value of the assets transferred, provided the stamp duties are not excessive. The ARC could be set up by one bank or a set of banks or even in the private sector. In case the banks themselves decide to set up an ARC, it would need to be ensured that the staff required by the ARC is made available to it by the banks concerned either on transfer or on deputation basis so that staff with institutional memory on NPAs is available to the ARC and there is also some rationalisation of staff in the banks whose assets are sought to be transferred to the ARC. To enable the ARC to effect recoveries against these assets, they will need to be allowed to file suits in DRTs by being assigned the rights over these assets to them by banks. In case the ARC is set up in the private sector, the bank wishing to hive off its NPAs could negotiate a one-time settlement and down payment or settlement by payment over a period of time or transfer the assets or carry the loan on its books. Funding of such an ARC could be facilitated by treating it on par with venture capital for purpose of tax incentives. Some other banks may be willing to fund such assets in effect by securitising them. This approach would be worthwhile and workable if stamp duty rates are minimal and tax incentives are provided to the banks. A view has been expressed before the Committee that though setting up of an ARC in the private sector seems attractive on conceptual grounds, in practice, there may not be many takers for the assets representing NPAs in the banks because most NPAs are in respect of working capital advances and there may not be any assets to transfer if those assets are either moveable, inventories or receivables. At the same time, the general practice for banks is to have a pari-passu charge or a second charge on the fixed assets of a company and banks share their charge with financial institutions. Borrowing companies whose debts have gone bad with the banks are also likely to be those whose debts form NPAs of the financial institutions. Banks and financial institutions, therefore, could together work out modalities for sale or management of these assets to effect recoveries. It hardly needs to be pointed out that any of the above approaches would need to be backed by changes in the legal system to make such reconstruction efforts feasible and effective.

3.29. An alternative approach to recapitalisation of banks with budgetary support could be to enable the banks in difficulty to issue bonds which could form part of Tier II capital. This will help the bank to bolster capital adequacy which has been eroded because of the provisioning requirements for NPAs. It is recognised that issue of bonds to increase Tier II capital would enable

the banks to meet provisions only if there is adequate head room in Tier I capital to make such provisioning possible. It may be noted that while provisions for NPAs help in reducing net NPAs, the gross NPAs figure would remain until the amount due to the bank is recovered or written off. As the banks in difficulty may find it difficult to attract subscribers to bonds, Government will need to guarantee these instruments which would then make them eligible for SLR investment by banks and approved instruments by LIC, GIC or Provident Funds.

3.30. The Committee recommends that the alternative approaches outlined above could be offered to the banks and it could be left to them to decide which of the approaches they would like to follow.

3.31. Indian experience has shown that asset quality has suffered as a result of directed credit. In this, our record is not much different from international experience. Directed credit, apart from leading to possible misapplication or misallocation of credit resources, has led in this country as elsewhere to an increase in non performing loans and has thus adversely affected the efficiency and viability of the banks. Our own experience with priority sector credit bears this out. The RBI Report cited earlier points out that 47% of all NPAs emanate from the priority sector against the targeted credit proportion to this sector of 40%. In other words, the 'contamination coefficient' of directed credit is above unity. These figures in fact validate the concerns expressed by the CFS in this regard. It is not that credit to agriculture and the small industrial sector are not important from the larger national economic viewpoint. Far from it. The problem arises that when the banking system is directed to lend a certain proportion of its credit to specified sectors it all too often degenerates into targeteering. Bank managements tend to have an understandable concern, sometimes bordering on the obsessive, with the need to meet prescribed quantitative targets and in the process adequate appraisal and post credit supervision tend to suffer. Credit discipline has also tended to suffer and as the Reserve Bank ruefully states "borrowers willingly defaulted because they believed creditors would not take legal action against those considered to be in priority sectors". This has led to erosion and sometimes serious deterioration in the quality of the loan portfolio in these two sectors. Perhaps an extreme example of the serious erosion of quality is the experience with regard to Government sponsored lending such as the IRDP where recoveries are reported to touch barely 35% of the amounts due. The Reserve Bank's above cited Report states that "the impact of directed credit on the allocation of resources is not certain" and adds that "in many countries directed credit has led to large non performing loans and adversely affected the efficiency and viability of banks". Thus, while the positive impact of such credits on production is somewhat hypothetical the negative impact on banks' portfolio quality has turned out to be real. The objectives of social banking and the canons of sound banking are not indeed incompatible. Both objectives would be served if the credit to the directed sectors were made on the basis of supervised credit to emphasise the nexus between credit and production and to ensure in the process that credit is made available to the credit-needy borrowers for productive purposes which would also assure orderly repayment and over a period of time institute a measure of credit discipline. The weakness in the system of directed credit arises from the breakdown in this nexus between the dispensation of credit and its application as a result of the insufficient attention to the credit-worthiness of the individual borrower in credit decision making. The earlier mistaken identity between priority and concession has since been mitigated (in that the concessional interest rates now apply only to loans of Rs 2 lakhs and under though it should be added that this sub sector which still enjoys concessional credit is a very significant proportion, both in the credit totals and in the figure of NPAs from this sector) and the beneficiary sectors' definition enlarged to include borrowers outside the earlier defined priority sector along with the upward revision of the definition of small scale industry. Meanwhile, there is continuing need for banks to extend credit to these two important sectors on commercial considerations and on the basis of credit-worthiness. There is, therefore, still scope for correcting the distortions arising out of directed credit and its impact on banks' asset quality.

3.32. The Committee has given careful consideration to the issue of directed credit with particular reference to the measures that have been taken since the Report of the earlier CFS. The Committee has also noted the reasons why the Government could not accept the recommendation

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** This figure, incidentally, is part of the NPA total to the extent it represents existing credit dues of the BIFR referred units as distinct from new finance made to them under rehabilitation schemes.*

for reducing the scope of directed credit under priority sector from 40% to 10%. The Committee recognises that the small and marginal farmers and the tiny sector of industry and small businesses have problems with regard to obtaining credit and some earmarking may be necessary for this sector. Under the present dispensation, within the priority sector 10% of net bank credit is earmarked for lending to weaker sections. A major portion of this lending is on account of Government sponsored poverty alleviation and employment generation schemes. The Committee recommends that given the special needs of this sector, the current practice may continue. However, for ensuring greater involvement and accountability and also appraisal of schemes on commercial considerations without any extraneous influences, the branch managers of banks should be fully responsible for the identification of beneficiaries under the Government sponsored credit linked schemes. The Committee has also noted the changes in the scope of beneficiaries under the priority sector since the earlier CFS Report was submitted and proposes that given the importance and needs of employment oriented sectors like food processing and related service activities in agriculture, fisheries, poultry and dairying these sectors should also be covered under the scope of priority sector lending. The Committee notes that mere fixation of sub-targets has not helped to increase significantly the credit flow to agriculture because of a variety of reasons such as inadequate development of infrastructure, poor credit discipline and weak credit delivery system. Action in these areas rather than mere fixation of sub-targets would help to make agricultural credit commercially viable. The Committee also recommends that the interest subsidy element in credit for the priority sector should be totally eliminated and even interest rates on loans under Rs 2 lakhs should be deregulated for all banks as has been done in the case of Regional Rural Banks and cooperative credit institutions. The Committee believes that it is the timely and adequate availability of credit rather than its cost which is material for the intended beneficiaries. The reduction of the pre-empted portion of banks' resources through the SLR and CRR would, in any case, enlarge the ability of banks to dispense credit to these sectors.

3.33. An aspect of directed credit to which the Committee would like to draw specific attention to, as did the earlier CFS, is that arising out of behest lending which banks have had to undertake even against their better commercial judgement. This could take the form either of directives from Government, formally or otherwise, or even directions from the Courts. This is particularly so with respect to rehabilitation finance for sick industrial units. As of now, bank finance to companies under BIFR schemes amounts to about Rs 6,500 crores and this is the amount that has become locked up in unproductive uses*. While a case could be made for credit institutions nursing sick industries the burden of such nursing has tended to increase the level of NPAs leading to the health of the lending institutions themselves being affected. If Government agencies insist that sick units need to be provided with finance where banks in their best commercial judgement do not wish to do so, it should more appropriately be a charge on the budget than on the credit system. Directed credit (like directed investments) transfers to banks a quasi fiscal function. The Committee wishes to reiterate the point made by the CFS that the pursuit of the redistributive objective should use the instrumentality of the fiscal rather than the credit system.

Prudential Norms and Disclosure Requirements:

3.34. There is also a need for constant review of prudential norms governing banks' operations. The present prudential norms relate to, among others, income recognition practices and provisioning on the basis of four-way asset classification which has now been adopted following the recommendations of the earlier Committee and represented the initial movement in this direction and were set at levels which did not unduly strain the system in the short run. In the light of experience the Committee is of the view that some of these norms call for review.

3.35. With regard to income recognition, in our case, income stops accruing when interest or instalment of principal is not paid within 180 days. The more general international norm is 90 days. The Committee believes that we should move towards international practices in this regard and recommends the introduction of the norm of 90 days in a phased manner by the year 2002.

3.36. With regard to Asset Classification, as per international best practices, our standards, as mentioned earlier, are liberal and need to be revised as would the provisioning norms for different categories of assets. At present there is no requirement in India for a general provision on standard assets. Here also our practice is different from that of several Asian countries. In the Committee's

view a general provision of say, 1% would be appropriate and RBI should consider its introduction in a phased manner. For substandard assets and for the doubtful and loss assets, the present provisioning norms may continue.

3.37. Government guaranteed advances represent a case where our income recognition and credit classification norms are distinct. While income recognition norms apply as in other cases, even if no income is recognised, the asset is classified as standard. This is somewhat anomalous. The Committee believes that in the case of all future loans, the income recognition and asset classification and provisioning norms should apply even to Government guaranteed advances in the same manner as for any other advance. If a Government guaranteed advance becomes non-performing it should be treated on par with other such advances. This could be applied for all prospective Government guaranteed advances. For existing Government guaranteed advances, RBI, Government and banks may work out a mechanism for a phased rectification of the irregularities in these accounts. Asset classification, income recognition, definition of NPAs and the provisioning norms, it goes without saying, should be strictly enforced.

3.38. Substantial progress has been made in disclosure of information in financial statements and the Indian disclosure standards compare well with those of some developing countries, though they are perhaps not fully on par with international accounting standards. There is a need for disclosure, in a phased manner, of the maturity pattern of assets and liabilities, foreign currency assets and liabilities, movements in provision account, and non performing assets. We also suggest that the RBI should direct banks to publish, in addition to financial statements of independent entities, a consolidated balance sheet to reveal the strength of the group. Furthermore, it should also ask banks to disclose loans given to related companies in the banks' balance sheets. Full disclosure of information should not only be a regulatory requirement. It would be necessary to enable a banks' creditors, investors and rating agencies to get a true picture of its functioning — an important requirement in a market driven financial sector.

3.39. The Committee recognises that the prescription of these tighter norms would put banks under some strain. As an incentive to banks to make such specific provisions in this manner, the Committee believes that such provisions be tax deductible. The CFS had also made a recommendation on the above lines and we would reiterate the same. The Committee has been informed that the recommendation of the CFS in this regard did not find favour with the Central Board of Direct Taxes presumably on revenue considerations. The Committee believes that the revenue loss may not be considerable but the benefits in the form of a healthy banking system would outweigh the costs represented by the revenue loss. The Committee accordingly recommends that, as is the practice in some countries, consideration be given again to making such specific provisions tax deductible with the obvious corollary that in the event of recoveries, the same would be taken into account in computing tax liability.

3.40. One of the dangers which banking systems abroad have encountered is that arising out of connected lending. Since social control was instituted in 1967 and subsequently after nationalisation connected lending has not figured in our bank practices. There is, in fact, a provision in our legislation effectively prohibiting loans by banks to companies in which their directors are interested as directors or employees of the latter. However, with liberalisation and the emergence of more banks on the scene and with the induction of private capital through public issue in some of the nationalised banks there is a possibility that the phenomenon of connected lending might reappear even while adhering to the letter of the law. It is necessary to have prudential norms which are addressed to this problem by stipulating concentration ratios in terms of which no bank can have more than a specified proportion of its net worth by way of lending to any single industrial concern and a higher percentage in respect of lending to an industrial group. At present, lending to any single concern is limited to 25% of a bank's capital and free reserves. This would seem to be appropriate along with the existing enhanced figure of 50% for group exposure except in the case of specified infrastructure projects. Similarly, concentration ratios would need to be indicated, even if not specifically prescribed, in respect of any bank's exposure to any particular industrial sector so that in the event of cyclical or other changes in the industrial situation, banks have an element of protection from over-exposure in that sector. Prudential norms would also need to be set by way of prescription of exposure limits to sectors particularly sensitive to asset price

fluctuations such as stock markets and real estate. As it happens, Indian banks do not have much exposure to the real estate sector in the form of lending for property development as distinct from making housing loans. The example of banks in East and South East Asia which had over-extended themselves to these two sectors has only confirmed the need for circumspection in this regard. We would leave the precise stipulation of these limits and, if necessary, loan to collateral value ratios to the authorities concerned. The implementation of these exposure limits would need to be carefully monitored to see that they are effectively implemented and not circumvented, as has sometimes happened abroad, in a variety of ways. Another salutary prescription would be to require full disclosure of connected lending and lending to sensitive sectors.

Asset/Liability Management:

3.41. The other aspect of strengthening the functioning of banks is upgrading management skills. In a subsequent chapter we discuss the internal organisation of banks to secure better management. We, therefore, confine our observation here to risk management as an aspect of managerial efficiency. The management of assets and their composition traditionally had as its objective the maximisation of profitability by having a high return to risk ratio at any given level of liquidity. This approach which concentrates only on the assets side of the balance sheet is increasingly being replaced internationally by a more comprehensive treatment of both the assets and liability portfolio instead of treating liabilities as given. It is now being realised that both assets and liabilities are subject to interest rate and currency risks, while asset price variation has also been a destabilising factor. The dangers to liquidity and solvency of a mismatch between assets and liabilities either in terms of maturity, currency or value have been brought home by the recent experience of banks in East and South East Asia, where in different countries, assets-liabilities mismatches have been in evidence in relation to maturity, currency and asset values. Volatility in currency movements and asset prices affects the relationships between the value of assets and liabilities and causes an ex post mismatch which may not have been anticipated. Several institutional and regulatory measures are possible, as international experience has shown, to deal with this problem aimed at minimising the impact of asset liability mismatches. These range from money market operations, central bank intervention, access to refinance and prescription of liquidity and reserve ratios. Short term foreign currency borrowing, whether by banks or even their constituents, is a particularly vulnerable source of mismatches and needs special attention. The Committee has noted that the Reserve Bank is actively seized of this problem and is working out, in consultation with banks, a framework of assets/liability management to cover liquidity and interest rate risks. Assets and liabilities are being categorised in terms of time buckets, based either on specified maturities or as an estimate which takes into account seasonal and behavioural patterns. The sensitivity of assets and liabilities to market and interest rate risks in relation to maturity could also be built into the model as also currency risks. In this sense, asset liability management merges into overall risk management and as the Reserve Bank describes it "is a process and .... practised in an ongoing manner". There are factors here beyond individual banks' control but bank managements must be on the alert to anticipate and meet risk inducing contingencies. Banking in the ultimate analysis is an exercise in risk management. Risk management traditionally was in respect of credit and liquidity risk. As mentioned earlier, to these prudential concerns we now have market, income and foreign exchange risks. Banks, in this context, should be encouraged to adopt statistical risk management techniques like Value-at-Risk in respect of balance sheet items which are susceptible to market price fluctuations, forex rate volatility and interest rate changes#.

3.42. While the Reserve Bank may, initially, prescribe certain normative models for market risk management, the ultimate objective should be that of banks building up their own models and RBI backtesting them for their validity on a periodical basis. To start with, banks should base their

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 # The value-at-risk concept, as recommended by the Basle Committee, as the standard measure of risk, is an estimate of the maximum loss in the value of an asset or position over a given time period at a certain level of confidence, which in turn is based on the probability that the actual loss will not exceed the maximum estimated. The Basle Committee on Banking Supervision has recently recommended that Value-at-Risk may be calculated on 99% confidence interval basis and Tier III capital may be maintained equivalent to the figure arrived at for Value-at-Risk.

open forex position limits on the basis of the Value-at-Risk concept. It may, in due course, be necessary to prescribe a similar requirement in respect of all the items of the asset portfolio of banks which are exposed to market risk; this would be possible only over time as markets acquire depth, liquidity and sophistication. It is important to recognise the impact of unhedged corporate client exposures (both off and on-balance sheet) on credit exposure of banks. While appraising credit, banks should take into account the unhedged forex exposures of their clients and stipulate suitable covenants related to hedging such risk so that the currency risk faced by borrowers does not translate into credit risk for the bank as indeed has happened recently in East and South East Asia. The existing system of regulatory reporting does not adequately focus on off-balance sheet items particularly those relating to foreign currency liabilities like guarantees/LCs extended to/in favour of foreign companies, foreign arms of Indian companies, etc. Such items of mismatch, albeit outside the balance sheet, need a fair and acceptable degree of public disclosure. Apart from setting full disclosure standards in this regard, RBI should set out certain maximum limits for such off balance sheet mismatches. When off balance sheet foreign currency liabilities are backed by rupee denominated collaterals, the problem of currency risk comes into sharp focus. A sharp depreciation of the local currency as has happened recently in East and South East Asia, for instance, would quickly expose the inadequacy of the collateral security and the currency risk translates itself into a credit risk in the bank's balance sheet.

3.43. Risk management has a dimension internal to an individual bank's functioning. Market instruments such as a range of derivative instruments that are designed to afford a measure of protection against interest and exchange rate fluctuations may themselves generate risks and as international experience has shown, it is critically important that 'Chinese Walls' are erected between the trading and back office functions to ensure that derivative trading itself does not add to the risks.

3.44. The above discussion has dealt mostly with aspects of strengthening the system in the light of the changing economic and institutional environment. One of the more significant changes that we are witnessing is the phased move towards capital account convertibility. Though we have still not met the pre-conditions laid down by the Committee on Capital Account Convertibility, there is no gainsaying the fact that we have moved some distance towards this objective and Indian banks would need to be fully prepared for the eventual completion of the process of moving towards capital account convertibility. The Committee on Capital Account Convertibility has rightly stressed the importance of macro economic stability and equally the necessity for having a strong financial and banking system before we embark on full capital account convertibility. Capital account convertibility has significance inasmuch as it could lead to large movement of funds both by way of inflows and outflows with their consequence for liquidity of the system and the impact on interest rates and distribution of credit with possibilities of adverse portfolio selection and on profitability. Capital account convertibility would enable our banks to participate in foreign exchange markets both at home and abroad more actively and to the extent they do so they would naturally be taking greater exchange rate and interest rate risks. Risk management techniques would need to be placed in the form of hedging and other derivative instruments.

Earnings and Profitability:

3.45. An important aspect of strengthening the system is to enhance its net earning power. Profitability is primarily a function of the level of earnings. In recent years, operating profits of the banking system have recorded some small increase. In the case of public sector banks, figures for the latest year show that as a proportion to total assets gross profits measured 1.60%. This compares quite unfavourably with the other categories of banks, viz., old Indian private sector banks, the new Indian private sector banks and the foreign banks, whose respective ratios were 1.93%, 3.01% and 3.58% and the average for all scheduled banks of 1.82%. The corresponding figure for net profits of PSBs, old Indian private banks and new Indian private banks and foreign banks were in percentage terms 0.56, 0.92, 1.77 and 1.41 respectively as against the average for all scheduled banks of 0.68. The PSBs are thus below the average for the system and if the State Bank group were excluded, the contrast is even starker as the other public sector banks had together a rate of 0.41 per cent - well below the average for the system and other individual groups.

3.46. These low levels of profitability in our public sector banks have been recorded inspite of relatively high net interest income amounting to 3.16% of total assets. The explanation is provided

in the high intermediation costs which amount to 2.88% of total assets, thus leaving a small margin. Nearly three-quarters of the intermediation cost is represented by staff costs. Banks in the private sector in India and foreign banks have lower intermediation costs in relation to assets which explains their higher profitability. The high level of intermediation costs are an aspect of the high transaction costs in our financial system which puts Indian industry and trade at a competitive disadvantage. The reasons for high intermediation costs in our public sector banks are varied and were discussed in the CFS Report. High intermediation costs reflect the impact of unremunerative branches (even on the basis of commercial transfer pricing of deposits from the concerned branches), considerable over-manning and arcane methods of operations. The incidence of "regulatory taxation" in the form of a high proportion of pre-empted use of bank funds is now much less with the reduction of the SLR/CRR requirements and the mitigation of subsidised priority sector lending. Profitability has also been affected by the high NPA levels and the need for provisioning and as a result of some mismatch between assets and liabilities. The measures outlined earlier in this Chapter to improve the functioning of banks would have a salutary effect on profitability levels. Action on reducing expenditures through rationalisation of branches and of staff and adoption of newer technological tools would also be needed for intermediation costs to be brought down. These are discussed in a subsequent Chapter. At the same time, banks, particularly our public sector banks should explore the new opportunities that are opening up with respect to non-interest and fee-based income. Such income today is an important element of total earnings in international banking. The reduction in intermediation costs in relation to total assets should, while bringing down the cost of banking services to the community which is an important objective in itself, also leave enough scope for an improvement in profitability levels of our public sector banks.

General Observations:

3.47. The recent WTO agreement on financial services will lead to greater international competition in the financial services market. India is committed to the granting of at least 12 branches per year for existing and new banks. In non-banking financial services, we are committed to permitting majority foreign equity in merchant banking, financial leasing, factoring, venture capital and financial consultancy and 49% foreign ownership in stock broking.

3.48. Easing restrictions on foreign banks is expected to improve the quality and availability of financial services by stimulating competition in and contestability of domestic financial markets and by facilitating the application of more modern banking skills, management and technology in the domestic market. Niche banking, technology and excellent support systems have helped the progress of foreign banks in the country despite their limited reach. The quality of assets and their ability to structure complex cross-border deals have also been of advantage to them. Indian banks can thus expect to face increased competition from foreign banks, particularly in corporate banking/wholesale banking. Furtheremore, the negotiations for progressive liberalisation on trade in financial services will resume in the year 2000 and, therefore, Indian banks will need to gear themselves to facing increasing competition from foreign service providers.

3.49. In this context, those Indian banks which seek to become international players would need to benchmark their performance against international standards. The major parameters in this connection could be Return on Equity, Return on Assets and Employee productivity measured not in terms of business volume but net profit.

3.50. In the first phase of banking reform, the effort at strengthening banks focused on arresting the qualitative deterioration in their performance judged by the parameters of efficiency and profitability and enhancing their net worth. A measure of success has attended these efforts. In the second phase, the task of strengthening the banking system will have to be related to enhancing its ability to meet the challenges of competition and the need to adapt its functioning to the evolving requirements of an expanding economy which is also interacting in greater measure with the international economy. The competitive challenges will thus be emanating both from within the country and from outside. How effectively the banking system will respond to these challenges will depend not only on the broader macro environment but on their internal strengths and capabilities. As mentioned earlier, this process of strengthening has to be a continuing one and calls for policy and institutional initiatives as discussed in this Chapter and improving the internal system and organisation of the banks which is a subject we address in the following Chapter.

Chapter IV

Systems and Methods in Banks

4.1. Operational methods and procedures and the internal organisation systems are important determinants of the efficiency and productivity of the banking system. The CFS had noted several weaknesses in the internal systems and organisation of banks. In this Chapter we address these issues and the related aspects of human resource development and technology upgradation both of which also determine the efficiency and productivity of the system.

Internal Systems

4.2. In its Report, the CFS had laid great stress on the need to tone up the internal audit and internal inspection systems in banks. In the last 5 or 6 years, there has been some measure of progress in this regard. The number of changes that have occurred during this period has, however, only reinforced the need for further streamlining audit and inspection machinery and internal control systems. In the context of a more liberalised framework, these issues need to be addressed once again and more specifically in the context of the present system of prudential supervision and control. A preliminary point here is the cumbersome loan and other documentation procedures in banks which partly arise from legislative and regulatory requirements. In the interest of promoting efficiency banks need to review their documentation systems with a view to simplifying them.

4.3. There can indeed be no substitute for adequate and good quality internal control and internal audit. External audits are at best a complement to the self-regulatory and supervisory efforts of banks. The Committee believes, therefore, that a framework of sound banking should include proper support systems for putting internal governance on a firm footing. The primary responsibility for running individual banks on sound lines would obviously have to rest with each bank management including its Board of Directors. They have a significant role to play in establishing an efficient system of controls and instituting healthy corporate governance. The RBI has also been constantly working towards establishing and strengthening the internal control systems of banks as an aspect of its regulatory and supervisory strategy. RBI has accordingly advised banks to lay down, with the approval of their Boards, detailed policy documents on various aspects of a bank's functioning, such as Loan Policy (inclusive of approving suitable methods of assessment of working capital), Recovery Policy, Investment Policy, etc. Based on guidelines issued by the RBI from time to time on different aspects of the working of banks (viz., opening of customer deposit accounts, reporting procedures for loans as also prudential banking policies and practices to be followed normally), banks are expected to draw up a detailed Operational Manual and Check List for procedures to be followed, and precautions to be taken in putting through each variety of activities and transactions. Banks should bring out revised Operational Manuals and update them regularly keeping in view the emerging needs; and ensure adherence to the instructions so that these operations are conducted in the best interest of a bank and with a view to promoting good customer service. These should form the basic objective of internal control systems, the major components of which are:

- (i) Internal Inspection and audit, including concurrent audit;
- (ii) Submission of Control Returns by branches/Controlling Offices to higher level offices;
- (iii) Visits by controlling officials to the field level offices;
- (iv) Risk management systems;
- (v) Simplification of documentation, procedures and of inter office communication channels.

4.4. Internal inspection and audit in banks are by far among the most important tools in the hands of the management to exercise efficient internal control. Banks have their internal inspection/audit machinery and the periodicity of such inspection of branches is between 12 and 18 months in most of our public sector banks. Depending on the size of the banks, its geographical spread and scale of operations, banks have been availing of the services of chartered accountants also to carry out internal inspection and to supplement the internal efforts of the banks. These

inspections are meant to cover all areas of operations but the focus and content of the reports would vary from bank to bank, in the absence of a model inspection format and up to date comprehensive guidelines. There is need for a measure of uniformity in this regard. The Jilani Committee on Internal Control Systems made a number of recommendation to this effect and our Committee understands that the issue is being addressed. We refer to this later.

4.5. Besides internal and external audit, banks also have the system of concurrent audit. Considering the relevance and importance of such audit, RBI has issued detailed guidelines about the coverage of the audit and on its advice, banks have introduced concurrent audit in exceptionally large and very large branches as also problem branches. As per RBI's prescription, such concurrent audit should cover 50% of a bank's business (deposits and advances) and 100% of investment and dealing room operations pertaining to foreign exchange. For the purpose of conducting concurrent audit, both internal auditors as well as professional external auditors are used in a suitable mix according to exigencies prevalent in each bank. As regards internal inspection machinery available in the banks and its effectiveness, the position now reported by banks, following the implementation of the Jilani Committee recommendations shows a measure of improvement. Surplus staff in many public sector banks could be redeployed after suitable training to undertake more audit/ inspection/ vigilance work as an aspect of strengthening the internal control systems.

4.6. Periodic visits undertaken by the controlling authorities to branches/ dealing offices, is yet another important tool. During such visits, the performance of the controlling office/branch in critical areas like NPA reduction, quality of credit decisions, exercise of discretionary powers etc., can be assessed. The report of the visits has to be followed up and action points complied with.

4.7. One more area requiring close scrutiny in the coming years would be computer audit, in view of large scale usage and reliance on information technology. A lesson to be learnt from the experience of some advanced countries where information technology has been put to great use in the last two to three decades is with regard to the safety standards and features that would be required to be adopted to maintain secrecy and integrity of data as also against perpetration of frauds in this area. Necessary computer audit measures relating to this area have, therefore, to be put in place.

4.8. Another area of control involves reporting of decisions relating to investments, funds management, credit particularly exercise of discretionary powers, expenses, etc., made by the dealing offices. These have to be reviewed by the controlling offices. The periodical reports of the dealing offices which are in the nature of control returns, need to be scrutinised and the controlling offices assess such decisions and take corrective actions with regard to deficiencies. With the increase in Treasury operations of banks and their greater involvement in forex and securities trading and with the increasing use of derivatives, there is need to ensure that there is a clear and well defined separation between the trading desk and back offices. There is enough international experience to show the dangers to an institution arising out of inadequate reporting to and checking by the back offices of trading transactions and positions taken. We recommend that our banks pay special attention to this aspect.

4.9. Following an assessment of the steps taken by the banks for streamlining internal control, inspection, etc., the RBI, on the direction of the Board for Financial Supervision, constituted a Working Group in February 1995, to review the internal control and inspection system in banks, viz., the Jilani Committee to which a reference has been made earlier. Some of the important recommendations of that Committee relate to:-

(i) Set up of the internal inspection and audit departments in banks - computerisation of Inspection Department.

(ii) Inspection - scope and coverage, periodicity, criteria for selection of branches, format for reporting, different types of inspections/ audit of service branches, administrative offices/ controlling offices, whether inspections and vigilance should be under the charge of same executive or should be separated.

(iii) Staffing of inspection department - selection system, incentives, training, etc.

(iv) System of follow up and compliance of inspection reports.

(v) System and criteria regarding rating of branches and monitoring of poorly and unsatisfactorily rated branches.

(vi) System of reporting and follow up of very serious irregularities observed during inspection - system of fixing accountability on inspectors for failure to detect and report serious irregularities.

(vii) Concurrent audit - functioning of the system, follow-up and its impact on fraud prevention and detection.

(viii) Inspection and control of subsidiaries of banks.

(ix) Computer/ALPMS audit - training of officers in computer audit.

(x) Inspection/audit of overseas branches.

(xi) Role of external auditors in strengthening internal control system in banks.

(xii) Surveillance over new deposit accounts opened.

4.10. These recommendations were communicated to the banks for implementation, after their approval by the BFS. Twenty-five of these, mainly relating to coordination between inspection and operational wings, system of accountability of inspectors/auditors, periodicity of inspection for poorly rated branches, system of rating and profiling of branches, broadening of the role of Audit Committee of the Board, expediting Electronic Data Processing, etc., are compulsorily to be implemented. Most of the other recommendations are to be adopted by banks depending on their need, having regard to individual bank's organisation. We suggest that the BFS make an early review of the progress in this regard.

4.11. House-keeping in banks, in particular the public sector banks, had not received priority attention for various reasons in the past. This has cumulated into a difficult situation with passage of time. The RBI has, therefore, issued instructions to banks for balancing of books, reconciliation of inter-branch and inter-bank accounts under a time bound programme. Guidelines on these aspects have also been issued to the banks from time to time and banks have been required to put in place proper procedures/ safeguards in these critical areas and monitor them regularly. As a result of close follow-up, some improvement has been brought about in reconciliation of entries and balancing of books, etc. However, the situation is still not fully satisfactory and there is considerable scope for improvement. It has also been suggested that the General Manager in-charge of internal inspection and audit should be designated as 'Compliance Officer' in banks entrusted with responsibility to ensure that a proper watch is kept on compliance with the important instructions of the Government/RBI and the banks' Board and reporting directly to the Chairman/ Managing Director.

4.12. With a view to providing focused attention by the Boards of banks on aspects relating to internal control, banks have, as directed by the RBI, constituted Audit Committees of the Boards, vested with authority to oversee the inspection and audit functions in the bank. The Committee also looks into compliance with RBI Inspection Reports and of the statutory audit (Main and Long Form Audit Reports). While, as mentioned earlier, some improvement has been recorded in aspects of internal control in banks, there is still scope for further improvement and the situation needs to be monitored by the authorities. There are also some other areas which call for attention such as instituting an independent loan review mechanism especially for large borrowal accounts, and systems to identify potential NPAs.

4.13. We have had occasion to comment in an earlier Chapter on the issue of connected lending and risk concentration. The present prudential limits to restrict bank exposures to single borrowers and groups of related borrowers upto of 25% and 50% respectively of the Capital Funds of the banks is, in the Committee's view, appropriate. It would be desirable that banks evolve a filtering mechanism by stipulating in-house prudential limits beyond which exposures on single/group borrowers are taken keeping in view their risk profile as revealed through credit rating and other

relevant factors. Further, in-house limits could be thought of to limit the concentration of large exposures. A similar methodology could be developed to manage the industry/sector/geographical exposures within the Board approved exposure limits keeping in view the bank specific situation like bank's exposure, risk profile of its borrowers and the level of NPAs.

4.14. Investment decisions should be taken by Committees at various operational levels within the policy framed by the bank. Such decisions should be reported to the higher levels (Investment Review Committee/ Board) on monthly basis with details about the transactions, profit flowing out of it, compliance with internal and RBI instructions, etc., instead of submitting data of transactions as at present.

4.15. The Committee has commented on several occasions on the growing importance of risk management procedures and skills. In the context of internal control systems, the Committee would suggest that there should be clearly laid down procedures to enable appropriate overseeing by Senior Management and Boards of the risk exposure of various types in a bank and the measures to deal with the same.

4.16. Internal systems in banks should obviously be so devised as to ensure speed and transparency of decisions while adequately recognising the attendant risks and prescribing a control mechanism for managing the risks. In order to speed up decision making, banks need to clearly work out an acceptable policy with regard to delegation of powers. In this connection, we would specifically like to comment on the role and constitution of the Management Committees of the board, constituted in terms of the nationalised banks schemes. The boards of the banks have delegated all operational powers to the Management Committee. Presently, the Management Committee of the Board of a bank comprises the Chairman, the Executive Director, the nominee Directors of RBI and Government, a Chartered Accountant and another member of the board by rotation. The Management Committee is performing what are essentially management functions. It has been suggested that the present system does not allow for quick decision making as the Management Committee comprising persons other than whole time directors is often unable to meet as frequently as may be necessary. Further, the part time directors are required to participate in what are essentially day to day operational decisions. While they are fully responsible for the decisions, they are naturally faced with time constraints as well as information asymmetry placing them in a somewhat difficult situation. The presence of the Government and RBI directors is not without its impact on the balance in the Committee. In another Chapter, we have raised the question of the appropriateness of a director from the RBI, which is also the regulatory authority, being directly involved in the decision making of banks in view of the possible conflict of interest. On the other hand, it has been felt that both the RBI and the Government Director bring to the deliberations a wider and an independent perspective, arising out of their experience with various banks or derived from their organisations, which may not be immediately available within the bank. On balance, however, we feel that it would be appropriate if the management committees are reconstituted to have only whole time functionaries in it, somewhat on the pattern of Central Office Credit Committee constituted in the State Bank of India. All decisions taken by these committees could be put up to the Board of Directors for information.

4.17. Presently, in accordance with the statute, the Boards of nationalised banks have only two whole time directors. Over the past decade, the size of the banks, the sphere of their activities and the nature of decision making have shown substantial changes. We feel that it would be appropriate to induct an additional whole time director, on the board of the banks with an enabling provision for more whole time directors for bigger banks. In addition to creating a balance between whole time directors and part time directors, this would be in harmony with and help in implementing our recommendations regarding the constitution of the management committee contained in the preceding paragraph.

4.18. The Committee has been given to understand that there are a large number of activities which can be outsourced thereby effecting productivity and efficiency improvements. In fact, jobs like running of canteens, maintenance of air conditioners, electrical installations, lifts, etc., part medical consultancy, architects are currently being outsourced by some banks. There are opportunities of outsourcing in other activities like building maintenance, cleaning, security,

despatch of mail and more importantly, in computer-related areas. The Committee has been informed that in some areas banks are unable to subcontract work because of a notification issued by the Labour Ministry under Contract Labour (Regulation and Abolition) Act, 1970. The Committee would urge that this be looked into by the authorities so that banks are enabled to effect efficiency and productivity improvements. The global trend in the banking and financial sector also reflects an increasing reliance on outsourced services. In an increasingly competitive environment, statutory provisions should not lead to banks having to carry on internally functions and tasks which can be performed more efficiently by outside service providers.

4.19. The discussion on systems in banks would not be complete without a reference to external audit. Appointment of statutory auditors, both at the central level and at the branch level is another area which requires some review. There has been a suggestion that it would enable better coordination amongst various central statutory auditors if one of them were to be designated as the principal auditor. Similarly, the scope of audit would be more comprehensive if zonal auditors on the pattern of separate auditors for different circles of State Bank of India are appointed. The selection process and the system of rotation aims at broad basing the utilisation of auditors and thereby providing over a period of time opportunity to a number of firms who satisfy the norms. It has also been mentioned that the present system is objective and provides opportunity for new entrants into the field of statutory bank audit. Nevertheless, the Committee feels that the present practice of RBI selection of statutory auditors for banks with the Board of Directors having no role in the appointment process, is not conducive to sound corporate governance. We would recommend that the RBI may review the existing practice in this regard. It may also reassess the role and function of the Standing Advisory Committee on Bank Audit in the light of the setting up of the Audit Committee under the aegis of the Board for Financial Supervision.

Issues in Human Resources

4.20. As in any service industry, the human resource is the crucial resource in the banking sector. Not only is this so because of the need to serve with efficiency and courtesy a very large number of customers with varying requirements, but also because of the increasing complexities of banking business. Assessing and managing a variety of risks is, as we have had occasion to say more than once, the core activity in banking. The whole spectrum of risk management functions has become far more complex in recent times as the business environment in the real sector has turned more dynamic and competitive. Today's bankers must be competent to assess and manage a wide variety of risks, which, as earlier Chapters have indicated, cover credit risks, market risks, interest and foreign exchange risks, liquidity risks and operational risks. Another factor adding to the complexity of managing banking business today is the growing use of information and communication technologies. These technologies are being deployed not only for delivering products and services to customers at their doorsteps, but also for developing and offering a whole range of newer products and services. These developments are taking place in a market place which is witnessing increasing competition and becoming wider geographically often going beyond national borders. Banks are also facing rising competition from non-banking institutions. The implications of these developments on the quality of human resource needs in banks is obvious.

4.21. Recognising these oncoming challenges in the banking sector, the CFS had urged a review of the system of recruitment and promotion in banks and recommended that banks turn to the open market for recruitment of manpower with special skills from time to time, establishing a convention that a certain percentage of posts in several cadres be recruited from the open market. Merit-based recruitment has almost come to a halt. While the need for pursuing such a policy has intensified severalfold in the last few years, because of growing complexities of banking business referred to earlier, the Committee notes that public sector banks and financial institutions have yet to introduce a system of recruiting skilled manpower from the open market. The Committee believes that this delay has had an impact on the competency levels of public sector banks in some areas and they have consequently lost some ground to foreign banks and the newly set up private sector banks. The Committee urges that this aspect be given urgent consideration and in case there are any extant policy driven impediments to introducing this system, appropriate steps be taken by the authorities towards the needed deregulation. In this context, it may be noted that, unlike many private sector banks and foreign banks and some Development

Finance Institutions, public sector banks have not so far been making any recruitment from the campuses of Indian business schools, which today form an important catchment area for young talent. This is so despite the fact that following acceptance of the D R Mehta Committee's recommendations, banks have been permitted to participate in campus recruitments to fill up a portion of their vacancies. The Committee would urge that banks move quickly in this direction. The Committee would like to stress that while in the past it was possible for the public sector banks to rely entirely on the system of recruiting officers at the trainee level and developing them through internal training systems, the new challenges of developing, marketing and managing world class banking services and products in a fast changing and competitive business environment have significantly altered this situation. Public sector banks have also lost some of their experienced professionals to new private sector banks and foreign banks. Banks have to top up their skills' base by resorting, on an ongoing basis, to lateral induction of experienced and skilled personnel, particularly for quick entry into new activity/areas.

4.22. The Committee has noted with concern that some PSBs including SBI have considerably diluted the concept of direct recruitment by counting internal promotions to trainee officers' cadre as direct recruitment. The Committee would strongly urge the management of public sector banks to reverse this trend.

4.23. The CFS had reviewed the set up in public sector banks for handling recruitment of officers and other staff and had recommended that there was no need for continuing with the Banking Service Recruitment Boards insofar as recruitment of officers was concerned. The Committee had felt that this would give individual banks the necessary scope for scouting for talent. This Committee, upon examination of the issue, reaffirms that recommendation, as with the deregulation and liberalisation of financial markets in the past few years, the need for banks to gain flexibility in the matter of recruitment of officers matching their individual business profiles has become even more pressing. Each bank must, however, set up objective, fair and transparent procedures and mechanisms for recruitment of officers whether for the annual entry-level recruitment or periodically at lateral levels. As for recruitment in the clerical cadre, the Committee is of the view that the time has come for entrusting this responsibility also to individual banks. This is because the needs of different banks vary even at the clerical level, depending on the geographical spread, business mix, extent of IT use in operations, etc. Also, individual banks may like to compete to attract the best talent in this category too. The Committee, therefore, recommends that a beginning be made in this regard by permitting three or four large well-performing banks, including State Bank of India, to set up their own recruitment machinery for recruiting clerical staff. As in the case of recruitment of officers, banks will have to lay down appropriate policies, procedures and mechanisms for undertaking such recruitment. If the experience under this new arrangement proves satisfactory, it could then pave the way for eventually doing away completely with the Banking Service Recruitment Boards.

4.24. From the evidence tendered and submissions made before the Committee, it seems apparent that there are varying levels of overmanning in public sector banks. In the interest of long term viability of the banking industry, in an increasingly competitive environment, it is important that the banks adjust their manning levels to the right size wherever appropriate. The Committee has also noted one particular aspect of overmanning, viz., that while there has been an increase in the workforce in public sector banks, the availability of staff with requisite skills and specialisation has proportionately declined. In many cases, in their desire to contain the overall level of the work-force, vacancies arising from the retirement of officers have been filled up by recruitment of subordinate staff. Today, every fifth employee in most public sector banks is of sub-staff category. There are clearly redundancies in this category. Apart from outsourcing some services to which we have made a reference earlier, the managements of individual banks must initiate steps to measure what adjustments in the size of their work force is necessary for the banks to remain efficient, competitive and viable. Surplus staff, where identified, would need to be redeployed on new business and activities or, as mentioned earlier, on internal inspection/audit, where necessary after suitable retraining. Customised training programmes will need to be developed to reduce mismatches between skills-needs and skills-availability. It is possible that even after this some of the excess staff may not be suitable for redeployment on grounds of aptitude and mobility. It will, therefore, be necessary to introduce an appropriate Voluntary Retirement Scheme with incentives.

The managements of banks would need to initiate a dialogue in this area with representatives of labour. The Committee believes that with a constructive approach on the part of the management, based on transparent information, bank labour would recognise the need to strengthen the banking system by making it viable and competitive and understand the need for right-sizing the work force in the interest of protecting long term employment and their own career advancement prospects.

4.25. The CFS in its report had referred to the growth of restrictive practices in banks in areas such as work norms, transfer and placement of staff, computerisation of branches, etc. These restrictive practices had arisen either from understandings reached between unions and managements or in situations where managements were perhaps unable to resist demands of unions even in matters that were beyond legitimate trade union functions. This Committee understands that the problem of various restrictive practices continues and in fact several banks are not able to implement even computerisation programmes in the way their managements would prefer to do because of trade union views on branches and activities that can be or cannot be computerised. The Committee would wish to stress that the roles of managements and unions are distinct and need to be recognised and respected by each other. Bank managements must not shy away from their core managerial responsibility of running their businesses efficiently and profitably; they must not let their managerial roles to be diluted. Trade unions, on their part, have the legitimate role of protecting and promoting the interests of the employees and to negotiate and reach agreements with managements for that purpose, keeping in mind the need for banks to remain financially viable in an increasingly competitive environment.

4.26. The CFS had also observed that there was merit in considering moving over from industry-wide wage (and non wage) negotiations in the banking sector to bilateral negotiations so that the problems and potential of individual banks would not get obscured by industry-wide considerations. The Committee is of the view that banks should move over to bank specific negotiations and agreements especially as public sector banks are now competing not only with each other but also with private sector banks and foreign banks. In such a situation, it is important to take into account the ground realities, the special needs and the potential of individual banks and this is possible only in a bilateral system. The Committee understands that with the next round of wage negotiations due, this is an opportune time to review the existing system of industry wise negotiations and shift to bank wise negotiations and settlements. The Committee would strongly urge the public sector banks to move over to a bilateral system of negotiation and settlement without further loss of time.

4.27. The Committee would also like to flag the issue of remuneration structure at managerial levels prevailing in public sector banks and financial institutions. The present structure is based on "one size fits all" approach and also falls far short of what is prevailing in the private sector and foreign banks, particularly in respect of skilled professionals. It is not surprising that in recent years, public sector banks have, as mentioned earlier, lost a fair number of skilled and experienced management personnel to foreign banks and the newly set up private sector banks. There is an urgent need to ensure that public sector banks are enabled to retain their skilled and experienced manpower and for that purpose be given the flexibility to determine managerial remuneration levels taking into account market trends. Unless this is done, the system of lateral recruitment of skilled personnel from the open market, as recommended by the Committee, will not be feasible in a meaningful way. The Committee recommends that the necessary authority in this regard be given to the Boards of the banks. The Committee would like to add that if the Government so prefers, this can be initially permitted in the case of profit making public sector banks which have gone public, for they would, in any case, be required to operate with an accountability to the market. The Boards of these banks may be authorised to determine the remuneration structure applicable to their managerial and other staff depending on their size, strength, business mix, viability and paying capacity.

4.28. A key issue in the human resource area relates to the quality of the top management in the public sector banks, particularly the Chief Executive. There are three aspects to this and these are: (i) the process of appointment of the Chief Executive; (ii) his tenure; and (iii) the remuneration structure. The earlier Committee had flagged the need to depoliticise the appointment of the Chief

Executives and had recommended that the Chief Executives of public sector banks be appointed on the basis of the recommendations of a high powered Group consisting of eminent personalities invited for the purpose by the Governor, Reserve Bank of India. The Committee notes that these appointments are now made on the recommendation of an "Appointments Board" headed by the Governor of the Reserve Bank of India and comprising other eminent Government and non-Government personalities.

4.29. With regard to the tenure for which the Chief Executive is appointed, this is still often for periods shorter than the five year term recommended by the CFS. This Committee is of the view that in today's increasingly challenging business environment, a large institution can only be led effectively by a Chief Executive who has a reasonable length of tenure, which the Committee believes should not be less than five years. Since, however, moving over to this tenure may be difficult, we suggest that in the first instance the minimum tenure should be three years. A shorter tenure does not give the incumbent the opportunity to plan ahead and implement changes and the long term goals of the organisation do not get addressed.

4.30. With regard to the remuneration levels of Chief Executives of banks and financial institutions, these now fall far short of what is being offered to their counterparts in private sector banks and financial institutions. Clearly, it is necessary to revise appropriately these levels of remuneration and bring about a better balance between what is paid in the public sector and in the private sector. Many of our public sector banks are now accessing both the domestic and international markets for capital. Investors often take a dim view of the comparatively low levels of remuneration of the Chief Executives of public sector banks and their perception of the quality of the Chief Executives also indirectly suffers. In this connection, with the growing internationalisation of the Indian market and the anticipated growth of activities of some of the Indian banks in overseas markets, the time is not too far when Indian banks may feel the need to attract qualified bankers and financial sector professionals of Indian origin who are now serving in the international market, to fill senior positions in the Indian banks and institutions. There is no reason why Indian banks and institutions should not, in course of time, be enabled to look for and attract such talented and experienced professionals. The Committee feels that there is now a need to delink the pay scales of the Chief Executives of public sector banks and financial institutions from the Civil Service pay scales and that this should be left to be decided by the individual banks not excluding the possibility of performance based remuneration. The Committee would like to add that these observations and recommendations also apply to the whole-time Directors on the Boards of banks and financial institutions appointed by the Government.

4.31. The Committee has taken stock of the position of the training system prevailing in the banking industry. While the public sector banks in India deserve to be complimented for building up extensive training facilities to train up their personnel, the Committee believes that there is a need for some qualitative changes in the training system. These changes are warranted by the new challenges faced by the banking industry to which we have referred earlier.

4.32. The training system in Indian banking emerged mainly during the years of state directed banking when there was neither much competition between banks nor frequent changes in the range of products and services; and this system served the somewhat limited needs of such banking well. But, as mentioned by the CFS, the training programmes became somewhat routine and stereo-typed. With the liberalisation of the economy and the financial sector, with increasing competition and growing internationalisation of the markets, training systems in our banks need to be refined to address newer areas. Some of these are:-

- Product development and marketing skills
- Modern credit management skills
- New risk management practices
- Skills for operating in an electronic environment
- New internal audit skills in a changing business environment
- Most importantly, bringing about a new focus on the customer and his needs.

4.33. The Committee would urge the managements of Indian banks to review the changing training needs in individual banks keeping in mind their own business environment and to address these urgently. In this context, the Committee would suggest that they explore, wherever appropriate, the feasibility of entering into collaborative arrangements with universities and other institutions in India and abroad, offering specialised training to the financial services industry, so that there can be an arrangement in place for ongoing inflow of emerging training packages and methodologies.

4.34. The Committee emphasises that everybody in the organisation, right from the CEO to the clerk, needs to be trained/retrained on a continuing basis. Considering the fact that the profitability of the banking industry depends on the productivity of its people, it is essential that a senior level appointment for this position (similar to a Compliance Officer) should closely monitor the implementation and impact of training.

4.35. Any discussion on human resource in banks must touch on the issue of 'morale' of the staff. The Committee is fully cognisant of the importance of ensuring a clean and transparent functioning of the system and the need to prevent, even if it is not possible to eliminate, the emergence of fraudulent transactions. There is no question that those employees of banks whose conduct gives rise to suspicion of malafides should be investigated. One must make a distinction between genuine commercial misjudgement with respect to decisions taken in good faith and deliberate malfeasance. However, the pervasive fear of an external vigilance authority has tended to inculcate what has been described as a "fear psychosis" amongst bank personnel. The morale of personnel has been affected by the fear that they may be held responsible on the ground of malafide actions in the event of loans or investments turning bad. There has been, consequently, a tendency on the part of middle and senior management for risk aversion. Safety appears to lie in taking no decision or taking a negative one. One of the very visible manifestations of this problem is the setting up of Settlement Advisory Committees by various banks. In effect, it results in externalising basic banking decisions. While this may appear to be necessary under the present circumstances, we have no doubt that such a mechanism is inappropriate in the long run. Risk is inherent in credit and investment decision making. There is indeed no such thing as riskless banking and there would be occasional losses which, with the benefit of hindsight, might appear to have been avoidable. Provided that the losses are bona fide business losses they should be accepted as such. Mistakes will be made but an atmosphere of fear of being subjected at some later date to investigation and unsavoury publicity is not conducive to efficient and informed decision making. This point has been urged upon the Committee by representatives of both management and labour. The Committee is aware that banking personnel have been given clear assurances that decisions taken in the normal course of business would be treated as exercise of banking risks and no criminal motives attributed unless there was prima facie evidence of malafides but such assurances do not appear to have had the desired effect in eliminating the fear complex and restoring morale. As long as the system remains as it is, we are likely to continue to face this problem.

4.36. The Committee is of the view that Government should review this situation for otherwise decision making in public sector banks can neither be quick nor aggressive nor even entrepreneurial. There may be need to redefine the scope of external vigilance and investigative agencies with regard to banking business. It is recognised that oversight by external vigilance agencies is a manifestation of the public ownership of banks. It is, however, necessary to underscore the fact that external agencies should have the requisite skill and expertise to take into account the commercial environment in which the decisions are taken. The vigilance manual now being used has been designed mainly for use by Government Departments and public sector undertakings. The concept of loss arising from a credit decision taken in good faith should not be seen as akin to the concept of loss to the Government which is central to the manner in which the vigilance authorities in Government approach their task. It may be necessary that a separate vigilance manual which captures the special features of banking should be prepared for exercising vigilance supervision over banks. The initiative taken by the RBI setting up the Advisory Board for Bank Frauds is a welcome step. The scope of this Board is presently confined to functionaries one level below and at the board level. The Committee feels that this is an extremely critical area and some similar arrangements be made for various levels of staff of banks.

4.37. In the context of appraising the work of officers of banks a suggestion has been received by the Committee that the banks should put in place a system where a record of all credit decisions made by an individual officer together with his successful performance is maintained. We understand that some large private sector banks have such a system and it has proved to be extremely beneficial. We would recommend that public sector banks should consider the suggestion and try to devise a system suited to their needs.

Issues in Technology Upgradation

4.38. No area of commercial activity has been more influenced by the ongoing revolution in information and communications technology than the banking and financial systems. Information Technology and electronic funds transfer system have emerged as the twin pillars of modern banking development. In fact, technology has moved banking towards a whole paradigm shift. Not only have the services or "products" offered by banks moved way beyond conventional banking, but access to these services has become a round the clock, round the week routine. Most global banks can today be accessed on phone via PC, via Internet or at the neighbourhood ATM or kiosk, 24 hours a day, 7 days a week.

4.39. This phenomenon has largely bypassed India. While most technologies that could be considered suitable for India have been introduced in some diluted form as a pilot. Requisite success has not been achieved because of the following reasons:-

- Inadequate Bank Automation.
- Not so strong commercially oriented inter-bank platform.
- Lack of a planned, standardised, electronic payment systems backbone.
- Inadequate telecom infrastructure.
- Inadequate marketing effort.
- Lack of clarity and certainty on legal issues
- Lack of Data Warehousing network.

4.40. With a very low level of old mainframe technology systems, India is poised to leapfrog several stages that other developed nations had to go through due to a fragmented and incremental approach.

4.41. In terms of developing a state of the art IT infrastructure for the banking sector, we are of the view that the issue needs to be considered in terms of serving the two major sectors in India, that have slightly different priorities, viz., rural and urban.

4.42. The rural segment, at least as of today, is less mobile and the focus is more on "fairness" of the system and adequacy of credit. In urban areas, on the other part, there is a greater mobility of consumers and a relatively higher frequency of use. Thus, access, convenience and time are of the essence. We may sum up these needs as follows:-

Rural

- Quick credit
- On an objective basis
- At reasonable rates and
- Sensitive to the vagaries of nature
- A friendly supporting system for encouraging savings and attracting them into the financial mainstream.

Urban

The urban sector has all the needs of the rural sector, plus the following:-

- Easy to access
- To a wide range of banking and payment services
- Of high quality
- Customised to as narrow a segment of customers as possible.

4.43. This should not be taken to mean that the two sectors have divergent needs. In fact, the ultimate infrastructural needs for both the sectors are the same. However, the priorities for the two sectors differ somewhat and it would be advisable to keep this in mind in our technological solutions to address their needs. Obviously, the structure that we recommend should respond to these needs.

4.44. An overall examination of the products and services offered by banks in the more developed economies shows that technology adoption and absorption has revolved around two basic themes, viz., retail banking and corporate banking. Retail banking with its emphasis on numbers and 'segments' of customers has leaned more on basic technology infrastructure.

4.45. Data warehousing technology is used to collect data on the credit profiles and payment of individuals, data mining and modelling tools to develop new products and the latest access technology to make the product accessible "anywhere", "anytime" and "anyhow".

4.46. Corporate banking on the other hand has moved way beyond such "triple a" to, very literally a segment of one. In corporate banking, therefore, there is a dominance of specific products offered by very focused banks to very narrowly defined customer segments.

4.47. Some of the major trends may be described as under:-

Indian Situation	Developed Economies
• Buy technology rather than considering other than alternatives	• Buy technology or "outsource" it
• All banks to all people	• Specialised banks targeting specific segments of the market
• Branch Network	• PCs, Internet, Phone
• Distributed Processing	• Centralised processing
• Distributed Appraisal	• Centralised appraisals by specialised teams
• Rules/Regulation driven	
• Bank at nearest bank	• Bank with most friendly bank
• Walk to your branch	• ATM, PC, Telephone, Internet
• Little choice in types of accounts	• Wide array of "products"
• Paper based, wire remittances only intra-bank	• Account to Account, Interbank EFT
• Directed credit, no knowledge rules	• Objective, data based assessment
• Delayed, reactive approvals	• Proactive, pre-approved credits
• Regulations to force credit to underprivileged	• Regulations to prevent discrimination
Some innovations seen abroad	
• Franchising branch networks	
• Forming alliances with global banks for developing risk assessment skills	
• Limited bank joint ventures	

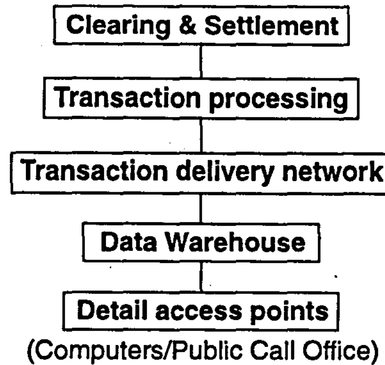
4.48. The challenge for India, very clearly, is to integrate this retail/corporate model into a rural/urban one.

A Payment Systems Backbone

4.49. The financial institutions and their customers are likely to incur substantial inefficiencies, redundancies and/or risk management gaps if there is not a structure in place for a set of payment services - each optimised to its own function. Conversely, if the infrastructural elements are designed within a comprehensive master plan, a higher level of customer service, timeliness, efficiency and risk management can be developed at less cost.

The Payment System Vision

4.50. Thus, our vision for a payments system in this country comprises the following layers:-



(Computers/Public Call Office)

4.51. The initial set of services that would ride on this infrastructure could include:

- Electronic intra-bank and inter-bank payment clearing and settlement
- Cheque truncation
- Electronic tax collection
- Electronic bill payment
- Corporate interest and dividend payments
- Salary and pension payments

Automated Clearing House Operations

4.52. Today, no automated clearing house exists in the country. With the introduction of electronic clearing service, there is some progress in this respect and the Saraf Committee has proposed a tiered system of clearing houses, somewhat on the lines of the current paper based clearing systems. This architecture appears appropriate, except that currently the branches of most public sector banks are not electronically connected to their service branches.

4.53. Clearly, this is an area where RBI/IDRBT need to lay down standards for inter-bank file transfer and also learn from experience elsewhere by indigenising standards developed in some other countries. Private commercial service providers could also be encouraged to offer such services to banks.

A Network of Regional Datawarehouses - Credit information Bureaux

4.54. Information management is an area where, globally, technology has played a very active role. Banks face this issue every day. Perhaps in no area does lack of readily available, verifiable information hurt banks more than in risk assessment. What is needed is a broad information infrastructure that captures not only individual and corporate information, but also transactional information. This requires a new industry of information service providers that would develop and maintain relevant corporate and personal information that is easily accessible to all authorised users. This calls for an environment that facilitates the collection of accurate credit information on a transparent basis.

4.55. Banks would then have an easily accessible matrix for risk assessment that will enable them to benchmark their risk-reward position with the rest of the system. Such a system, by itself would tell banks whether the price they charge for the risk assumed is adequate and also whether their cost of intermediation is in tune with the local/global economy.

4.56. The essential requirement for data warehouses are as follows:-

- Unique identification, at least, for bank account holders - this could be the PAN, Voter ID, Driving Licence or some other. The ID will, of course, aid in several other national priorities, including driving/other licences, public distribution system, elections, taxes, police investigations, illegal immigration, etc.
- Storage of land records and land use data on electronic media, particularly, in rural areas; and

- Storage of loan utilisation and repayment data on electronic media.

4.57. We further recommend setting up, possibly by IBA, of a high-level group to suggest the kind of data to be picked up which can serve the purpose meaningfully. Such data would be stored at regional centres and could be available, subject to user passwords and security levels, on an "as needed" basis, to district Government bodies as well as bankers for determining credit needs. Where required, the system would automatically access other regional databases.

4.58. Such a system would ensure availability of past payment record and enable statistical models (based on regional information) rather than subjective assessments. The data will also enable credit delivery to be tailored to regional industry needs.

4.59. A great deal of attention is being paid to customer confidentiality. This is certainly warranted. However, the emphasis is somewhat misplaced considering the fact that it can be taken care of very easily through technological as well as administrative measures. It should be remembered that a good system will benefit the consumer as much as the banker. It can be very easily ensured that the information is made available only to "authorised" institutions and only subject to a certification to the effect that the institution has the express consent of the concerned consumer to obtain the information. Of course, every borrower and loan applicant may be presumed to have given this permission. Necessary legislative changes with requisite safeguards would be required for this purpose.

4.60. This service could be developed by a group of banks and financial institutions or it could be organised, managed and offered by independent private bureaux.

Bank Automation

4.61. Little of what we have discussed so far can be achieved without basic bank automation. While banks in India seem to have realised this, the pace is rather slow for various reasons.

4.62. Bulk of the Indian (domestic) banking system today is based on a Branch Automation model. Customers today have accounts at a branch, not a bank. Increasingly, however, customers are demanding a higher degree of flexibility and anytime, anywhere banking. The branch automation model cannot achieve this unless the branches are networked. Networking intra-bank branches which is a common denominator should at least start with immediate effect and banks should take up the selection of communication software and development of the requisite interfaces. While the interfaces would be specific to the application and communication software, the use of a message standard like ISO 8583 would enable easy compatibility with an inter-bank platform. One approach suggested is that in urban areas a "cluster" automation models could be adopted which facilitates anywhere banking, at least within defined regions. This could be achieved by setting up relatively centralised processing in selected regions, which would then link up at state and national levels, via wide area networks.

4.63. Another approach to this issue could be to encourage service providers who enable the "outsourcing" of branch/bank automation. Small and medium sized banks need not, then, invest in expensive technological investments in small, isolated branches and can yet automate such branches by hooking up to the service provider.

4.64. Technology needs to be introduced in this area at two different levels. One of these is the inter-branch networking, which we referred to. What is perhaps equally important is customer access. This can happen via telephones, ATMs, PCs, point of sale terminals at convenient locations.

4.65. Further, bulk of branch automation today is a mere translation of existing manual processes, which in turn have changed little since they were first conceived. What is called for, therefore, is a total process re-engineering to suit an automated environment. Designing the process again needs to be done with high levels of domain knowledge and familiarity with what technology can achieve. For instance, whole functions rather than individual elements need to be considered. Similarly, signatures are still often verified manually rather than "imaging" on computer. An integrated approach is, therefore, required while developing software.

Computerisation as Management Control Tool:

4.66. MIS is the key to successful operation and control of any business. Managements need to know and track the key parameters like credit outstanding, liabilities/deposits, reserves maintained, earnings on day to day basis, etc., on a real time basis. Computerisation helps in better deployment of human resources and enables management to interact electronically. Information and control systems need to be developed in several areas like:-

- Tracking spreads, costs and NPAs better for higher profitability
- Accurate and timely information for strategic decisions - Identify and promote profitable products and customers
- Risk and Asset-Liability management; and
- Efficient Treasury management

Approach towards technology introduction and management

4.67. Banks all over the world are grappling with the problem of attracting and retaining high quality technical talent. In India, particularly in the public sector, given their salary structures, this should be equally true. This is thus more so, because this is not their core activity. Top management of banks cannot devote more attention to technical staff than they do for their maintstream employees. On the other hand, the technical employees need an environment where they can learn more and keep their knowledge up to date. It is also essential that a mechanism be devised which ensures that in areas of hardware and software banks keep pace with fast changing technology.

4.68. At a different level, small banks find it difficult to make heavy investments in technology at a time when they are struggling hard to maintain capital adequacy. One possible way of making investments by banks in technology more attractive is by offering suitable fiscal incentives like provision for accelerated depreciation, for such investments. Another solution for such problems could, as mentioned earlier, be outsourcing. Today, in many countries, outsourcing is done at various stages and it offers the whole range between build-own-operate-maintain to utilising the services alone on a pay-per-use basis, very much analogous to public telephones. In these countries, such services are available to banks in several areas, including:

- EFT Networks;
- ACH;
- Bank Automation;
- Data Warehousing;
- Call Centres;
- ATM Networks;
- Systems maintenance

4.69. It is such sharing that would defray the investments of service providers and enable them to offer state-of-the-art technology at affordable prices. This needs to be encouraged by providing clarity in laws relating to customer confidentiality and giving banks a free hand in areas not specifically restricted. Here banks need to solve their own problems rather than wait for RBI to act or pronounce on an issue, before any action is taken. They could take the initiative by setting up an expert committee which could frame guidelines for the following with particular reference to outsourcing these services:-

- Type of services to be introduced and in what sequence;
- Rollout Plan (to start with 4 metros may be covered);
- Technical specifications of the various services to be offered;
- Qualification criteria for the bidder and technology Joint Venture partner;
- Ceiling on tariff to be charged from the users;
- Foreign equity permissible in JV;
- Criteria for selection of the best service provider; and
- Other commercial terms/rollout plan.

Implementation Steps

4.70. The action points emerging from the points discussed in the foregoing paragraphs may be summarised as follows (in order of priority, but each item does not necessarily depend on the conclusion of ones listed earlier):-

(i) Necessary legislative changes keeping in view the recommendations of Shere Committee should be implemented at the earliest. This will build necessary confidence in the new processes and ensure wholehearted participation. In particular, the following issues need to be addressed immediately:

- Encryption on Public Switching Telephone Network (PSTN) lines;
- Admission of electronics files as evidence;
- Treating electronic funds transfers on par with crossed cheques/drafts for purposes of income tax, etc.; and
- Record keeping

(ii) Automation of banks needs to be coupled with process re-engineering and expedited. Service providers, who can offer branch/bank transaction services, could be considered.

(iii) Intra-bank networking which is a common denominator should be expedited. This would be facilitated by clarity on issues relating to connectivity of leased lines with VSATs and of network to network connections.

(iv) Government(s) should take the lead in adopting technology to automate inbound and outbound funds transfers. To begin with the ideal for applications in selected areas the top metros should be automated and the success should then be methodically replicated in an increasing number of applications and cities.

(v) The IDRBT, in consultation with RBI, should accelerate the process of establishing standards, designing the payment systems backbone and other enablers of technology adoption and should not be getting into operating and managing networks. Operational and transactional areas should be progressively handed over to private hands.

The IDRBT should focus on establishing standards relating to:

- Security levels;
- Time lines desired which can, otherwise be close to immediate;
- Roles and obligations of the entities involved; and
- It should examine the various standards available for smart cards and lead the way not only in introducing a "universal" solution for the country, but also impacting the way the technology has been moving globally.

(vi) RBI should take the lead in enabling the allotment of a unique identifier to anyone needing the use of banking services. A beginning could perhaps be made with persons transacting above certain values. This should become a mandatory/electronically verifiable part of any transaction. The Personal Account Number of the Income-tax Department, the IDs on driving licenses or those on Election Cards may be adopted for this purpose. This is an area where large technology integrators and data warehousing companies could be asked to put in bids.

(vii) RBI should encourage the set up of a network of regional data warehouses, to enable objective, up-to-date and quick risk assessment against verifiable information, besides comprehensive statistical information. Here also emphasis should be more towards inviting third party service providers to build, own and operate on a pay-per-use mode. IBA/Banks should participate in suggesting the kind of data required from time to time.

(viii) RBI should encourage the development of a strong payment system backbone including ACH across the country and mandate/ encourage all payments to use this route. It should encourage the inter-linking of payment system networks, and establishment of third-party networks. RBI should encourage usage of call centres for various transactions/queries.

(ix) The possibilities of outsourcing many of the activities should be actively pursued. To this end banks could set up an expert committee for framing guidelines.

Chapter V

Structural Issues

5.1. The discussion in the earlier Chapter on the internal strengthening of the banking system needs to be complemented by a review of the structural issues at the industry level. While it is clear that individual banks must address the issues of their own internal strengthening, the strength of individual banks will, in the ultimate analysis, be significantly influenced by the structure of the industry. Furthermore, it is the appropriateness of the structure in a given economic scenario that can ensure that the banking system is able to provide efficient and cost-effective service to the various segments of the economy.

5.2. The CFS had recommended in 1991 a possible structure towards which the system could evolve. The broad pattern envisaged was as under:-

- 3 or 4 large banks (including the State Bank of India) having an international presence;
- 8 to 10 national banks with a network of branches throughout the country engaged in general or universal banking;
- Local banks whose operations would be confined to specific regions; and
- Rural banks (including RRBs) whose operations would be confined to rural areas and whose business would predominantly be financing of agriculture and allied activities.

5.3. There has not been any visible change in the industry structure apart from the one single instance of a merger between two public sector banks, a merger which was not driven by commercial considerations. However, as recommended by the CFS, ten new banks in the private sector have been allowed to be established and a more liberal policy is under implementation with regard to entry of foreign banks. As of now these banks in the aggregate do not account for any significant level of business but they are, with their emphasis on technology and cost consciousness, developing special niches and are offering at the margin a measure of competition to the older Indian banks as reflected in their increasing market share of banking business. The Committee welcomes this trend and would hope that this would grow further.

5.4. The Committee has reviewed the issues relating to the structure of the banking industry in India in the context of the current national and international environment and having regard to the progress with respect to the deregulation and liberalisation of the Indian economy. The challenges to the structural basis of Indian banking emanates from the increasing role banks will be called upon to play to meet the developing needs of an increasingly market-driven domestic economy and to enable them to meet competitive pressures from abroad as a result of the increasing pace of internationalisation of our economy. We are today at a point where we are not fully integrated into the global economy nor are we, as we were until not so long ago, relatively insulated from the impulses generated in the international economy. The direction of movement, however, is clearly towards greater international integration of our economy and our financial systems and structures will need to adapt themselves to this emerging situation.

5.5. The Committee has noted, in this connection, the global trends in banking which is marked by the twin phenomena of consolidation and convergence. The trend towards consolidation has been driven by the need to attain meaningful balance sheet sizes and market shares in the face of intensified competition. There has also been a falling apart of the boundaries between suppliers of various products and services. The dichotomy of the savings and investment functions is no longer confined to national frontiers. Finance is increasingly becoming a cross border activity with availability of a wide range of products and services being delivered to customers across the global market. Not surprisingly, the risks of banking business have greatly increased in complexity warranting significant strengthening of the individual bank's financial footing and the development of new and sophisticated risk management tools. Extensive use of information technology and modern communication and electronic funds transfer systems for delivering products and services have generated new investment needs of high magnitude which only institutions of a certain size

can afford. Size has, therefore, come to be regarded as a major source of strength. The trend toward convergence is also being driven by the move, across the industry, towards relationship banking, that is to identify and meet all of the needs of a customer through a single (or affiliated) institution. Banks are not only offering wide ranging services to their customers across the globe through sophisticated satellite-based electronic systems, they are also acquiring allied businesses such as asset management, investment banking, brokerage, insurance etc., operating these where appropriate through dedicated corporate vehicles often as their subsidiaries. Even in those countries where there are still legal or regulatory impediments to providing a combination of commercial, investment and other banking service, relaxation of the restrictions are either contemplated or are under discussion.

5.6. Some of these trends are not without their echo in India. Thus, commercial banks have been moving into certain areas previously open only to DFIs, as for instance, project finance and investment in corporate bonds and debentures and also into areas which earlier were the preserve of NBFCs, such as leasing and consumer finance. DFIs in their turn have been entering the field of short term non-project lending and retail deposit-taking. For the same market reasons as have influenced the growth of universal banking elsewhere, a similar trend is visible in India too, fuelled by enhanced competition, greater ability to offer a wider range of products and services by use of technology and the desire to meet all the requirements of a customer. In the wake of the trend towards banking disintermediation, and of competitive pressures banks would need to display flexibility in responding to the new challenges. If FIs are going into banking, they would need to take out banking licences which will permit them to undertake the full range of banking business including accepting demand and short term deposits and the full range of foreign exchange business. If FIs engage themselves in commercial bank like activities, it stands to reason that they should also be subject to the same discipline regarding reserves and liquidity requirements as well as capital adequacy and prudential norms. A DFI which converts to a bank can be given some time to phase in reserve requirements in respect of its liabilities to bring it on par with the requirements relating to commercial banks. Similarly, as long as a system of directed credit is in vogue a formula should be worked out to extend this to FIs which have become banks.

5.7. The Committee is of the view that with the convergence of activities between banks and DFIs, DFIs over a period of time should convert themselves into banks. There would then be only two forms of intermediaries, viz., banking companies and non-banking finance companies. If a DFI does not intend to become a bank with a banking licence it would be categorised as a non-banking finance company.

5.8. It is against the background of these trends that the Committee has addressed some of the important structural issues in the Indian scene.

5.9. One of the issues to be considered is whether we need to have as many as 27 banks in the public sector (there were 28 of them before a merger of two of the banks). This number has been the result of historical evolution. The PSBs vary greatly in size, number of branches, deposit base, quantum and quality of assets. If Indian banks are to improve the standards of their services and compete more effectively, they would need to be more capitalised, automated and technology-oriented even while strengthening their internal operations and systems. Capital funds of the public sector banks, as mentioned in an earlier Chapter, are still somewhat low as compared to international standards even without allowing for the fact that in a developing country situation, capital levels have to be higher than in developed countries. If Indian banks are to be made more comparable with their competitors from abroad with regard to the size of their capital and assets base, it would be necessary to restructure these banks.

5.10. The broad CFS model, in the Committee's view, continues to have relevance. An additional consideration merits mention here. Today, our system is characterised by the dominance of one bank, the SBI which on its own accounts for 18.53% of the aggregate deposits of the banking system and with its associate banks for a further 6.22%. The skewness in the distribution of banking business is further evidenced by the fact that the second and third largest banks have a share of barely 5.38% and 5.35% of business. The situation though the result of historical evolution has not helped in making for meaningful competition though it should be added that competition among

the banks has itself not so far been a primary or even proximate objective of policy. Today, with increasing emphasis on a market driven economy and allocating to competition its well recognised function of promoting efficiency, we need to consider whether such a dominance by one group makes for competitive efficiency in the system and whether instead we should not develop some measure of countervailing power by having 2 or 3 other banks which even if not of the size of the SBI would be able to offer a greater competitive thrust to banking operations in the country. Having 2 or 3 other large banks in addition to the SBI would also correspond to the first tier of the CFS model.

5.11. While State Bank of India, which already has a wide network of overseas branches and has successfully tapped the GDR market apart from the domestic capital market, is clearly one such bank, it should not be difficult for two or three other public sector banks to emerge in this category. These banks should then develop medium to long term plans for necessary preparations either on their own through capital enhancement or by taking the merger route. For banks aiming to have an international presence, size is a critical factor and for them to grow and participate increasingly in international business the banks have to have a large strong domestic operation and a high net worth. Particularly, for banks operating internationally, size is an important factor as it increases the risk appetite and gives the bank the necessary strength to bear the risks of international operations and generate confidence. Such planning would include identification of markets and target customer groups in these markets, products and services to be offered, appropriate strengthening of the balance sheets, and mobilisation of human resources necessary for the endeavour. These banks will need to address issues of internal organisation, systems and technology which need to be raised to international standards. They will do well to bear in mind that remoteness of operating locations and varying operational environment, local cultures and regulatory regimes lead to complex demands on organisational efficacy and internal control systems. Indian banks aiming to become international in character must examine the desirability and feasibility of entering overseas markets, not only through a network of branches as has largely been the case so far, but also through subsidiaries and joint ventures. All of these need careful preparation and planning. A key issue relates to human resources policy for these banks. If an Indian bank is to maintain a meaningful presence in international markets, it must be able to attract and retain high calibre professionals in these markets on competitive terms. Appropriate policies will thus need to be developed in this important area. In this context, the Committee is of the view that the existing practice followed by Indian banks of having their overseas operations run almost entirely by personnel deputed from India for a limited number of years calls for some re-examination. This arrangement does not provide continuity of management in these markets as each new incumbent has to go through an acclimatisation process and does not stay abroad long enough to benefit from this. Also, this practice excludes the possibility of taking on board high quality professionals from the local market who are well experienced in products and services in these markets but which are relatively new for Indian banks. There is now evidence that global companies including banks having operations in other countries are for similar reasons, turning increasingly to local personnel for manning their business and relying less on expatriate staff.

5.12. On the Second Tier of the CFS model, viz., of 'national" level banks, all the public sector banks now have 'national' characteristics. The Committee believes that there is scope for consolidation in this sector while retaining its competitive structure. Such consolidation would lead to benefits such as stronger balance sheets permitting larger exposures, economies of scale, avoiding duplication in I.T. related investments, better ability to attract high quality human resources, and rationalisation of branch network. In the Committee's view, a process of consolidation should lead to a reduction in the number of these 'national' level banks. Since it is neither possible nor desirable to be precise in this regard, the Committee feels that the CFS recommendation of 8 to 10 national banks with a large network of branches and 3 to 4 banks with international presence be used as an indicative reference point. This leads us to a discussion of the scope and potentialities of mergers between banks and indeed between banks on the one hand and DFIs and NBFCs on the other or between public sector and private sector banks. Such mergers need to be based on synergies and locational and business specific complementarities of the concerned institutions and must obviously make sound commercial sense. An important point the Committee would like to make here is that merger of public sector banks should emanate from the

managements of banks with the Government as the common shareholder playing a supportive role. Mergers to be meaningful, should lead to the emergence of a stronger unit by way of increased capital base and organisational strength.

5.13. As mentioned earlier, the initiatives for such mergers between public sector banks must emanate from the managements of the concerned banks. While the Government of India continues to be a major shareholder of the public sector banks, eight of them including SBI and two of its associate banks have raised capital through public issue of shares. These banks will need the approval of RBI as regulator and their shareholders (including Government) for any decision affecting their future set up. Consistent with its approach that mergers should not be imposed, the Committee does not wish to name the individual institutions which could be merged.

5.14. It needs, however, to be recognised that mergers to be meaningful and useful should not be a mere arithmetical merger of balance sheets and staff of the banks but should yield benefits in terms of staff and branch network rationalisation. Unless these benefits can become available, mergers of public sector banks would tie down managements with operational issues and merely distract attention from the real issues without giving any commensurate benefits.

5.15. It would be necessary in this connection to evolve policies aimed at "right-sizing" and redeployment of the surplus staff either by way of retraining them and giving them appropriate alternate employment or by introducing a VRS with appropriate incentives. This would necessitate the co-operation and understanding of the employees and towards this direction, managements should initiate discussions with the representatives of staff and would need to convince their employees about the intrinsic soundness of the idea, the competitive benefits that would accrue and the scope and potential for employees' own professional advancement in a larger institution. The problem of rationalisation of branches of the two banks would also require consideration. It would be necessary to evolve a judicious policy with regard to swapping/relocation of branches of the two banks which should not only make the exercise viable but also meet the credit needs of the clientele of the branches. The problem of the 'work culture' in different banks hindering smooth merger of two banks is not insurmountable. We have examples of banks with different cultural affinities merging successfully. The overriding concern of any proposal of merger should be making the merged unit stronger by way of capital standards and make it organisationally strong. Mergers should not be seen as a means of bailing out weak banks. Mergers between strong banks/FIs on the other hand would make for greater economic and commercial sense and would be a case where the whole is greater than the sum of its parts and have a "force multiplier effect".

5.16. The reference to weak banks leads us to discuss this important aspect of restructuring the Indian banking sector. Presently banks which have incurred an operating loss are categorised as 'weak banks'. This definition has, some limitations in that operating loss in a year of extraordinary circumstances would lead to a bank being categorised as 'weak'. There is, therefore, need for evolving a proper definition of a 'weak bank'. A 'weak bank' should, in our view, be one whose accumulated losses and net NPAs exceed its net worth or one whose operating profits less its income on recapitalisation bonds is negative for three consecutive years. The indications of incipient sickness, inter alia, are lowering operating profits, lower productivity, and a trend of increasing NPAs. A case by case examination of the weak banks should be undertaken to identify those which are potentially revivable with a programme of financial and operational restructuring. Such banks could be nurtured into healthy units by slowing down on expansion, eschewing high cost funds/borrowings, judicious manpower deployment, recovery initiatives, containment of expenditure, etc. These initiatives towards downsizing of their balance sheets have been implemented in a limited manner by way of strategic revival plans relating to performance obligations.

5.17. The future set up of such banks should also be given due consideration. These banks being small in size with regard to capital and asset base, may not be able to compete with more capitalised and technology driven banks. Merger could be a solution to the problem of weak banks but only after cleaning up their balance sheets. If there is no voluntary response to take over these banks, it may be desirable to think in terms of a Restructuring Commission for such public sector banks for considering other options including restructuring, mergers or amalgamations or failing these closure.

5.18. Weak banks which on a careful examination are not capable of revival over a period of three years, should be referred to the Commission. Such a Commission could have terms of reference which, inter alia, could include suggestion of measures to safeguard the interest of depositors and employees and deal with possible negative externalities.

5.19. The small older private sector banks operating in India have a useful role to play. Although they are not comparable to public sector banks by way of capital or asset base, these banks have developed a strong regional presence and have been able to meet the credit needs in their areas of operation. Their future set up needs to be considered taking into account their history and their local strength. They have a special role in local areas and could form part of the Third Tier of local/rural banks. There has also not been any attempt to restructure the fourth tier of the CFS model barring some attempts at rehabilitating the RRBs and announcing a policy to permit the setting up of Local Area Banks, for which only three applications have been approved in principle and none has been actually established so far.

5.20. The policy of licensing new private banks (other than local area banks) may continue. The start up capital requirements of Rs 100 crores were set in 1993 but this calls for a review with a view to its enhancement and as an incentive for the emergence of stronger private sector banks. Further, as their business expands, the requirement of capital adequacy ratios would inevitably call for an enhancement of their capital funds. The major problem in the case of new private banks is to decide the eligibility of the promoters to set up a bank. In the past, financial institutions, NBFCs, NRIs and certain professionals have been permitted to promote banks. The Committee would recommend there should be well defined criteria and a transparent mechanism for deciding the ability of promoters to professionally manage the banks and no category should be excluded on priority grounds. The question of a minimum threshold capital for old private banks also deserves attention and mergers could be one of the options available for reaching the required capital thresholds. The Committee would also, in this connection, suggest that as long as it is laid down (as now)that any particular promoter group cannot hold more than 40% of the equity of a bank, any further restriction or voting rights by limiting it to 10% may be done away with.

5.21. Foreign banks are allowed to operate only as branches. Government also allows foreign banks/finance companies to invest upto 20% in a private sector bank as technical partner/ collaborator. The Committee reiterates the view of the CFS that in addition foreign banks may be allowed to set up subsidiaries or joint ventures in India. Such subsidiaries or joint ventures should be treated on par with other private banks and be subject to the same conditions with regard to branches and directed credit as these banks. Only reputed foreign commercial banks with a well-diversified ownership pattern should be eligible to set up subsidiaries or majority owned subsidiaries. The minimum capital requirements for subsidiaries may be higher than the amount prescribed for the Indian banks for prudential reasons. There is also need to modify the existing capital prescriptions for these banks. The present minimum start up capital requirement of US $10 million should be raised to US $25 million as start up capital and not allowed to be brought-in in a phased manner. Existing foreign banks operating with branches with good track record may also be encouraged on merits to convert themselves into subsidiaries.

5.22. No discussion of the structural issues would be complete without referring to the future organisational pattern of our public sector banks. This is also closely related to the issue of autonomy in their functioning.

5.23. In 1991 the CFS had observed that its approach to the issue of financial sector reform was "to ensure that the financial services industry operates on the basis of operational flexibility and functional autonomy with a view to enhancing efficiency, productivity and profitability. .... Ensuring the integrity and autonomy of operations of banks and DFIs is by far the more relevant issue at the present time than the question of their ownership. .... The issues of competition, efficiency and profitability are, in this sense, ownership neutral. It is how the institutions function or are allowed to function that is more important". (emphasis added).

5.24. This Committee endorses the above approach. The operations of the financial system should be governed by the objective of promoting productivity and efficiency and, in the ultimate analysis, profitability, to be able to serve the economy more efficiently and more effectively. For

this, the system would require within the framework of purposive rule-bound, non-discretionary and prudential regulation and firm supervision, autonomy in critical decision making, whether in terms of strategy or in day to day operations.

5.25. Operational flexibility and functional autonomy are integral requirements for the efficient functioning of the financial system and especially the banking sector. This has become more urgent as our economy is becoming increasingly deregulated and market driven and is facing increased competitive challenges with its growing internationalisation. Finance is increasingly becoming borderless and the ability of our system to respond quickly and effectively to the demands of the internal economy and the external environment re-emphasises the importance of autonomy in decision making. The developments since 1992 have not worked in a manner to vindicate the hope expressed by the CFS. Though in the last year or so some steps have been taken to grant a measure of autonomy to those public sector banks that have met some specific performance parameters in areas like branching and recruitment of professionals, this does not address the central issues. In critical areas there is still considerable direction from the owners and administrative directives and regulations in areas which should more appropriately be of concern for internal management but this we understand flows from the current statutory requirements. It also appears to be the case that managements of banks are not keen on autonomy and feel more comfortable under the protection of Government in several areas. Even in respect of credit approvals and other important management decisions a committee of the boards consisting, apart from the Chairmen, the Executive Directors of the banks, the Government and RBI director and the chartered accountant member and another member (by rotation) of the board is vested with the authority to take decisions.

5.26. The world over, corporate organisation is marked by a separation of ownership and management. In India, however, ownership has become an instrument of management. The distinction between ownership responsibility and managerial duties has got blurred. In the absence of autonomy, it has been difficult to assign accountability for performance (or non performance). Management initiative in the process has suffered and banks have been found wanting in responding quickly and adequately to the changing environmental situation. The CFS recommendations, in retrospect, appear to be a case of triumph of hope over experience.

5.27. Autonomy is not an absolute. It has necessarily to go with clearly enunciated accountability. In the Committee's view it is for the boards of the banks to take decisions on corporate strategy and all aspects of business management and to be responsible for the same to the stakeholders, viz., the shareholders, the customers, employees and the public at large. As long as Government happens to be the sole or major shareholder of the banks, the boards have necessarily to be responsible to Government, which is a factor that has led to the present situation. The Committee attaches the greatest importance to this issue of autonomy with accountability. In the light of developments since the CFS Report was written, it would wish to re-examine the question as to whether full functional autonomy with accountability is indeed consistent and compatible with public ownership.

5.28. The Committee would like to stress that its views in this matter are not in any way influenced by any questions of ideology. The Committee has approached the issue purely in terms of a pragmatic assessment of the present situation and in terms of evolving a practical solution to the problems of effective and efficient management of our public sector banking institutions.

5.29. There are certain other considerations which also suggest the need to review the question of the public sector having by law a majority share in the ownership of banks. As mentioned in an earlier Chapter, Indian banks by and large are not sufficiently capitalised though most of them may have met the standards set in 1992. Given the dynamic context in which our banks are operating and considering the situational experience the point was made in an earlier Chapter that further capital enhancement would be necessary for the larger Indian banks and especially those which wish to have an international presence. Against the background of the need for fiscal consolidation and given the many demands on the budget for investment funds in areas like infrastructure and social services, it cannot be argued that subscription to the equity of our public sector banks to meet their enhanced needs for capital should command priority. Public sector banks should be encouraged, therefore, to go to the market to raise capital to enhance their capital. At present, the laws stipulate that not less than 51% of the share capital of public sector banks

should be vested with the Government and similarly not less than 55% of the share capital of the State Bank of India should be held by the Reserve Bank of India. The Committee believes that these minimum stipulations should be reviewed. It would suggest that the minimum share holding by Government/Reserve Bank in the equity of the nationalised banks and the State Bank should be brought down to 33%. The Reserve Bank as a regulator of the monetary system should not be also the owner of a bank in view of the potential for possible conflict of interest$. Accessing the market would engender a discipline of its own in terms of performance which would enhance shareholder and enterprise value. The market is usually a hard task master. Responsibility would, therefore, be cast on managements to manage their institutions in a manner which enhances profitability through improvements in productivity and efficiency. To enable them to discharge their managerial duties with a measure of operational flexibility, they would need to be given adequate functional autonomy within the framework of accountability. The issue of autonomy and effective corporate governance are thus closely linked. The market perception of the quality of corporate governance is important for banks would constantly need to enhance their capital with growing volume of business by going to the market as an increase in net worth only through internal accruals to reserves may not be large or quick enough to meet these needs.

5.30. It would not be necessary for the Government/RBI to divest their stake in those nationalised banks accessing the market and in the State Bank of India. A reduction in their shares would come about through additional subscription by the market to their enhanced capital.

5.31. A proportion of up to 5 or 10% of the equity of the bank concerned may be reserved for employees of the bank with a provision at some later date for the introduction of stock options. This would give the employees a positive stake in the banks and their involvement in their progress.

5.32. The CFS had strongly urged that appointments to the posts of Chairmen and Managing Directors and the Boards of banks be depoliticised as a major step towards giving banks and financial institutions a measure of functional autonomy and operational flexibility. A measure of depoliticisation has, as mentioned earlier, been effected with respect to appointments of Chairmen and Managing Directors and Executive Directors of public sector banks. The same is not the case with other Board level appointments. The Committee recommends that all Board appointments should be made by the Government on the recommendations of the Appointments Board. The appointment by the Government of Boards and top executives of banks derives from its majority holding and if, as suggested above, the majority holding itself were to be given up, the appointment of Chairmen and Managing Directors should be left to the Boards of the banks and the Boards themselves left to be elected by shareholders. Needless to say, with a significant stock holding of not less than 33%, Government would have a say in the election of Boards and indirectly of the chief executives without their being seen as administrative appointments.

5.33. The reduction in the minimum holding of Government below 51% would in itself be a major and clear signal about the restoration to banks and financial institutions of autonomy in their functioning. The Committee makes this recommendation in the firm belief that this is essential for enhancing the effectiveness and efficiency of the system and not on any other consideration.

5.34. The CFS in its report had made a number of recommendations with a view to providing operational flexibility, internal autonomy and a measure of competition to DFIs. Recommendations were made with regard to appointment of Chief Executive and Boards of DFIs, doing away with consortium approach, encouraging commercial banks to provide term finance, permitting DFIs to provide core working capital, doing away with the cross holding of equity and cross representation if the Boards, removal of tax concessions to IDBI and transferring of direct lending function of IDBI, etc. One of the important recommendations made by the Committee was that DFIs should obtain resources from the market on competitive terms and that their access to concessional finance through the SLR should be phased out. Some of these recommendations have since been implemented. DFIs no longer have access to concessional finance through SLR etc. There have also been initiatives towards corporatisation of DFIs. IFCI has been corporatised and made a joint stock company under the Companies Act. As regards hiving off direct lending activities of IDBI, the issue needs to be considered anew in the changed environment. IDBI has set up its

$ Pursuing this line of reasoning, the CFS had recommended in 1991 that the Reserve Bank should withdraw its directors from the Boards of commercial banks.

own banking company and it now provides not only working capital financing but also undertakes many other related activities. It would be desirable to corporatise IDBI and make it a joint stock company. Since IDBI has already issued its shares to public, corporatisation of IDBI should not pose difficulties. Once IDBI is corporatised, the refinance function vested with it could be hived of to a separate entity such as SIDBI, which should be delinked from IDBI. The refinancing of SFCs is now appropriately vested with SIDBI and to provide focussed attention to the work of SFCs, IDBI shareholding in them should be transferred to SIDBI. The modalities of bringing harmonisation in the role and operations of banks and FIs including state level institutions and the regulatory framework therefor are currently engaging the attention of the Working Group under the Chairman, IDBI.

5.35. NBFCs are playing an increasingly important role in the country. The aggregate deposits (including 'exempted deposits') mobilised by NBFCs increased from Rs 51185 crores in 1992 to Rs 295345 crores in 1996. The rate of growth of regulated deposits of NBFCs in 1996 has also been much sharper compared to that of scheduled commercial banks. As mobiliser of funds and purveyors of credit at the retail end of the market, NBFCs have thus a useful role to play. Often the rates of interest offered by NBFCs were high leading to the problem of adverse portfolio selection. In a market where information is freely available, the problem of adverse selection should not be an issue, for the investor is expected to make an 'informed' decision. In our conditions, however, there is a considerable measure of information asymmetry. Depositors do not have the benefit of full information. NBFCs undertake a number of activities such as equipment leasing, hire purchase, housing finance, consumer finance, loans and investments, etc. Hire purchase/ leasing companies have played a major role in channelling resources to asset finance area (e.g., transport). Though introduced in India in 1991, factoring has witnessed constrained growth and the concept is yet to gain popularity and desired status among the business community as well as the commercial banks. The Committee believes that the way forward is to develop linkages between the commercial banks and NBFCs. Small and local intermediaries possess information advantage over larger and non-local agencies. There are interesting possibilities in NBFCs undertaking the retailing of banks' activities on consumer HP and equipment finance. While they depend upon the banking sector for finance, banks have shown some reluctance on account of NBFCs weaning away their customers. The extent of bank finance available to NBFCs is regulated. In an integrated financial system, there should be complementarity between banks and NBFCs. NBFCs have the advantage of large network of agents and branches. Linkages with well run NBFCs would have the benefits of cost effectiveness.

5.36. The RBI has recently announced a comprehensive regulatory framework for NBFCs. All NBFCs are statutorily required to have a minimum net worth of Rs.25 lakhs if they are to be registered. The Committee is of the view that this minimum figure should be progressively enhanced to Rs 2 crores, which is permissible now under the statute and that in the first instance it should be raised to Rs 50 lakhs. The protection of the depositor's interest is paramount and an enhancement as suggested above is intended to build a strong and healthy NBFC sector. The quantum of deposits which an NBFC can raise has been linked to the credit rating obtained by it. Capital adequacy, prudential norms on income recognition, asset classification and provisioning on par with banks have been made applicable to NBFCs. Likewise, reserve requirements have also been prescribed. These are clearly steps in the right direction both as a measure of promoting the safety of depositors' funds and of extending surveillance to their credit activities.

5.37. There have been some suggestions that the deposits with the Non Banking Finance Companies should also be covered by a deposit insurance scheme. Deposit insurance for NBFCs could blur the distinction between banks, which are much more closely regulated and the non banks as far as safety of deposits is concerned and consequently lead to a serious moral hazard problem and adverse portfolio selection. The Committee would, therefore, advise against any such insurance for deposits with NBFCs.

5.38. The large number of NBFCs operating in the country makes the supervision of NBFCs a difficult task. As a result, the inspection and audit of NBFCs have been delegated to external auditors and Chartered Accountancy firms while the RBI has set up a separate department to oversee NBFC sector under the guidance of BFS. While appreciating the practical considerations that have led to this decision, the Committee, nonetheless, has some reservations on the decision

to rely entirely on the assessment of the financial position of the NBFC and linking the quantum which it can raise as deposits to the rating given by credit rating agencies. This we believe is an essential regulatory function to be performed by the body entrusted with financial supervision. The recent developments have led to the need for an integrated approach to supervision. The blurring of distinction between banks and DFIs on the one hand and banks and NBFCs on the other as also the multiplicity of activities undertaken by them necessitates such an integrated approach.

5.39. Urban Cooperative Banks form an important segment of the system. These banks, primarily organised with the concept of promoting thrift and co-operation among the lower and middle strata of the society, have developed a niche market for themselves. As of March 1997, there were over 1,650 Primary Urban Cooperative Banks with a network of a little under 5000 branches and with deposits of about 6% of aggregate deposits of scheduled commercial banks. Recognising the importance of these banks in purveying credit primarily to the lower and middle income groups of the society, well run Primary Urban Cooperative Banks (UCBs) have been permitted to expand their area of operations. The Committee recognises that there is a place for these credit institutions to continue and grow in strength. The prudential and regulatory standards applicable to commercial banks are now also being made applicable to UCBs also though the current entry norms, specially the capital requirements are much too liberal and RBI should urgently undertake a review of these norms and prescribe revised minimum capital norms for these banks. An effective supervisory regime however, needs to be put in place for these banks. At present, the supervision of these banks is the responsibility of the RBI and not the Board of Financial Supervision. With a view to achieving an integrated system of supervision over the financial system, the Committee recommends that UCBs should also be brought within the ambit of the Board of Financial Supervision. One of the problem areas in supervision of the UCBs is the duality in control by the State Government and the Reserve Bank of India. Though co-operation is a state subject, since UCBs are primarily credit institutions meant to be run on commercial lines, the Committee recommends that this duality in control should be dispensed with. It should be primarily the task of the Board of Financial Supervision to set up regulatory standards for UCBs and ensure compliance with these standards through the instrumentality of supervision.

5.40. Deposit insurance is historically linked to banking failures. The benefits of deposit insurance are stability and attendant reduction in runs on banks. It has increased public confidence in the banking system, promoted savings in bank deposits and has enabled banks to perform the intermediation function more effectively through various forms of 'transformation' viz., size transformation, maturity transformation and risk transformation. Deposit insurance enables banks to operate with a much higher degree of leverage than other financial institutions.

5.41. While deposit insurance protects consumers and avoids systemic risks, it has altered the risks and returns in banking. Deposit insurance and the aversion to bank failures could create a moral hazard that distorts the incentives for banks and create competitive distortions. It could encourage higher risk taking by management since they can reap the gains resulting therefrom without bearing the full costs of that risk - the 'Pangloss' syndrome as it has been referred to. The depositors, on the other hand, are indifferent to management actions or the financial position of the bank as their exposure is on the deposit insurance fund and not the bank. One of the objectives for bank regulation is, therefore, to reduce the risk the banks pose to the deposit insurance fund.

5.42. The Committee is of the view that there is need for a reform of the deposit insurance scheme. In India, deposits are insured upto Rs 1 lakh. There is no need to increase the amount further. There is, however, need to shift from the 'flat' rate premiums to 'risk based' or 'variable rate' premiums. Under risk based premium system, all banks would not be charged a uniform premium. In fact, a basic principle in insurance is that the premium is assessed taking into account the risk being taken by the insurance company and higher risks are subject to higher premium. A similar system should be followed in the case of deposit insurance. While there can be a minimum flat rate which will have to be paid by all banks on all their customer deposits, institutions which have riskier portfolios or which have lower ratings should pay higher premium. There would thus be a graded premium. As the Reserve Bank is now awarding CAMELS ratings to banks these ratings could form the basis for changing deposit insurance premium.

Integration of the Financial Market

A.1. A well integrated financial market is the sine qua non of a well developed financial system. Over the years, particularly since the submission of the 1987 Report of the Working Group on the Money Market (Chairman Shri N Vaghul), a series of measures have been undertaken in an endeavour to develop the money market and to integrate it with the forex and securities market. The various segments of a financial market to function well should be seamless and well integrated and changes in one segment should have an impact on the other segments. The Committee is of the view that although much has been achieved over the past decade, there are certain structural impediments in the development of the financial market and unless these issues are tackled the Indian financial market will remain stunted. While restructuring the financial market is itself a major task, the Committee has certain specific suggestions which would facilitate the smooth functioning of a well developed and integrated financial market.

A.2. The Indian money market, despite commendable efforts over the years, remains lop-sided, thin and extremely volatile. The inter-bank call market, which is the epicentre of the money market, has certain structural weaknesses which need to be addressed. Unlike in most well developed inter-bank call money markets the market in India is not strictly an inter-bank market as access is provided to a large number of non-bank participants, primary dealers, financial institutions and mutual funds. While the access to non-bank participants has been a source of comfort to these institutions, it has not led to the development of a stable market with liquidity and depth.

A.3. The non-bank participants, unlike the banks are not subjected to reserve requirements and the market is characterised by chronic lenders and chronic borrowers and there are heavy gyrations in the markets. Moreover, while the Reserve Bank of India does not have an effective presence in the market, it operates predetermined lines of refinance, though in the more recent period the Repo rate has been used to impart an element of stability to the inter-bank call money market.

A.4. Freeing of interest rates, as has been done in the recent past, has not yet resulted in the emergence of an interest rate structure that reflects the differences in liquidity, maturity and risk. The prevailing interest rate structure is in fact indicative of a segmented financial system. The banks' role in the money market has been impaired by the health of their own balance sheet, the lack of integrated treasury management and sound asset-liability management. The market lacks a well defined yield curve from the short-term to the long maturity. Nor is there a market determined wholesale refinance rate like the LIBOR to price instruments and help in the emergence of a mature market with depth and opportunities for risk diversification. While interest rates on money market instruments are linked to the interest rate in the inter-bank segment, volatility in call money rates inhibits proper interest risk management and pricing of instruments. For the debt market to develop, a market determined yield curve is essential since this device facilitates the pricing of floating rate debt instruments. Besides the factors indicated above, another reason often cited for the lack of a reference rate is the reserve requirements of inter-bank borrowings, which have been substantially reduced in the recent period. Banks in India do not really assess the interest rate scenario and take a view of the interest rate and then act on the basis of such a view. There is, therefore, no inter-bank term market of different maturities and this is essential for the development of term structure of interest rates. As a result, the call money market is used as an ongoing funding source essentially by chronic borrower banks to meet reserve and other funding requirements.

A.5. The Committee has elsewhere recommended that banks should put in place proper asset-liability management policies which should prescribe tolerance levels for mismatches in various time bands. In view of interest rate deregulation, it is necessary to take steps to create conditions for developing a money market reference rate on the pattern of LIBOR to enable issuance of floating rate instruments/deposits and develop a yield curve. Without a six month yield curve with deep liquidity therein, it is also not possible to have a liquid forward forex market developing as it would have to depend on interest rate differentials to be viable. Similarly, other derivatives, whether for interest rate risk management purposes or for options markets, cannot be introduced unless there is a viable money market of upto 6 months tenure.

A.6. Although the Vaghul Working Group had categorically recommended that the inter-bank call money market should be strictly restricted to banks, the Reserve Bank of India did not accept this recommendation and instead of the two non-bank parties, viz., UTI and LIC being taken out of the call money market, a large number of non-bank parties were provided access to the call market. The ostensible reason for not restricting the call market only to banks was that it was felt that the money

market should not be 'fractured'. In retrospect, this decision has not worked towards a well developed money market and the time has come to undertake a basic restructuring of the call money market.

A.7. The Committee is of the view that the inter-bank call and notice money market and inter-bank term money market should be strictly restricted to banks. The only exception should be the primary dealers who, in a sense, perform a key function of equilibrating the call money market and are formally treated as banks for the purpose of their inter-bank transactions. All the other present non-bank participants in the inter-bank call money market should not be provided access to the inter-bank call money market. These institutions could be provided access to the money market through different segments as discussed subsequently.

A.8. Secondly, there must be clearly defined prudent limits beyond which banks should not be allowed to rely on the call money market. This would reduce the problem of vulnerability of chronic borrower banks. Access to the call market should be essentially for meeting unforeseen swings and not as a regular means of financing banks' lending operations. Thirdly, the interest rates movements in the inter-bank call money market should be orderly and this can only be if the RBI has a presence in the market through short-term Repos for as short a period as one day through the primary markets. The RBI support to the market should be through a Liquidity Adjustment Facility under which the RBI would periodically, if necessary daily, reset its Repo and Reverse Repo rates which would in a sense provide a reasonable corridor for market play. While there is much merit in an inter-bank reference rate like a LIBOR such a reference rate would emerge as banks implement sound liquidity management facilities and the other suggestions made above are implemented. Such a rate cannot be anointed, as it has to earn its position in the market by being a fairly stable rate which signals small discrete interest rate changes to the rest of the system.

A.9. Non-bank parties can be provided free access to bill rediscounts, commercial paper (CP), Certificates of Deposits (CD), Treasury Bills (TB) and Money Market Mutual Funds (MMMFs). The issue does arise of the minimum period for the issue of these instruments. At present, the minimum period for bills rediscounting by scheduled commercial banks is 15 days. The minimum lock-in period for CDs, CP and MMMFs is 30 days. In the restructuring of the market, proposed by the Committee, the minimum period of fixed deposit could, in the first instance, be reduced to 15 days and all money market instruments should likewise have a similar reduced minimum duration. There is reason for keeping a minimum duration for fixed deposits as in the absence of such a minimum all current accounts would become fixed deposits and thereby greatly add to the cost of funds of banks. The question needs to be addressed of the non-bank institutions, which have funds for a duration less than the minimum period stipulated for money market instruments. At the present time, the investors in money market instruments invariably hold the instruments to maturity and as such there is no secondary market in these instruments. In the kind of structure envisaged by the Committee, there will be an active secondary market in money market instruments. The Committee is of the considered view that these structural changes would result in the development of a strong and stable money market with liquidity and depth.

A.10. At the present time, there is an absence of a link between the money and securities market. While much has been done to develop the securities market, there has been a serious setback to the development of the Treasury Bill market which has been dislocated by interest rate rigidities. The Committee notes with satisfaction that the link between the 91 days Treasury Bill and the interest rate on Ways and Means Advances, which was meant to be a transitory arrangement, has been severed as it was operating in a manner detrimental to the development of the 91 days Treasury Bill market. Because of this link the 91 days Treasury Bill market had become dormant. It is imperative that the 91 days Treasury Bill market should reflect conditions in the money market. The Committee recommends that the RBI should totally withdraw form the primary market in 91 days Treasury Bills; the RBI could, of course, have a presence in the secondary market for 91 days Treasury Bills. If the 91 days Treasury Bill rate reflects money market conditions, the money and securities market would develop an integral link. The Committee also recommends that foreign institutional investors should be given access to the Treasury Bill market. Broadening the market by increasing the participants would provide depth to the market.

A.11. With the progressive expansion of the forward exchange market there should be an endeavour to integrate the forward exchange market with the spot forex market by allowing all participants in the spot forex market to participate in the forward market upto their exposures. Furthermore, the forex market, the money market and the securities market should be allowed to integrate and the forward premia should reflect the interest rate differential. As instruments move in tandem in these markets the desiderative of a seamless and vibrant financial market would hopefully emerge.

Chapter VI

Rural and Small Industrial Credit

6.1. Credit to agriculture and the small industrial sector has always commanded special attention, both in terms of policy issues and institution building efforts in view of their recognised importance in our national economy and especially in relation to their employment potential, income redistribution and support to the balance of payments. These two sectors have also been the beneficiaries of the policy of directed credit which, as an earlier Chapter has discussed, has also created its own problems.

6.2. The Committee recognises the imperative need to maintain adequate flow of credit to these sectors. The Committee also recognises the need of the small and marginal farmers as well as micro entrepreneurs requiring small loans which has to be met to make them competitive and efficient. However, because of regulated interest rates which did not meet the financial and operating cost of the institutions, the poor implementation of subsidy linked Government programmes, vitiated credit culture, coupled with organisational inadequacies in the rural financial institutions (RFIs) priority sector lending has resulted in higher NPAs, poor recovery rates and low profitability. While some of the deficiencies have been corrected as part of the financial sector reforms introduced since 1992, it is necessary to take further measures to improve the asset quality and profitability of priority sector lending. In this Chapter we address the specific issues of rural and small industrial credit in terms of issues relating to policy and institutions.

6.3. As observed in the preceding paragraphs the main policy issues revolve around directed credit. Currently, the mandate requires that commercial banks lend 40% of net bank credit to the 'priority sector' with sub-targets of 18% to agriculture, 10% to weaker sectors and different sub-targets under SSI sector, linked to loan size. The priority sector also includes the Government directed programmes which involve provision of capital subsidy along with credit and a major role to the Government agencies in the identification and selection of borrowers. Experience with the implementation of the Government sponsored programmes has also not been altogether happy and instead of developing a sustainable ongoing bank-client relationship, the IRDP and other Government sponsored programmes have become a 'one shot' operation of lending. The Committee is of the view that the banking system should be in a position to equip itself to identify the eligible clients based on prescribed norms in the Government sponsored programmes so that the full responsibility for all aspects of the credit decision remains with it. This should also help improve the client-bank relationship instead of the present system of virtually imposed clientele and build a credit culture and discipline. The credit delivery systems in respect of rural credit also need attention to make them more effective, speedy and transparent. The Committee understands that RBI has constituted a one-man committee to review the delivery systems and expresses the hope that improved systems would be put in place following the review.

6.4. While the mandate has resulted in an expanded flow of credit to the sub-sectors and the economically weaker segments of the population, the implementation of the programme has also resulted, as mentioned earlier, in higher NPAs, poor recovery rates and low profitability. As mentioned earlier, about 47% of the NPAs in public sector banks is accounted for by the portfolio under directed lending. This higher level of contamination is largely due to ill-administered Government subsidy programmes. NPAs are also higher in RRBs and cooperative banks. Based on the available data of 196 RRBs, the gross NPAs constitutes 36.5% of their outstanding loan portfolio. Similarly, the gross NPAs of 178 DCCBs constitute 17% of their loan portfolio. There is a need to review and strengthen the operating systems of RFIs in terms of appraisal, supervision and follow-up, loan recovery strategies and development of bank-client relationships.

6.5. Risk management systems in agriculture have not yet been properly developed. Today, the banking system perceives high risk in financing agriculture, which is subject to natural calamities and seasonal vagaries. Evolution of a risk management mechanism would provide greater comfort to the banking system to finance agriculture. The reasons for the high level of NPAs in this sector were spelt out earlier while the low profitability of these transactions derive both from a subsidised interest rate structure and the higher unit costs of administering their loans.

6.6. The Committee also recommends that a distinction be made between NPAs arising out

of client specific and institution specific reasons and general (agro climatic and environmental issues) factors. While there should be no concession in treatment of NPAs arising from client specific reasons, any decision to declare a particular crop or product or a particular region to be distress hit should be taken purely on techno-economic consideration by a technical body like NABARD. In such a situation, a rescheduling programme could be considered and this need not be regarded as a case of 'evergreening'. Such a decision has to be taken totally free of political considerations.

6.7. In an earlier Chapter, the Committee has indicated the lines in which the present system of priority sector lending should be adapted keeping in view not only the requirements of the sectors concerned but also safeguarding the interests of banks and their profitability by correcting the distortions that have crept in and building a system where credit even to the priority sector would be made on the basis of proper credit appraisal and the credit worthiness of the borrower and follow this up with proper monitoring of the end use of credit and with stress on credit discipline and repayment capacity. In this context, the Committee strongly urges that there should be no recourse to any scheme of debt waiver in view of its serious and deleterious impact on the culture of credit. The Committee has recommended in an earlier Chapter that the subsidisation of interest rate even in respect of loans upto Rs 2 lakhs provided by commercial banks should be removed.

6.8. As a measure of improving the efficiency and imparting a measure of flexibility the Committee recommends consideration of the debt-securitisation concept within the priority sector. This could enable banks which are not able to reach the priority sector target to purchase the debt from institutions which are able to lend beyond their mandated percentage. This could also involve a repo transaction before the debt matures to avoid liquidity and credit risks to the purchasing banks. Alternatively, a simple mechanism of transfer of part of the priority sector portfolio of the institution which is able to reach a higher percentage to another institution on payment of an agreed premium which would reflect the transaction costs and risks of the primary lender could be tried. While this may help the attainment of the priority sector targets over the system it should be pointed out that this by itself may not help to even out regional distortions in credit supply. The "excess" of credit over the mandated figure may well represent credit in the better banked areas and transferring this to another credit institution would not help in meeting the credit needs in less developed regions. Similarly, a mechanism could be considered that could facilitate the RRBs and other RFIs which may have "excess" lending to agriculture and small scale sector to transfer them to banks which may not have the same branch outreach and which might prefer to purchase the rural or small industry debt portfolios towards their priority sector commitments.

6.9. The Committee has earlier suggested a further enlargement of the coverage of the priority sector. This should give banks and credit institutions a greater measure of flexibility. In any event, with the progressive reduction of the SLR/CRR, the funds available for credit disbursement with the banks has been considerably enlarged and 40% of the credit totals today could be somewhat under twice what it was when pre-empted investments (at the margin) accounted for around 63% of banks' liabilities.

6.10. At present, under the Income Tax Act general provisions for bad and doubtful debts not exceeding 5% of income and 10% of the aggregate average advances made by rural branches of a scheduled or a non scheduled bank are allowed as deductions in computing the income chargeable to tax. Consideration could be given to increasing this to 5% of income and 20% of average aggregate advances of rural branches to provide incentives to banks for lending to rural sectors.

6.11. In respect of rural credit, legal support mechanisms are important for recovery as the present system is somewhat inadequate. Even where the law has been enacted by State Governments based on the recommendations of the Talwar Committee to recover priority sector debts under Revenue Recovery Act, the implementation has not been effective on account of recovery officers not being placed at the disposal of the banking system in adequate numbers.

6.12. At present, prudential norms, viz., assets classification, provisioning and income recognition have been applied to RRBs and cooperative banks. The other remaining issue relates to extending capital adequacy prescription to RRBs and cooperative banks. Capital adequacy prescription to

the RFIs is important to develop a sound and healthy rural financial system. The Committee recommends that the RRBs and cooperative banks should reach a minimum of 8% capital to risk weighted assets over a period of 5 years. As regards the RRBs the Committee suggests that, a review of their capital structure be undertaken with a view to enlarging public subscription in line with the recommendation of the 1975 Working Group on establishing RRBs. Sponsor banks should be given greater ownership and responsibility in the operation of the RRBs. The RRBs were conceived of as instruments of low cost banking in rural areas and with that object in view, the salaries of the staff of these banks were originally fixed at the levels prevailing in respect of State Government employees of comparable rank. However, consequent upon the Award of a National Industrial Tribunal and its acceptance by the Government, the salaries of the employees of RRBs were revised upwards to be on par with those prevailing in commercial banks, considerably diluting the very rationale for setting up the RRBs. The Committee is, however, given to understand that there have been subsequent legal pronouncements to the effect that the award cannot be construed to mean parity of pay scales between the employees of RRBs and those of commercial banks for all time to come. Consequent upon this the Reserve Bank of India, on a suggestion from the Government, had set up a Committee to examine the question of suitable pay scales for the employees of RRBs so that Government of India could determine the emoluments of employees of RRBs under Section 17 of the RRBs Act. This Committee would strongly urge that while considering this issue the basic feature of RRBs as low cost credit delivery institutions should not be diluted any further. As regards the co-operative credit system, the Committee urges that consideration be given to delayering of the system with a view to reducing the intermediation costs and providing the benefit of cheaper NABARD credit to the ultimate borrowers. Cooperative credit institutions also need to enhance their capital through subscription by their members and not by Government.

6.13. The Committee notes that NABARD was established in 1982 with quasi central banking functions over the rural credit institutions with a view to relieving RBI from the operational aspects of supervision over numerous rural financial institutions and to facilitate RBI to focus on monetary policy and regulation of commercial banks. As a corollary while the regulation of the rural financial institutions remains with RBI, the supervisory function has been entrusted to NABARD which has the overall mandate of facilitating adequate credit flow to agriculture and smaller of small scale industry. The Committee understands that NABARD has initiated re-engineering of its supervisory systems on the lines of the improvements/refinement of supervisory system by RBI. In Chapter VII the Committee has made recommendations relating to improvement in the supervisory system over commercial banks and financial institutions. The improvement in design and procedure of supervision recommended therein may be adopted by NABARD, mutatis mutandis, taking into account the special characteristics of rural financial institutions, falling under its supervisory jurisdiction. While this arrangement may continue for the present, over the longer term, the Committee would suggest that all regulatory and supervisory functions over rural credit institutions should vest with the Board for Financial Regulation and Supervision.

6.14. The present duality of control over the cooperative credit institutions by State Government and RBI/NABARD should, we believe, be eliminated and all the cooperative banking institutions should come under the discipline of Banking Regulation Act under the aegis of RBI/NABARD/BFS. This would require amendments to the Banking Regulation Act. The control of the Registrar of Cooperative Societies over cooperatives would then be somewhat on the lines of control that Registrar of Companies has over the Banking Institutions, registered under the Companies Act.

6.15. The Committee notes the recent developments in banking policy providing linkages between self-help and thrift groups and banks as an effective instrument to provide banking facilities to poor, without subsidies and Government support. The Committee notes with appreciation that in areas where this has been tried the repayment record under these linkage banking programmes has been good. Various other initiatives have also taken place involving NGOs in micro-credit operations. The Committee recognises the need for banking policy to (a) facilitate evolution of cost effective systems for banking for the poor, with satisfactory linkages; and (b) support scaling up of such efforts resulting in expanded outreach as well as high quality of loan assets.

6.16. The main issue is to evolve a system whereby the RFIs at the district and sub-district

level can be constituted into a third tier of banking as indicated in the Chapter on structure of banking institutions. This would call for a re-examination of the earlier recommendation of CFS with regard to reorganising of commercial banks' rural branches. Banking policy should facilitate the evolution and growth of micro credit institutions, including LABs which focus on agriculture, tiny and small scale industries, including such specialist institutions as may be promoted by NGOs for meeting the banking needs of the poor. Third-tier banks should be promoted and strengthened to be autonomous, vibrant, effective and competitive in their operations.

6.17. Regional Rural Banks (RRBs) which have achieved viability or which have potential to become viable in the future may be allowed to continue in their present form. However, selective mergers of RRBs sponsored by the same bank within the same State could be considered to provide economies of scale and optimum use of human resources.

6.18. The RRBs, cooperatives and other third-tier banking institutions having focus on agricultural and small scale industries would have close linkages with NABARD and SIDBI for resource support as well as institution building. The RFIs in the third-tier should also be linked with the rest of the financial system through equity and resource linkages.

6.19. Credit flows to small scale industries as part of priority sector directives have increased considerably to reach 16.6% of net bank credit as on March 1997. Despite this increase, complaints continue regarding inadequacy of credit and suggestions accordingly made to enhance credit flows to this sector by liberalising credit appraisal norms. Recent examples of this are the recommendations of the Nayak Committee and endorsed by the Abid Hussain Committee. While it is certainly true that banks and other credit institutions should devise appraisal criteria suited to the small industrial sector and be responsive to genuine credit needs, such a responsive approach need not and indeed should not sacrifice sound canons of banking prudence. If banks have problems in financing this sector it is based partly on their experience with the high incidence of sickness in the sector. As on March 1996, the outstanding credit to sick units in the small scale sector was reported to be Rs 3,722 crores. Banks should be concerned with the proper utilisation of credit and repayment capacity of the borrowers. Borrowers on their part need to accept credit discipline in matters such as furnishing on a transparent basis full and adequate details of their turnover and other aspects of their operations. Credit institutions should also help in developing the greater use of bills as is now required by policy and assist in developing factoring services. The Committee has taken note that RBI has set up a one-man Committee to review credit delivery systems to SSIs.

6.20. State level financial institutions, viz., State Finance Corporations, State Industrial Development Corporations and State Small Industries Corporations (SSICs) which have been set up in different States have played a significant role in providing credit, financial and escort services to the small and medium industrial units. However, the financial health of most of these state level institutions leaves much to be desired. The recovery rate of SFCs averaged nearly 37% of demand and the NPAs constituted 39% of the loan portfolio of the SFCs. Several Committees - and most recently, the Abid Hussain Committee - have pointed out the weakness in their functioning and the heavy political and administrative interference in their working. This needs correction and as a first step towards the eventual disinvestment by the State, these institutions should be corporatised and work within the ambit of the Companies Act. The IDBI holding of their capital could also be transferred to SIDBI which in any case is the referring agency for them. There is need also for restructuring of the state level institutions into a single state level financial institution.

6.21. In conclusion, the Committee recognises the importance of agriculture and small scale industries to the national economy. A sudden reduction of priority sector targets could have the danger of a disruption in the flow of credit. With the removal of the concessional rates on loans upto Rs 2 lakhs as proposed by the Committee, the authorities should consider a phased move away from overall priority sector targets and sub-sector targets. The Committee recognises that the enhancement of credit to these sectors is critically dependent on the availability of adequate infrastructure in these areas.

Chapter VII

Regulation and Supervision

7.1. No financial or banking system, anywhere in the world, is unregulated. National concerns with regulating financial and banking systems stem from the central role they play in an economy's functioning and the public responsibility for ensuring the safety of funds committed by depositors or investors in financial institutions. Depositor and investor confidence in the system is basic to the growth of the financial sector and for successful financial intermediation. The safety of funds placed with financial institutions is a function of the solvency and liquidity of the institutions concerned and ensuring that institutions remain solvent and liquid is the proximate objective of regulation. This translates itself into ensuring a set of accurate, transparent and credible accounts, sound asset quality, judicious asset liability management and adequate capital cushion and the pursuit of well laid down prudential norms relating to provisioning and other aspects as well as encouraging sound management practices. These should constitute the content of a well designed regulatory policy.

7.2. Regulation could be considered to be the framework of policy in this regard and supervision the instrumentality to ensure compliance with regulatory prescriptions through both off-site surveillance and on-site inspection. In more mature economies with well developed financial systems, greater reliance is placed on off-site surveillance implying a greater measure of confidence in the self-regulating capacity of the constituents of the system through aspects of management based on internal controls, audits and inspection. Even in these economies, such off-site surveillance is often supplemented by on-site inspections wherever appropriate.

7.3. The system that had evolved in India was marked by an ever increasing range and complexity of regulations governing virtually every aspect of banks' working through a host of directives supplemented by heavy reliance on periodic on-site inspections. The very complexity, extensive range and intensity of regulating directives led to a situation where regulation and supervision tended to go into detailed aspects of internal administrative and other minutiae of banks' working resulting in a case of micro management of the institutions. This was a situation that led the CFS to remark that the system was "over-regulated and over-administered". That such a system failed to arrest the deterioration in portfolio quality with its corollary of high and rising levels of NPAs, declining profitability and under-capitalisation along with a measure of opacity in accounts was indicative of its relative ineffectiveness in meeting the basic objectives of regulatory policy. The regulatory exercise tended to get dissipated over so many areas that a form of Gresham's Law was in operation where excessive attention to relatively inessential aspects of regulatory interest did not leave enough time or effort for concentrating on the essential and critical elements determining the performance of banks such as sound asset liability management, asset quality and the disposition of assets in the form of credit and investment to meet larger economic objectives of growth even while keeping institutions themselves solvent and liquid.

7.4. The CFS made the point that while it was essential that the financial system be regulated the regulation itself should cover essential aspects of protecting the quality of assets and the emphasis in its approach was accordingly on the prescription of prudential norms and statutory requirements relating to asset quality such as minimum liquidity ratios, qualitative and quantitative checks on credit portfolios, stipulation of risk asset limits, checks on individual credit exposure, prescription of well accepted and transparent accounting practices, provisioning norms and disclosure requirements, as well as prescription of minimum capital adequacy norms. It suggested that the system should be impersonal and objective and move towards self-regulation which in turn would call for strengthening the management quality and internal controls, inspection and internal audit systems of banks.

7.5. In this sense, regulation/supervision should act as a backstop to internal governance and market discipline. The evaluation of the quality of management and the adequacy of internal controls and internal audit as well as adequate provisioning should essentially be on the basis of off-site surveillance as recommended by the CFS. The regulatory/supervisory authorities' emphasis should increasingly be on assessing the quality of management, adequacy of policy procedures

and systems used by the banks to assess and limit risks. Where the supervisor comes in is to examine in addition to these aspects individual bank's positions related to a systemic view of the bank's overall exposures.

7.6. The Committee believes that this approach continues to have validity. In fact, given the far reaching changes in the broader macro economic and institutional environment, with a greater measure of deregulation of industry and trade and in the light of international developments, it is vitally necessary for the regulatory exercise to concern itself with the main determinants of financial soundness of banks (and financial institutions) with a view to minimising the emergence of both systemic risks as well as institution specific risks, such as market risk, income risk and asset price risk, in addition to the more usual forms of credit and liquidity risks.

7.7. In pursuance of the recommendations of the earlier Committee, a new supervisory strategy has been devised, the key elements of which are to restructure the system of bank inspections in terms of their focus, process, reporting and follow-up, setting up an off-site surveillance system based on supervisory report systems as a supplement to on-site inspections — it will be noted that this differs from the CFS recommendation for off-site surveillance to be supplemented by on-site inspection — enhancing the role of external auditors in the supervisory process, and, more generally, strengthening of corporate governance and internal control and audit functions as support systems for supervision.

7.8. Regulation and supervision, as observed earlier, are two aspects of the same discipline and the central issues involved here are: (a) What aspects should be regulated and, (b) In what manner and through what instrumentalities should regulation be exercised.

7.9. Regulation, in this context, refers to banking regulation as distinct from monetary policy regulation which appropriately should be the defining function of the central monetary authority, namely, the Reserve Bank of India. These two aspects are, of course, closely connected but this does not mean that they are the same. At an analytical level there could be a conflict in that monetary policy is supposed to have a counter cyclical effect whereas banking supervision policy could have a pro cyclical effect. Indeed there could be occasions when the banking regulatory interest may be somewhat at variance with a monetary regulatory objective, as, for instance, a policy of credit contraction and constricting liquidity could put individual banks in a liquidity squeeze to the point of the banking regulatory authority seeking to protect the institution from liquidity pressures. The central bank is closely involved in the payments system and the payments risk is a major concern also of the supervisory authorities. Central banks have to monitor liquidity and liquidity payments of the system will have to be made consistent with the conduct of monetary policy. Further, the difference between a liquidity crisis and a solvency crisis is sometimes difficult to discern. This is only an illustrative example that the two distinct sets of regulation could at times not be in full concert with each other. Thus, even while one should bear in mind this close inter-connection between monetary and banking regulation, the key concern of the banking regulatory exercise is to insulate it from external pressures. An autonomous regulatory and supervisory system which provides for a closely coordinated monetary policy and banking regulation would, in fact, be the ideal to work towards.

7.10. In the Indian context, the regulatory framework has become complex because it subserves diverse objectives apart from the basic objectives of ensuring solvency and liquidity of the institution concerned. Thus, it has been used as an adjunct to monetary policy where the instruments were one of controls rather than market oriented instruments of monetary policy. Again, with the predominant part of banking activity being in the public sector, the regulatory system has been used as an instrument to meet the proprietorial concerns of Government. The regulatory framework should not be used as a micro tool of monetary policy and should also eschew the use of regulatory devices to further proprietorial concerns. These attempts have led to the present situation where we have virtually a maze of controls which have become difficult to administer.

7.11. The first corrective step in this situation is a careful examination of the extant regulations to see which of them continue to have validity and relevance in the present context and geared to the central objectives of regulation, retain these and eliminate the rest. Those regulations which need to be continued should also be properly codified and made interconsistent. The Committee

understands that this process has now been taken on hand by the Reserve Bank and it commends the attempt to do so and looks forward to an early completion of this exercise.

7.12. The regulatory framework then would essentially be focused on prudential regulation covering all the major aspects which determine a bank's solvency and liquidity, and this would, as mentioned above, include such aspects as capital adequacy, asset quality and related provisioning norms, asset liability management and accurate accounting to present the true picture of the state of affairs of the institutions alongside full and adequate disclosure provisions. The task of the regulator should be to set down principles governing these aspects of banks' working. Some of these aspects of regulatory interest are encapsulated in the RBI's reference to the concept of CAMELS. There have been suggestions that the concept should be expanded to cover regulatory compliance and aspects of business planning, control system, organisation and technology. The RBI may wish to consider these suggestions.

7.13. In an increasingly integrated world the regulatory and supervisory norms have to converge between countries. In this connection, we would need to take note of the work of the Basle Committee of the BIS in evolving the various norms. The Basle Committee's norms were initially addressed to international banks based in the developed countries but over time the prudential norms came to be applied by national regulators the world over to all kinds of banks irrespective of the domestic or international nature of their activities. The Basle Capital Accord of 1988 was primarily concerned with capital adequacy in relation to credit risk, that is, the counterpart of bank failing to meet its obligations. In India, we adopted these norms in 1992 and, as mentioned in an earlier Chapter, most of our banks now meet the enhanced minimum capital adequacy ratios. Meanwhile, the Basle norms themselves have been progressively refined and as we integrate into the global financial system the time period available for us to adjust to the international norms would be somewhat less than at the time of the Capital Accord of 1988. In 1992, the Basle Committee established four principles of supervision of cross border banking and one of them was that international banks should be supervised by a home country authority, which in that capacity performs consolidated supervision. These principles become relevant for operation of Indian banks overseas and for monitoring their country exposures. In January 1996, the Basle Committee amended the 1988 Accord to apply capital charges to market risks arising from movements in market prices impacting on both on and off balance sheet positions. International banks were required to incorporate market risks into their risk based capital ratios by the end of 1997. The options that were given, as an earlier Chapter indicated, were either to adopt the standard risk rating process set out by the Committee or follow their own internal risk measurement models. Understanding of market risk management in our financial system is unfortunately not widespread. The Committee recommends that to strengthen the soundness and stability of the Indian banking system, the regulatory authorities should make it obligatory, as stated in Chapter III, for banks to take into account risk weights for market risks. The movement towards greater market discipline in a sense would transform the relationship between banks and the regulator. By requiring greater internal controls, transparency and market discipline, the supervisory burden itself would be relatively lighter. These are the changes that are taking place in the international financial scenario and our own approach to the regulatory/supervisory framework must take the international trends into account.

7.14. The Basle Committee has been, as mentioned earlier, constantly at work in refining regulatory and supervisory norms. In September 1997, the Committee set out a comprehensive set of "Core Principles" for Effective Bank Supervision. These Core Principles are intended to serve as a basic reference for supervisory authorities and are so designed that they may be verified by supervisors and more importantly by the market. We note that there is insufficient awareness of the Core Principles in India and perhaps even a complacent feeling that we are already implementing them in effect. This is not the case. There is, in fact, a need for all market participants to take note of the new guidelines. The implementation of the Core Principles by individual countries is to be reviewed by the BIS in October 1998. It is essential that we in India also formally announce full accession to these principles, their prescription to our financial institutions and their full and effective implementation. This is particularly so with regard to disclosure requirements to enable market participants to assess the risks inherent in any bank. While prescriptive norms for the regulators is the preventive aspect in terms of minimising the risks and providing for proper

corrective action, the supervisory authorities have a responsibility to ensure that prudential requirements are observed and arm themselves with the powers to enforce corrective penal action where such is called for.

7.15. The Basle Core Principles should in fact be regarded as the minimum to be attained. The reasons for this are, as discussed in an earlier Chapter, that given the greater element of financial volatility, which developing countries such as ours have to endure and, given also the relatively undeveloped market systems in terms of depth, width and international access, our norms should, if anything, go beyond what the Basle Committee recommends which is based on the situation and experience of the developed countries.

7.16. Of particular interest to us in India is the special section in the Core Principles on Government owned banks. While it is recognised that Government support can be an advantage, it also notes that precisely because they are Government owned banks, corrective action could be delayed or diluted and the concerned bank management continue to take excessive risks, especially as the market discipline also tends to be weaker in these cases. The Core Principles emphasise that Government owned banks should also be subject to the same exacting supervisory standards as private banks. We have enough evidence in India as to how proprietorial concerns in the case of our public sector banks impacts on the regulatory function leading to a situation of 'regulatory capture' where the regulators tend to identify regulatory activity with banking interests and as a consequence of which the quasi fiscal impact of such regulation affects the quality of regulation.

7.17. The Basle Committee has just formulated (in January 1998) a comprehensive framework for banks' internal controls and these guidelines are expected to be finalised by July 1998. These guidelines have their origin in the significant losses incurred by several banks owing to weaknesses in internal control systems, such as the relationship between the trading and back office functions. As Indian banks expand the area of their activity into greater volume of Treasury business and other newer forms of bank business and increasingly partake of derivative trading, it is essential that proper systems are put in place within the banks to minimise the exposure to risk even while putting risk management tools in place. The Committee recommends that our regulatory and supervisory authorities should take note of the developments taking place elsewhere in the area of devising effective regulatory norms and to seek to apply them in India taking into account our special characteristics but not in any way diluting the rigour of the norms so that our prescriptions match the best practices abroad. It is equally important to recognise that pleas for regulatory forbearance such as waiving adherence to the regulations to enable some (weak) banks more time to overcome their deficiencies could only compound their problems for the future and further emasculate their balance sheets. An instance in point is capital adequacy. A bank without capital adequacy which attempts, nonetheless, to grow would have incentive towards an adverse portfolio selection by taking greater risks in its credit and investment decisions.

7.18. In an earlier Chapter we discussed how while capital adequacy ratios were important for enhancing the inherent strengths of the institutions, merely satisfying these minimum ratios did not guarantee a bank from factors affecting its liquidity and solvency. As it was pointed out, proper asset classification, asset quality and asset liability management, income recognition and provisioning norms were at least as important as factors promoting solvency and profitability.

7.19. An important aspect of regulatory concern should be, as mentioned earlier, ensuring transparency and credibility of the state of affairs of financial institutions and this is particularly relevant as we move into a more market driven system where the market should be enabled to form its judgement about the soundness of an institution. An earlier Chapter referred to the importance of provisioning for various types of assets including standard assets and for adhering strictly not only to the letter but the spirit of defining NPAs to avoid a tendency where financial institutions and banks sometimes lend more to troubled borrowers to keep up the pretence that the accounts are regular. We had suggested that the supervisory authorities should take a firm view of such transgressions in spirit of the prescriptions and we repeat this recommendation here. There should be punitive penalties both for the inaccurate reporting to the supervisor or inaccurate disclosures to the public and one should add transgressions in spirit of the regulations. It is all

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the more necessary, therefore, that the rules prescribed by the regulator are clear and unambiguous and in the codification that we have suggested above, we would wish to emphasise the need for clarity. We cannot emphasise too strongly the importance of adequate disclosure which helps the general public to distinguish the sound from the unsound institutions. On a more general plane it is not as if the supervisor should concentrate only on substandard assets. Often, the entire portfolio of a bank needs to be put under scrutiny so that even the standard loan assets — the 'good' loans are looked into carefully to avoid the possibility of their subsequent descent into the substandard category.

7.20. The Committee is of the view that banks should be required to publish half-yearly disclosure requirements in two parts. The first should be a general disclosure, providing a summary of performance over a period of time, say 3 years, including the overall performance, capital adequacy, information on the bank's risk management systems, the credit rating and any action by the regulator/supervisor. The disclosure statement should be subject to full external audit and any falsification should invite criminal procedures (such punitive action is provided for in the Core Principles). This would, in a sense, be a disclosure which would be scrutinised by analysts and other specialists in the financial sector. The second disclosure, which would be a brief summary aimed at the ordinary depositor/investor should provide brief information on matters such as capital adequacy ratio, non performing assets and profitability, vis-_-vis, the adherence to the stipulated norms and a comparison with the industry average. This summary should be in a language intelligible to the depositor and be approved by the supervisors before being made fully public when soliciting deposits. Such disclosure, we believe, will help the strong banks to grow faster than the weaker banks and thus lead to systemic improvement.

7.21. The essence of this approach is that the banks should be required to make public disclosures rather than only private disclosures exclusively to the supervisors. This would not mean an abdication of responsibility by the supervisors. Rather the supervisors should operate as a backstop to internal governance and market discipline. The evaluation of the quality of management and the adequacy of internal controls and internal audit and adequate provisioning for non-performing assets would require both off-site and on-site examination by the supervisor. The supervisor's emphasis should increasingly be on assessing the quality of management, the adequacy of policies, procedures and systems used by the bank internally to assess and limit risks. Moreover, the supervisor should give attention to a systemic view of the banking system's overall exposures. The supervisor must have enabling powers to act against banks without delays and without dilution by other authorities whose interests and objectives may be different from those of the supervisor. The supervisor should not be required to make a further referral to other authorities to permit action on a bank.

7.22. Prudential regulations should not be considered as monetary instruments to be varied with the growth cycles of the economy which may require alterations in domestic liquidity. Relaxing prudential regulations in such a manner would jeopardise the overall safety of the financial system.

7.23. Having discussed the content of the regulatory and supervisory exercise we turn to the second of the two questions posed earlier in this Chapter, namely, as to the choice of the institution to be charged with the regulatory/supervisory function. The CFS Report had recommended that the supervisory function over our banks and other financial institutions should be hived off to a separate authority to operate as an autonomous body under the aegis of the Reserve Bank but which would be separate from other central banking functions of the Reserve Bank. This recommendation was based on the belief that the system that existed then had over-burdened the Reserve Bank and did not allow undivided attention to be paid to the pursuit of monetary policy and other essential central banking functions. The Committee also recommended that with the financial system getting both diversified and interdependent there was a need for a single integrated system of regulation and supervision covering banks and financial institutions to avoid segmentation of the market for supervisory purposes and the associated problem of inadequate coordination between different supervisory authorities. It accordingly recommended that a Board for Financial Supervision be set up as an autonomous body composed of professionals from areas such as banking, development finance, accountancy, law, management and a representative of the Government at a senior level. The Governor of the Reserve Bank, it was proposed, should

be the ex-officio Chairman of the Board and its Chief Executive Officer an official with a status of a Deputy Governor of the Reserve Bank. The implementation of the recommendations of the CFS has been substantially modified though a Board for Financial Supervision was constituted in 1994. The CFS recommendation would have implied statutory transfer to the supervisory board of the powers of supervision now vested with the Reserve Bank under the Reserve Bank Act and the Banking Regulation Act. These statutory amendments recommended were not pursued and, in consequence of the legal constraints, the membership of the Board also has been restricted to the members of the RBI Board and in effect the Board functions like a Committee of the RBI Board. The Department of Supervision functions like a department of the Reserve Bank and, in the process, the objective of distancing the actual operations of the Board and its supervisory arm from the Reserve Bank has not fully been met. Furthermore, in the initial stages, there was an attempt to separate the concept of regulation from that of supervision by assigning two deputy governors of the Reserve Bank separate responsibilities for regulation and supervision, with the Deputy Governor in charge of supervision being ex-officio Vice Chairman of the Board and the Deputy Governor in charge of monetary policy being an ex-officio permanent invitee to the Board. This was clearly an unsatisfactory arrangement, for, apart from making a distinction between regulation and supervision which we emphasise are two sides of the same discipline, the association of the executives in charge of monetary policy on the Board could have the effect, which we referred to above, of weakening either the content of monetary policy or of banking regulation and supervision. There were also two distinct departments dealing with regulation on the one hand and supervision on the other. More recently, the regulatory and supervisory function have been brought under a single Deputy Governor. What needs to be clearly delineated is not a separation of supervision from regulation but separation of supervision/regulation from monetary policy.

7.24. In the light of the experience since the Report of the CFS and the formulation of the BFS, the present Committee has reviewed the issue of regulation and supervision. The Committee recommends that an integrated system of regulation and supervision be put in place to regulate and supervise the activities of banks, financial institutions and non bank finance companies (NBFCs). As mentioned earlier, the functions of regulation and supervision are organically linked and we propose that the agency be renamed as the Board for Financial Regulation and Supervision (BFRS) to make this combination of functions explicit. As regards the question whether the function should be performed by an institution separate and distinct from the institution which deals with monetary policy, international experience is varied. There are many countries where the functions are unified in the central bank even as those others where they are separate. International experience has, however, shown that to be effective the banking regulatory and supervisory function has to be unified so that the body responsible for regulating policy is actively involved in its administration. While there appears to be no overwhelming international experience in favour of one model or the other, what is of importance is for us to devise an institutional framework which does not allow the intrusion of banking regulation function into monetary policy formulation and implementation and vice versa. The issue needs to be approached from the pragmatic and practical viewpoint of what is likely to work better and be more effective. As mentioned earlier, an independent regulatory supervisory system which provides for a closely coordinated monetary policy and banking regulation and supervision would be the ideal to work towards. The Committee still regards this separation as the objective which needs to be pursued. In the light of the experience it is clear that the task of regulation and supervision needs special experience and expertise and we need to build up a cadre of regulators and supervisors. In the intervening period, we propose that even while functioning as now in close concert with the Reserve Bank, the Board for Financial Regulation and Supervision (BFRS) be given statutory powers and be reconstituted in such a way as to be composed of professionals.

7.25. At present, the professional inputs are largely available in an advisory board which acts as a distinct entity supporting the BFS. Statutory amendment which would give the necessary powers to the BFRS could be enacted and, over a period of time, the BFRS should develop its own autonomous professional character. Our recommendation, therefore, is that, taking note of the formation of BFS, we should begin the process of separating it from the Reserve Bank qua central bank and invest the Board with requisite autonomy and arm it with

necessary powers and allow it to develop experience and professional expertise and to function effectively. We would, however, suggest that the Governor of the RBI should be the ex-officio Chairman of the Board.

7.26. The preceding discussion has focused on the regulation and supervision of the banking system. We have not dealt separately with the near banking constituents of the system, such as Development Financial Institutions (DFIs) and NBFCs. The Committee recommends that the principles and procedures governing regulation and supervision of these institutions should be on the same basis as that for banks. Doubtless, in actual implementation the Board would be considering the very large number of NBFCs involved and take into account their special characteristics and work out norms, requirements and modalities appropriate to them.

7.27. An important consideration is the need for close coordination between the various regulatory authorities in the financial system. In particular, we propose that the BFRS and SEBI should be in close touch with each other so as to formulate and implement regulations that complement each other and avoid possible regulatory crossing of wires.

7.28. The Committee makes the following specific recommendations to ensure an effective regulatory/supervisory system:-

* The present Board for Financial Supervision (BFS) should be restructured. The Reserve Bank of India Act Section 58 should be amended to enable the RBI Central Board to frame regulations to set up a separate and distinct Board for Financial Regulation and Supervision (BFRS). The Board's exclusive task would be to regulate and supervise banks, financial institutions and non-bank finance companies so as to ensure the soundness of the financial system. The Board should consist of five independent part time members of eminent standing in the fields of banking, accountancy, law, management and modern banking technology and the Governor, RBI should be the ex-officio Chairman and the Chief Executive Officer of the Board should have the status of a Deputy Governor. If the majority advice of the independent members is not accepted the ex-officio members shall give written notice to the Finance Minister of such cases and the independent members should be entitled to place before the Finance Minister the reasons for their advice.

* If the BFRS determines that a bank or non-bank entity has problems that affect the institution's safety and soundness, or is not complying with the regulatory framework, it may take supervisory action to ensure that the organisation undertakes corrective measures which should be communicated in writing to the concerned institution.

* If remedial action is not forthcoming within a stipulated time bound framework and the BFRS is not satisfied with the action, the institution should be required to enter into a written agreement with the BFRS. In cases where the BFRS is convinced that there has been a serious violation or deficiency in functioning, the BFRS may issue a cease and desist order against the institution or against an individual associated with the institution. All written agreements and cease and desist orders, penalties and other prohibitory orders should be made public. There should be a notice issued on the violation or deficiency for a hearing as to whether a cease and desist order should be issued.

* Any legislative infirmities preventing the imposition of penalties should be expeditiously remedied by legislative amendments. For instance, there are no visible penalties for violation of prudential norms. To ensure compliance the legislative framework should provide for specific penalties. At the same time, it is necessary to ensure that the regulatory framework is clear, is confined to essential aspects of banks' functioning and does not proliferate while supervision of the tightened regulation should be strict. As soon as the BFRS determines that a violation has taken place a penalty should be imposed. While the penalty should be imposed on a violation being observed by the BFRS, the publicity of the adverse action should be only after the hearing and confirmation by the BFRS of the action. Invariably, a practice should evolve wherein the party recognises the BFRS judgement to be a studied one and reversals should only be in rare cases where the BFRS is convinced that it has erred in its judgement. Penalties should be non-negotiable. A supervisory system gains respect if incipient infringement are dealt

with expeditiously. In fact, as the supervisory authority gains recognition the need for adverse action would become the exception rather than the rule.

* The revamped regulatory and supervisory framework envisaged by the Committee would require a quantum jump in the delivery capabilities of the regulatory and supervisory wings of the RBI. The RBI would need to very quickly strengthen itself by infusion of commercial bankers, chartered accountants, financial analysts, lawyers, corporate specialists and economists to be part of a system which can quickly and effectively swing into action to deal with complex supervisory problems thrown up in the financial sector. It is recognized that the RBI may not have all the skills to deal with specific problem areas and a system should be introduced of hiring renowned consultants for short periods to deal with specific supervisory problems.

* To the extent that the RBI is a regulator/supervisor, it is essential that early action be taken to withdraw the RBI directors from public sector banks' boards. Nor should the RBI get into management aspects of public sector banks on behalf of the Government. In case of those private sector banks where it is deemed necessary to appoint a director, the RBI could appoint a nominee other than its own officers to the boards of these banks. It is also inconsistent with principles of effective supervision that the regulator (even in the interim period, viz., the Reserve Bank) is also an owner of a bank and this would require the RBI to divest its holding in banks and financial institutions. This recommendation has special relevance to the recommendation in the chapter concerning the depoliticisation of appointments of non official directors to the boards of banks.

7.29. The Committee is of the considered view that the strengthening of the regulatory/supervisory framework on the above lines should be given effect to in a phased manner to be completed in 3 years. Regulation and supervision are not ends in themselves. They are a means to attain better performance. A strengthening of the regulatory system, we believe, would go a long way in ensuring the ultimate objective, viz., safety, soundness, viability and profitability of our financial and banking system and enable it to meet better the competitive challenges of the future.

Chapter VIII

Legal and Legislative Framework

8.1. A legal framework that clearly defines the rights and liabilities of parties to contracts and provides for speedy resolution of disputes is a sine qua non for efficient trade and commerce, especially for financial intermediation. In our system, the evolution of the legal framework has not kept pace with changing commercial practice and with the financial sector reforms. As a result, the economy has not been able to reap the full benefits of the reforms process. As an illustration, we could look at the scheme of mortgage in the Transfer of Property Act , which is critical to the work of financial intermediaries. We can do no better than to quote from the Report on Real Property Security Law of the Banking Laws Committee (Chairman: Dr P V Rajamannar):-

> " Thus a distinction was made in the original scheme as regards mortgages to which Europeans were parties, mortgages where the property was situated in the Presidency towns, and mortgages where the mortgages were of native origin and mortgages where the property was situated in the mofussil. This distinction was based on the fact that in the mofussil it was the moneylenders with their unscrupulous methods, who were, by and large, the persons lending against mortgage of immovable property. On the other hand, it was presumed that, as regards mortgages of property situated in the Presidency towns and mortgages where Europeans were parties, the mortgagors might be fully competent to take care of their interests. Thus, at the time of the enactment of the Transfer of Property Act, the right of sale without the intervention of the court, which was considered as an important right of the mortgagees were of a specified ethnic group or the property was situated in the Presidency towns **(Para 1.2.17).**
>
> Evidently, the situation that prevailed at the time of the enactment of the Transfer of Property Act, 1882, justified the legislative action of the then Government of India in limiting the right of sale without the intervention of the court only to such class of mortgages. But this situation became totally out of context with subsequent developments **(Para 1.2.18).**
>
> Our Economic conditions have vastly changed since the enactment of the Transfer of Property Act in 1882. The role of the unscrupulous moneylenders dominating in the field of credit is no longer valid. It is not the village moneylender who is primarily required to extend credit in the mofussil. With our reliance on the institutionalisation of credit, banks and other financing institutions are the major lenders of credit today. In their dealings with their mortgagors, it is anachronistic to assume that they will adopt the unscrupulous methods which are characteristic of unscrupulous moneylenders **(Para 1.2.19).**
>
> In fact, in extending credit, the necessity for suitable safeguards to banks and other financing institutions is now rightly stressed. It is understandable that the legal framework essentially conceived to deal with unscrupulous moneylenders is no longer appropriate to deal with credit given by banks and other financing institutions whose motivation is essentially not profit but socio-economic development **(Para 1.2.20).**"

8.2. Given this unsatisfactory state of the law on mortgage, the response has been along two distinct lines.

8.3. The first approach has been to vest through special statute the power of sale in certain institutions like Land Development Banks and State Finance Corporations. There exists a possibility of extending this approach to other development financial institutions and if possible to banks through the Banking Regulation Act.

8.4. The second approach, taken up in pursuance of the recommendations of CFS has been to set up special tribunals for the recovery of the dues of banks and financial institutions. These tribunals follow a summary procedure that is expected to expedite disposal of suits filed by the banks. It is too early to evaluate the impact on the recovery climate of these tribunals but it has become obvious that there are several areas in which improvements can be effected. The tribunals need to have powers of attachment before judgement, for appointment of receivers and for ordering preservation of property. To achieve the objective, an amendment to the Act may be necessary. We also understand that constitutional validity of the Act itself is under adjudication in the Supreme

Court and any further amendment may also need to address any issues ruled on by the Court. The Committee would, however, like to emphasise the importance of having in place a dedicated and effective machinery for debt recovery for banks and financial institutions.

8.5. The next important aspect is that of securitisation of mortgages which is critically dependent on the ease of enforcement and the costs associated with transfer of mortgages. The power of foreclosing a mortgage without judicial intervention is not available to any class of mortgagees, although a mortgagee by conditional sale has the right to sue for foreclosure. The power of sale without judicial intervention is available either when the mortgagee is the Government or when the mortgage agreement so provide and the mortgaged property is situated in Bombay, Madras and Calcutta and other towns or areas notified by the State Governments. We were unable to obtain any authoritative information as to what towns or areas have been notified by the State Governments. We would, however, recommend along the lines of the Banking Laws Committee that the State Governments notify all towns and appurtenant industrial areas for this purpose. If legally feasible, and the State Government considers it more appropriate, such notification could be limited to mortgages where the mortgagee is a bank or a notified financial institution.

8.6. The power of sale without judicial intervention, by itself may not be enough - there would remain the question of putting the buyer in possession. Ordinarily, the buyer would be required to seek a remedy through the judicial process, which could be a deterrent to potential buyers. However, we are given to understand that the UP Legislature has enacted Section 69-B whereby the District Collector, on application shall put the purchaser into possession, using force, if necessary. The Collector is required to follow the relevant procedure prescribed in the Civil Procedure Code. The possibility of enacting a general amendment to Transfer of Property Act along the above lines needs to be examined.

8.7. There remains the question of stamp duties and registration fees. High fees and duties on mortgaged deeds have made equitable mortgage, despite their inherent disadvantages, more attractive to the banks and financial institutions and may have depressed State Governments' revenues rather than increasing them. There is clearly a case for reducing these duties substantially.

8.8. Since the mortgage based securities represent beneficial interest in immovable property, the transfer thereof would require registration and stamping. In order to provide for easy transferability of such securities, there is a need for special dispensation for registration of such certificates. As regards stamp duty, we are given to understand that recently, some states have drastically reduced stamp duties on transfers of mortgages for the purposes of securitisation. This is a welcome development and should be emulated by other State Governments.

8.9. We would like to refer to the recent amendment to Section 28 of the Indian Contract Act. This has generated a great deal of apprehension that henceforth the usual stipulation in bank guarantees limiting the period for making claims under the guarantees would not be valid as it may be construed to limit or curtail the time available under the normal laws of limitation to the counter party to enforce its rights under the guarantee.

8.10. Banks have expressed a fear that they can no longer limit their liabilities under the Bank Guarantees to a specified period and they will have to carry their Bank Guarantee commitments for long periods as outstanding obligations. Banks also apprehend that in case of Bank Guarantee to the Government, notwithstanding stipulation in the bank guarantee that it should be in force within a specified period, banks will be forced to treat in their books their liability under the Bank Guarantees to the Government as outstanding till the limitation period of 30 years available to the Government lapses. This will also force banks to continue to hold the securities taken for Bank Guarantees especially the funds deposited as margins, for long periods, and also severely curtail issue of fresh Bank Guarantee for their customers. If a bank chooses to continue the issuance of Bank Guarantees to its customers, it will have to reflect in its books the progressively increasing levels of Bank Guarantee obligations, thereby inflating the risk weighted assets of the banks without any real increase in the banking assets. This will pre-empt the available capital to meet the capital adequacy requirement and will also over stretch the exposure to the customers beyond acceptable levels.

8.11. Government Departments do not generally return the original Guarantee papers to the banks after the purpose is served. With the aforesaid amendment in force, banks will have to carry their liabilities under Bank Guarantee till 30 years. Unless, the original guarantee is received back from the beneficiary Government Departments, the banks will not be able to round off all their entries till the limitation period of 30 years. Banks' guarantee business may be severely hampered as a result with attendant implications for the economy as a whole. It would appear that the whole issue needs to be re-examined and bank guarantees exempted from the purview of the above amendment.

8.12. A substantial portion of the bank financing is against the security of book debt and inventories. The Banking Laws Committee in its report on the Personal Property Security Law had made a very detailed examination of issues relating to the enforcement of such securities and made several recommendations which need to be re-examined keeping in view the changes that may have occurred since the Banking Laws Committee submitted its report.

8.13. In this connection, we are given to understand that the Government of India is actively considering an amendment to the Indian Penal Code (IPC) which would, broadly speaking, raise a presumption of fraud against the borrowers who have removed the hypothecated inventories without the express or implied consent of the bank. This would act as a deterrent to the borrowers who at times are known to wilfully remove the hypothecated inventories. We would endorse this proposal.

8.14. We would also like to refer here to the proposed amendment to the Sick Industrial Companies (Special Provisions) Act, 1985. The proposed amendments seek to trigger off the remedial mechanism at the signs of incipient sickness rather than wait for a substantial erosion of the net worth of companies. Similarly, by providing that the stay of legal proceedings, suits for recovery of moneys or enforcement of securities, etc., against the sick industrial companies would operate only on the specific orders of the Board for Industrial and Financial Reconstruction rather than automatically, it has sought to limit the possibilities of misuse of the provisions of the Act. We are in agreement with the main thrust of the above amendments and would urge a speedy enactment of the proposed amendments.

8.15. With the advent of computerisation, there is a need for clarity in the law regarding the evidentiary value of computer generated documents. The introduction of such computer generated documents would perhaps require a certificate as to the proper operation of the computer system at the relevant times. The Shere Committee, set up by the RBI on the legal issues relating to Electronic Funds Transfer has made some recommendations in this regard. We are given to understand that the Central Government has already had extensive consultations with the public sector banks in this regard. While the amendment of the general law of evidence may take some time, we would underscore the urgent need to amend the Bankers Book Evidence Act for this purpose.

8.16. On the larger issue of electronically initiated funds transfer, there are several issues which need clarity. These relate to the authentication of the payment instructions, irrevocability and finality of payment, the burden of proof, the responsibility of the customer for secrecy of the security procedure, the procedure for notifying the loss of a card, the liability of the customers for unauthorised use of card, etc. At a systemic level, there are issues relating to the regulation of the third party operated electronic fund transfer systems, confidentiality of customer related data and the protection of such systems from mischief. The Shere Committee had gone into these issues in considerable detail. It has also suggested enactment of a separate law to cover such Electronic Fund Transfer systems. We would recommend that a group may be constituted by RBI to work out detailed proposals in this regard and implement them in a time bound manner.

8.17. We would now like to refer to the legislative framework which impinges on the structure of the banking system. The legislative framework should be such as to allow flexibility so that the institutions can rapidly adapt to the changing circumstances. While this could be the touchstone on which the existing legislation could be tested, we would like to confine ourselves to certain broad issues. The Banking Regulation Act is structured somewhat on the premise that banking supervision is essentially a Government function and Reserve Bank of India's position is somewhat

on the lines of an agent of the Central Government. The Act provides appellate powers to Government over decisions to RBI in several instances. It also provides original powers to Government in certain instances, e.g., by way of ordering special audit of banks or in the matter of amalgamation of banks under schemes prepared by Reserve Bank of India. We feel that these provisions should be reviewed.

8.18. Elsewhere in our Report we have recommended that it should be possible to constitute a Board for Financial Regulation and Supervision, comprising persons other than the Members of the Central Board of Directors of RBI. This Board for Financial Regulation and Supervision should have the same powers as the Reserve Bank of India in regard to the supervision of banks. Amendments would, therefore, be necessary in the Banking Regulation Act and the Reserve Bank of India Act.

8.19. There has been some debate whether the public sector banks should be converted into companies or even have a common statute for them. This is an area which will require detailed consideration and pros and cons will need to be carefully evaluated. For the present, amendments would be necessary in the Nationalisation Acts to enable grant of greater managerial autonomy to public sector banks, lowering the minimum requirement of 51% Government ownership and as regards the constitution of the Board of Directors and the Management Committees. The objective should be to gradually increase the market accountability of public sector banks. The provisions relating to prior approval of Government for regulations framed under the Act also need to be reviewed.

8.20. In line with the above recommendations, amendments would be need in the State Bank of India Act with regard to the extent of shareholding of RBI and the constitution of Central Board, allowing for induction of more whole time directors. The provisions relating to the role of the Local Boards, which, in our opinion, should not really be entrusted with essentially management functions, also need to be reviewed.

8.21. As regards the Associate Banks of SBI, amendments would be needed as to the extent of shareholding of SBI and also to have provisions enabling merger of Associate Banks either amongst themselves or with SBI or to enable some banks to operate independently. We believe that a common approach may not be suitable for all Associate Banks as each one has its own strengths and weaknesses. There should be sufficient flexibility in the legislative framework which will enable application of bank specific reforms. The boards of Associate Banks also should be constituted along the lines of nationalised banks with a Chairman and Managing Director and two whole time directors and it may not be necessary for the Chairman of the State Bank of India to be the ex-officio Chairman of the Board of Associate Banks. It is also necessary to provide greater operational and managerial autonomy to Associate Banks as from the State Bank of India.

8.22. These suggestions for legislative amendments are not exhaustive. We would recommend that the legal implications with reference to each of our recommendations be examined and detailed legislative steps identified by the Government in consultation with the Ministry of Law.

8.23. The Committee feels that given the need for making wide ranging changes in the legal framework affecting the work of the financial sector, there is a need to set up an expert committee comprising amongst others, representatives from the Ministry of Law, Banking Division, Ministry of Finance, RBI and some outside experts to formulate specific legislative proposals to give effect to the suggestions given above.

Chapter IX

Concluding Observations

9.1. The previous Chapters have indicated the Committee's approach to the issues that will be presenting themselves in the second phase of banking sector reform even as we are still to complete some of the unfinished agenda of the first phase. In that phase the focus was appropriately on arresting the qualitative deterioration in the functioning of the system and a measure of success has attended these efforts. We now need to consolidate these gains and move forward.

9.2. The central theme underlying our various recommendations is thus on strengthening of the system within the framework of purposive regulation and a strong and effective legal system. Fundamental to the strengthening the system is the improvement in the quality of the banks' assets portfolios. Banks as repositories of the community's savings have an economic and even a moral responsibility to deploy these resources in a manner which ensures their soundness even while making their contribution to the furtherance of investment, production and national wealth creation. The quality of assets of our banking system though somewhat better than what it was five years ago still leaves room for further improvement. Some of the external constraints in the functioning of the banks which affected their asset portfolio in the form of pre-emption of resources and an administered interest rate structure are now no longer present though one form of such an external constraint continues in the requirements of priority sector credit. These reductions in the pre-empted use of bank resources have, in the process, increased the 'franchise value' of the banking system with its concomitant of the greater need to manage the loan asset portfolio with greater care and diligence.

9.3. Nothing illustrates the erosion of asset quality over the years than the level of NPAs. We have commented on it somewhat extensively and have indicated also the reduction that we should aim at. NPAs constitute a real economic cost to the nation in that they reflect the application of scarce capital and credit funds to unproductive uses. The moneys locked up in NPAs are not available for productive use and to the extent that banks seek to make provisions for NPAs or write them off, it is a charge on their profits. To be able to do so, banks have to charge their productive and diligent customers a higher rate of interest. It thus becomes a tax on efficiency. It is the customer who uses credit efficiently that subsidises the inefficiency represented by NPAs. This also raises the transaction costs in the system thus denying the diligent credit customers the benefit of lower rates which would help them to be more efficient and competitive. NPAs, in short, are not just a problem for banks. They are bad for the economy.

9.4. Given the legal system's delays, recoveries of NPAs are not likely to be quick. Provisioning to reduce the net NPA figures would also take time and call for a higher level of bank earnings. There will have to be, therefore, a one time surgical solution through a "carve out" or some other form of asset exchange. Recapitalisation of financial institutions in distress has, however, been the route taken. There is not much point in our commenting at this stage on whether this was the right approach. Recapitalisation has not been particularly effective as seen in the continuing high levels of net NPAs of some banks which have had such capital infusion. It has been costly and, given our budgetary constraints, further recourse to it is not sustainable. Banks with high NPAs are also unlikely to attract investor interest should they approach the market. Some form of asset exchange, therefore, suggests itself.

9.5. Capital adequacy standards are now better than they were a few years ago, but the Committee has proposed that consideration be given to further enhancement of capital ratios, especially for the large banks even while widening the definition of risk assets that should go into the denominator. The reform in accounting policies and practices has made the balance sheets and other statements more credible and transparent though there is still scope for fuller disclosure to ensure even greater transparency and correcting information asymmetry. Prudential norms, we believe, should be kept under constant review in the light of the perceptions of new forms of risk and use of risk management devices. Asset liability management has now been accorded appropriate emphasis. Involved as they are in various forms of transformation of assets and

liabilities in terms of maturity, size and risk, there is now appreciation of the need for banks to take a total view of their operations in terms of their asset liability management in view of the growing incidence of market and income risk in a deregulated environment. These qualitative improvements need to go hand in hand with and indeed be reflected in a reduction in the current high levels of transaction costs in the system.

9.6. Soundness and strength would come about through strict adherence to statutory and prudential requirements. It is here that regulation and supervision assume importance. Regulation should appropriately be concerned with the prevention of problems rather than attempting a cure once the problems have surfaced in several individual institutions or in the system. Not that we can avoid altogether instances of institutions getting into financial distress but we need to have a framework for their early detection and measures to tackle the problems. Cures depend on their efficacy on the effective functioning of the legal system. It is also important, as the previous Chapters have indicated, that regulation be concerned with the critical areas of banks' operations and not get involved in administrative trivia which should be left to the management of banks. As the system is liberalised, there is in fact more need now for purposive regulation. Financial liberalisation without proper regulation and surveillance would be an invitation to financial anarchy. We have enough examples of this from international experience. Regulation, it needs to be stressed again, has to be rule-bound, non-discretionary and non-discriminatory and has to concentrate on the essentials and be clearly codified and strictly enforced through supervision.

9.7. Financial sector management and reform is a process rather than an event. It cannot be separated from reform in the real sector. They are mutually reinforcing, sustaining and sustained by each other. Thus an important outcome of financial sector reform is that it could contribute to greater flexibility in the factor and product markets. Reforms in the real sector, in the last few years in the areas of industrial and trade policy have perhaps moved somewhat ahead of reforms in the financial sector. With the real sector becoming increasingly market-driven, outward looking and with a premium on competitive efficiency, there would be need for a dynamic response from the banking and financial sector to match the evolving and diversified needs of the real sector. Banks and financial institutions would be called upon to increase not only the total volume of their business and the range of their services but do so in an increasingly technologically sophisticated environment even while keeping abreast of developments in both the internal and international economy. Banks cannot be expected to remain cloistered in the way they were - sheltered from competition under the protective umbrella of State ownership. In the new milieu that the Committee envisages we need a qualitative transformation of management skills to learn about new financial instruments and new modes of financial engineering. Credit appraisal skills, for instance, would need to be refashioned to factor in market uncertainties, external competition and, cyclical and structural changes in the economy. Even as investment and production decisions in the real sector assume a different qualitative character credit decisions by banks would also need to be suitably responsive. New appraisal skills based not only on traditional aspects such as collateral evaluation but an appraisal of the client's total financial position and his capital and credit needs would be needed. This is what relationship banking is about. As they enter new areas of activity, such as project financing in the infrastructure area, which they should do in larger measure, banks would need to hone their skills in terms of appraisal of cash flows rather than rely on more traditional working capital assessments. As banks develop these skills development financial institutions would also need in turn to fashion their appraisal processes with respect to short term and working capital requirements of customers. Over the years, we have set up different institutions with different objectives and focus of interest. The lines separating them, as has been indicated, are getting somewhat blurred now. Universal banking is catching on but this should not have as its casualty the interest, experience and expertise in development financing of projects which our DFIs have built up over the years. Rather they need to build on this experience over a wider range of services. With more players in the financial sector and with non-banking financial companies also increasing their market share, there might result a measure of banking, as distinct from financial, disintermediation. Even so, banks would still be far and away the largest segment of the financial system apart from being responsible for managing the country's payments system. A more efficiently run banking system reflected in a reduction of transaction costs would help the payments system to be managed in a more cost effective manner. This should continue to remain an object of policy.

The role of Government remains important even in an increasingly deregulated environment. Government responsibility would be to create and nurture a diversified and functionally efficient financial system through an appropriate incentive framework and a legal system rather than through direct interventionist policies.

9.8. As we move into the second generation of reforms, our objective has to be to evolve in this country a level of banking services which is efficient, effective and customer-oriented and which should seek to emulate the "best practices" in the industry the world over. For too long the customer has been taken for granted. In a competitive and market driven situation this has to change. Best practices cover a range of activities starting with the functioning of the Boards, of management, human resource development, risk management, technology development and regulatory policies and supervisory procedures - all of which we have discussed at some length earlier.

9.9. Reforms cannot be entirely painless. The strengthening of the system will take its toll on the weak and inefficient. Competition is a stern taskmaster and there is no room for laxity in its lexicon. The ultimate result of a stress on competitive efficiency would be a more productive and profitable banking system. If we are to derive the full benefits of a strong and viable financial system we need a sound macro economic policy framework. A sound macro economic environment and a strong financial system are the sure guarantees for progress and for growth with a reasonable measure of internal and external stability. This is all the more so as we tread cautiously towards a more open capital account regime. Globalisation of financial markets poses opportunities but in the absence of these prerequisites could also pose dangers. With improved strength and structural changes and with greater functional autonomy and operational flexibility, there is every reason to expect that our banking system will rise to the challenges of the next millennium. Our recommendations are designed to meet this strategic objective.

(M. Narasimham) **(D. Basu)** **(P. Kotaiah)**

(S. Munjal) **(Shiv Nadar)** **(Deepak Parekh)**

(M. V. Subbaiah) **(S. S. Tarapore)** **(C. M. Vasudev)**

Annexure I

(To be published in Part II Section 3(ii) of the Gazette of India - Extraordinary)

F.No.16/4/97-B.O.I
Government of India
Ministry of Finance
Department of Economic Affairs
(Banking Division)

New Delhi, dated 26th December, 1997
5th Pausa, 1919 (Saka)

NOTIFICATION

COMMITTEE ON BANKING SECTOR REFORM

In 1991, the Government had set up the "Committee on the Financial System" under the Chairmanship of Shri M. Narasimham. This Committee submitted its report in November, 1991. The time is now opportune to review the record of implementation of financial system reforms recommended by the Narasimham Committee and to look ahead and chart the reforms necessary in the years ahead so that India's banking system can become stronger and better equipped to compete effectively in a fast changing international economic environment.

2. Accordingly, it has been decided by the Government of India to set up a High Level Committee for this purpose. The Committee will consist of the following:-

1.	Shri M. Narasimham, Chairman, Administrative Staff College, Hyderabad.	Chairman
2.	Shri Dipankar Basu, Former Chairman, State Bank of India	Member
3.	Shri Deepak Parekh, Chairman, Infrastructure Development Finance Company Ltd., Chennai.	Member
4.	Shri P. Kotaiah, Chairman, NABARD, Mumbai.	Member
5.	Shri Shiv Nadar, Chairman, HCL Corporation, Noida.	Member
6.	Shri M.V. Subbaiah, Chairman and Managing Director, EID Parry India Ltd., Chennai.	Member

7.	Shri Sunil Munjal, Executive Director, Hero Cycles, Ludhiana.	Member
8.	Shri S.S. Tarapore, Former Deputy Governor, Reserve Bank of India, Mumbai.	Member
9.	Shri C.M. Vasudev, Special Secretary, Banking Division, Deptt. Of Economic Affairs, Ministry of Finance.	Member-Secretary

3. The terms of reference of the Committee will be as follows:

(i) To review progress in reforms in the Banking Sector over the past 6 years, with particular reference to the recommendations made by the (Narasimham) Committee on the Financial System in 1991.

(ii) To chart a programme of Banking Sector reforms necessary to strengthen India's banking system and make it internationally competitive taking account of the vast changes in international financial markets and technological advances and the experience of other developing countries in adapting to such changes.

(iii) To make detailed recommendations in regard to banking policy, institutional, supervisory, legislative and technological dimensions.

4. The Committee will submit its report by **March 31, 1998.** The Committee may however submit an interim report on any matter.

Sd/-

(M. DAMODARAN)

Joint Secretary to the Government of India

To,

The Manager,
Government of India Press,
Mayapuri Industrial Area,
Ring Road, New Delhi.

Special Secretary(Banking)

Government of India
Ministry of Finance
Department of Economic Affairs
(Banking Division)
"Jeevan Deep"
10, Parliament Street
New Delhi-110 001
Tele 3732100
FAX No. 3747018/3732207

D.O. No. 16/4/97-B.O.I

March 31, 1998

Dear Shri Narasimham,

I am desired to convey to you that the term of the Committee on Banking Sector Reform has been extended upto 30th April, 1998.

2. You may like to take further necessary action in the matter.

With regards,

Yours sincerely,

Sd/-
(C.M. Vasudev)

Shri M. Narasimham,
Chairman,
Administrative Staff College,
Hyderabad.

Annexure II

ORGANISATIONS/INDIVIDUALS WHOSE WRITTEN SUGGESTIONS WERE RECEIVED BY THE COMMITTEE

1. INDIAN BANKS ASSOCIATION
2. COMMITTEE OF PRIVATE MEMBER BANKS OF IBA.
3. COMMITTEE OF FOREIGN MEMBER BANKS OF IBA.
4. PRIVATE SECTORS BANK ASSOCIATION, CHENNAI.
5. INDUSTRIAL INVESTMENT BANK OF INDIA LTD., CALCUTTA.
6. AGRICULTURE FINANCE CORPORATION LTD., MUMBAI.
7. SMALL INDUSTRIAL DEVELOPMENT BANK OF INDIA.
8. NATIONAL FEDERATION OF URBAN CO-OPERATIVE BANKS AND CREDIT SOCIETIES LTD.NEW DELHI.
9. MINISTRY OF AGRICULTURE, NEW DELHI.
10. ALL INDIA BANK DEPOSITORS ASSN., MUMBAI.
11. FEDERATION OF INDIAN CHAMBER OF COMMERCE AND INDUSTRY.
12. CONFEDERATION OF INDIAN INDUSTRY, NEW DELHI.
13. ASSOCIATED CHAMBER OF COMMERCE AND INDUSTRY, NEW DELHI.
14. INDIAN MERCHANTS' CHEMBER, MUMBAI.
15. FEDERATION OF INDIAN EXPORT ORGANISATION, MUMBAI.
16. THE BENGAL CHAMBER OF COMMERCE & INDUSTRY, CALCUTTA.
17. MAHARASHTRA CHAMBER OF INDUSTRY, MUMBAI.
18. MADHYA PRADESH BANK OFFICERS' ASSOCIATION, INDORE.
19. ALL INDIA RRB EMPLOEES ASSOCIATION, BERHAMPORE.
20. ALL INDIA STATE BANK OF INDORE OFFICERS' CO-ORDINATION COMMITTEE, INDORE.
21. PROFESSIONAL WORKERS TRADE UNION CENTRE OF INDIA, BANGALORE.
22. ALL INDIA RESERVE BANK EMPLOYEES ASSOCIATION, CALCUTTA.
23. SHRI S. VENKITARAMANAN, EX-GOVERNOR, RESERVE BANK OF INDIA
24. SHRI Y.H. MALEGAM, S.B. BILLIMORIA & CO., MUMBAI.
25. SHRI R. NARASIMHAN FORMERLY DMD, SBI.
26. SHRI RAMESH GELLI, GLOBAL TRUST BANK LTD.

ANNEXURE III

ORGANISATIONS/ PERSONS WHO MET THE COMMITTEE

1. GOVERNOR AND DEPUTY GOVERNORS, RESERVE BANK OF INDIA
2. FINANCE SECRETARY, GOVERNMENT OF INDIA
3. ALL INDIA BANK EMPLOYEES' ASSOCIATION.
4. NATIONAL CONFEDERATION OF BANK EMPLOYEES,
5. INDIAN NATIONAL BANK EMPLOYEES' FEDERATION,
6. BANK EMPLOYEES' FEDERATION OF INDIA
7. NATIONAL ORGANISATION OF BANK WORKERS
8. ALL INDIA BANK OFFICERS' CONFEDERATION
9. ALL INDIA BANK OFFICERS' ASSOCIATON
10. INDIAN NATIONAL BANK OFFICERS' CONGRESS.
11. NATIONAL ORGANISATION OF BANK OFFICERS
12. ASSOCIATE BANKS OFFICERS' ASSOCIATION, HYDERABAD.
13. SHRI M.S. VERMA,CHAIRMAN, SBI,MUMBAI.
14. SHRI S.H. KHAN, CHAIRMAN, IDBI MUMBAI.
15. SHRI RASHID JILANI, CMD, PNB,NEW DELHI
16. SHRI DALBIR SINGH,CMD, OBC,NEW DELHI.
17. SHRI SHARDA SINGH, CMD, UCO BANK,CALCUTTA.
18. SHRI BISWAJIT CHOUDHARI, CMD, UNITED BANK OF INDIA, CALCUTTA.
19. SHRI MARTIN FISH, ALTERNATE CHAIRMAN, COMMITTEE OF FOREIGN MEMBER BANKS OF IBA, MUMBAI.
20. SHRI Y.H. MALEGAM, S.B. BILLIMORIA & CO., MUMBAI.
21. SHRI M.R. PAI, PRESIDENT, ALL INDIA BANK DEPOSITORS ASSN., MUMBAI.
22. INDIAN BANKS ASSOCIATION
23. SHRI E.A. REDDY, DIRECTOR, CENTRAL BOARD OF DIRECTORS, RBI
24. INFOSYS TECHNOLOGIES LTD., BANGALORE.
25. HCL CORPORATION LIMITED, NOIDA.
26. HERO CORPORATE SERVICES LIMITED, NEW DELHI