HARMONISING THE ROLE AND OPERATIONS OF DEVELOPMENT FINANCIAL INSTITUTIONS AND BANKS

A DISCUSSION PAPER

1. INTRODUCTION

1.01 In the light of a number of reform measures adopted in the Indian financial system since 1991, and keeping in view the need for evolving an efficient and competitive financial system, the Reserve Bank constituted on December 8, 1997, a Working Group under the Chairmanship of the then Chairman and Managing Director of Industrial Development Bank of India, Shri S. H. Khan, with the following terms of reference:

- To review the role, structure and operations of Development Financial Institutions (DFIs) and commercial banks in emerging operating environment and suggest changes;
- To suggest measures for bringing about harmonization in the lending and working capital finance by banks and DFIs;
- To examine whether DFIs could be given increased access to short-term funds and the regulatory framework needed for the purpose;
- To suggest measures for strengthening of organisation, human resources, risk management practices and other related issues in DFIs and commercial banks in the wake of Capital Account Convertibility;
- To make such other recommendations as the Working Group may deem appropriate to the subject.

1.02 The Working Group submitted its interim Report in April and final Report in May 1998. In the Monetary and Credit Policy announced in April 1998, it was indicated that a 'Discussion Paper' would be prepared which will contain Reserve Bank's draft proposals for bringing about greater clarity in the respective roles of banks and financial institutions for greater harmonisation of facilities and obligations applicable to them. It was also mentioned that the Paper would also take into account those recommendations of the Committee on Banking Sector Reforms (Chairman: Shri M. Narasimham)[1] which have a bearing on the issues considered by the Khan Working Group (KWG)[2] .

1.03 The main recommendations of the KWG are listed in the Annexure I, while Annexure II sets out those recommendations of the Narasimham Committee which have a bearing on the issues considered by the KWG.

1.04 The thrust of the KWG was on a progressive move towards universal banking and the development of an enabling regulatory framework for this purpose. In the interim, the Group recommended that DFIs may be permitted to have a banking subsidiary (with holdings up to 100 per cent). Among the changes in regulatory practices, the focus of the KWG was on the function-specific regulatory framework that targets activities and is institution-neutral. Keeping in view the increasing overlap in functions being performed by various participants in the financial system, the KWG recommended the establishment of a 'super regulator' to supervise and co-ordinate the activities of the multiple regulators. With regard to supervisory practices, it was recommended that the supervisory authority should undertake primarily off-site supervision and that DFIs/banks should be supervised on a consolidated basis, covering both domestic and global activities. For meaningful consolidated supervision, the KWG recommended the development of a 'risk-based supervisory framework'.

1.05 The KWG also made a number of recommendations relating to statutory obligations of banks. These, *inter-alia*, included progressive reduction in Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) to international levels. It recommended an alternative mechanism for permitting credit to the priority sector and in the interim, the infrastructure lending should not be included in the definition of the 'net bank credit' used in computing the priority sector obligations. For harmonising the role, operations and regulatory framework of DFIs and banks, the thrust of the recommendations was on removal of ceiling for DFIs' mobilisation of short to medium term resources by way of term deposits, CDs, borrowings from the term money market and inter-corporate deposits with a suitable level of SLR on such borrowings on an incremental basis. Other important recommendations were: to exclude investments made by banks in SLR securities issued by a DFI while calculating the exposures and DFIs should be granted full Authorised Dealer's licence. With regard to State level institutions, the KWG recommended immediate corporatisation to improve their competitive efficiency, to encourage strong State Financial Corporations (SFCs) to go public by making Initial Public Offer (IPO), to transfer the present shareholding of IDBI in the State level institutions to Small Industries Development Bank of India (SIDBI) and transfer of ownership of SIDBI from IDBI to the Reserve Bank of India (RBI)/Government.

1.06 The Second Narasimham Committee observed that, for the same market reasons as have influenced the growth of universal banking elsewhere, a similar trend is visible in India too. It recommended that if FIs engage themselves in commercial bank like activities, they should be subject to the same discipline regarding reserve and liquidity requirements as well as capital adequacy and prudential norms. It, however, recommended phasing out of reserve requirements and suggested a formula for directed credit in case FIs become banks. It felt that DFIs, over a

period of time, should convert themselves into banks in which case there would only be two forms of intermediaries, viz., banking companies and non-banking finance companies (NBFCs). And if a DFI does not become a bank, it would be categorised as a non-banking finance company. It emphasised the mergers between strong banks/FIs as they would make for greater economic and commercial sense. It recommended that IDBI should be corporatised and converted into a joint stock company under the Companies Act. For providing focussed attention to the work of SFCs, IDBI shareholding in them should be transferred to SIDBI. It recommended that SIDBI should be delinked from IDBI. It recommended that supervisory function of National Bank for Agricultural and Rural Development (NABARD) relating to rural financial institutions should vest with the Board for Financial Regulation and Supervision (BFRS). For effective supervision, it underlined the need for formal accession to 'core principles' announced by the Basle Committee in September 1997. It recommended an integrated system of regulation and supervision to regulate the activities of banks, financial institutions and non-banking finance companies. The Committee emphasised the importance of having in place a dedicated and effective machinery for debt recovery for banks and financial institutions. It underlined the need for clarity in the law regarding the evidentiary value of computer generated documents. It also emphasised that with electronic funds transfer several issues regarding authentication of payments, etc. required to be clarified.

1.07 This paper sets out issues arising out of recommendations of the KWG and those recommendations of the Narasimham Committee which have a bearing on the issues considered by the KWG. The remainder of this Paper is organised into six sections. Section two deals with the concept of 'universal banking' and its advantages and limitations. Section three outlines the practice of universal banking and the position as it prevails in India. Section four discusses some issues concerning future role of DFIs[3] in India with special reference to the state of the capital market. Section five deals with the various issues concerning harmonising the role and operations of DFIs and banks in India. Section six discusses the regulatory, supervisory and the other related issues. Section seven sets out the Reserve Bank's draft proposals. These proposals are being put forward for discussion/comments by experts, banks/FIs, other market participants, and the public in general. Necessary decisions will be taken by the RBI in due course, in consultation with the Government, in the light of comments received.

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[1] The Committee on the Banking Sector Reforms set up by the Government of India in December 1997 under the Chairmanship of Shri M. Narasimham submitted its Report in April 1998.

[2] The Reserve Bank would like to express its appreciation for the help and advice of Dr. V.V. Desai (formerly Director and Chief Economist, Asian Development Bank). Dr. Desai served as a Consultant; the views expressed here, however, are those of the Reserve Bank.

2. UNIVERSAL BANKING

Definition

2.01 The term 'universal banks' in general refers to the combination of commercial banking and investment banking, i.e., issuing, underwriting, investing and trading in securities. In a very broad sense, however, the term 'universal banks' refers to those banks that offer a wide range of financial services, beyond commercial banking and investment banking, such as, insurance. However, universal banking does not mean that every institution conducts every type of business with every type of customer. Universal banking is an option; a pronounced business emphasis in terms of products, customer groups and regional activity can, in fact, be observed in most cases. In the spectrum of banking, specialised banking is on the one end and the universal banking on the other.

Advantages and Limitations

2.02 Universal banking has some advantages as well as disadvantages. Merits and demerits of universal banking have been examined on theoretical grounds, and there have been some studies to test them on a firm basis. Some of the important conclusions emerging from a review of these are discussed below.

Advantages

2.03 The main argument in favour of universal banking is that it results in greater economic efficiency in the form of lower cost, higher output and better products. This logic stems from the reason that when sector participants are free to choose the size and product-mix of their operations, they are likely to configure their activities in a manner that would optimise the use of their resources and circumstances. In particular, the following advantages are often cited in favour of universal banking.

2.04 Economies of scale mean lower average costs which arise when larger volume of operations are performed for a given level of overhead on investment. Economies of scope arise in multi-product firms because costs of offering various activities by different units are greater than the costs when they are offered together. Economies of scale and scope have been given as the rationale for combining the activities. A larger size and range of operations allow better utilisation of resources/inputs. It is sometimes argued that acquisition of some information technologies becomes profitable only beyond certain production scales. Larger scale could also avoid the wasteful duplication of marketing, research and development and information-gathering efforts [Borio and Filosa, 1994].

2.05 Due to various shifts in business cycles, the demand for products also varies at different points of time. It is generally held that universal banks could easily handle such situations by shifting the resources within the organisation as compared to specialised banks. Specialised firms are also subject to substantial risks of failure, because their operations are not well diversified. Proponents of universal banking thus argue that specialised banking system can present considerable risks and costs to the economy. By offering a broader set of financial products than what a specialised bank provides, it has been argued that a universal bank is able to establish long-term relationship with the customers and provide them with a package of financial services through a single window. It is important to note that this benefit stems from the very nature/purpose of universal banking.

Limitations

2.06 The larger the banks, the greater the effects of their failure on the system. The failure of a larger institution could have serious ramifications for the entire system in that if one universal bank were to collapse, it could lead to a systemic financial crisis. Thus, universal banking could subject the economy to the increased systemic risk.

2.07 Universal bankers may also have a feeling that they are too big to be allowed to fail. Hence they might succumb to the temptation of taking excessive risks. In such cases, the government would be forced to step in to save the bank. Furthermore, it is argued that universal banks are particularly vulnerable because of their role in underwriting and distributing securities.

2.08 Historically, an important reason for limiting combinations of activities has been the fear that such institutions, by virtue of their sheer size, would gain monopoly power in the market, which can have significant undesirable consequences for economic efficiency [Borio and Filosa, 1994]. Two kinds of concentration should be distinguished, *viz*., the dominance of universal banks over non-financial companies and concentration in the market for financial services. The critics of universal banks blame universal banking for fostering cartels and enhancing the power of large non-banking firms.

2.09 Some critics have also observed that universal banks tend to be bureaucratic and inflexible and hence they tend to work primarily with large established customers and ignore or discourage smaller and newly established businesses. Universal banks could use such practices as limit pricing or predatory pricing to prevent smaller specialised banks from serving the market. This argument mainly stems from the economies of scale and scope.

2.10 Combining commercial and investment banking gives rise to conflict of interests as universal banks may not objectively advise their clients on optimal means of financing or they may have an interest in securities because of underwriting activities.

2.11 Saunders [1985] points out that conflict of interests might arise from the following:

(a) conflict between the investment banker's promotional role and the commercial banker's obligation to provide disinterested advice;

(b) using the bank's securities department or affiliate to issue new securities to repay unprofitable loans;

(c) placing unsold securities in the bank's trust accounts;

(d) making bank loans to support the price of a security that is underwritten by the bank or its securities affiliate;

(e) making imprudent loans to issuers of securities that the bank or its securities affiliate underwrites;

(f) direct lending by a bank to its securities affiliate; and

(g) informational advantages regarding competitors.

2.12 Conflict of interests was one of the major reasons for introduction of Glass-Steagall Act. Three well-defined evils were found to flow from the combination of investment and commercial banking as detailed below.

(a) Banks were deploying their own assets in securities with consequent risk to commercial and savings deposits.

(b) Unsound loans were made in order to shore up the price of securities or the financial position of companies in which a bank had invested its own assets.

(c) A commercial bank's financial interest in the ownership, price, or distribution of securities inevitably tempted bank officials to press their banking customers into investing in securities which the bank itself was under pressure to sell because of its own pecuniary stake in the transaction.

The provisions of the Glass-Steagall Act were directed at these abuses [Benston, 1990].

2.13 It is argued that universal banks are more difficult to regulate because their ties to the business world are more complex. In the case of specialised institutions, government/supervisory agencies could effectively monitor them because their functions are limited.

Empirical Evidence

2.14 The empirical studies to test the existence of "economies of scale" in universal banks do not provide any conclusive evidence. Some studies found that the economies of scale in commercial banking were exhausted at very low deposit levels, i.e., less than 100 million dollars in deposit [Benston, Berger, Hanweck and Humphrey, 1983; Clark, 1988]. Noulas, Ray and Miller [1990], in a study of North American banks, in which very small local banks were not included, found certain economies of scale for assets exceeding 600 million dollars. Some studies even show diseconomies [Mester, 1992 and Saunders and Walter, 1994]. Using the historical evidence of the 1980s, Saunders and Walter [1994] found that very large banks grew more slowly than the smallest among the big banks in the world.

2.15 The empirical evidence of "economies of scope" is also not clear. Though some studies suggest that economies of scope emerge with the joint use of information technologies [e.g. Gilligen, Smirlock and Marshall, 1984], such economies are admittedly small. It may be noted that there are also difficulties in measuring economies of scope. One could measure economies of scope only if the firms studied produce different kinds of output of sufficient variety to produce measurable differences in costs. Because most banks offer almost the same kinds and proportion of services, it is difficult, if not impossible, to conduct meaningful empirical studies of economies of scope [Benston, 1990].

2.16 While analysing the cost efficiency of universal banking in India, Ray [1994] found that the Indian banks have been gradually assuming the responsibility of developmental financing which is also cost efficient. The study clearly reveals that the banks have been found to realise overall scale economies if output is defined in terms of term loans, other loans and deposits. Furthermore, the study also indicates the presence of substantial economies of scale with respect to the developmental banking activities and confirm the presence of scope economies for development financing among banks.

2.17 Thus, the empirical evidence available on economies of scale and scope which the literature suggests is not categorical.

2.18 Historical experience as to whether universal banks are more risky offers contradictory evidence as detailed below:

i) In the U.S., during the banking crisis of the 1930s, universal banks that offered commercial and investment banking services had a lower rate of failures than the

specialised banks. This was because the securities trading business provided a significant diversification of revenues [Benston, 1990].

ii) A critical examination of the financial crisis that affected Germany and France during the post-war period, revealed that the financial crisis was not due to the presence of universal banks. On the contrary, because of their diversity in their business, they could reduce the risks. Franke and Hudson [1984], who analysed the three most serious banking crises recorded in Germany in the 20th century and their bearing on the universal banking system prevailing in that country, concluded that it did not seem possible to establish a close relationship between universal banks and financial crisis.

iii) Many banks suffered crises in several European countries during the recession of the second half of the 1970s and the recession of the early 1990s. The banks that suffered most from these recessions and went bankrupt were the medium and large sized universal banks and, in particular, universal banks that had major stakes in the industrial sector [Cuervo, 1988].

2.19 Although many German financial institutions offer almost all kinds of financial services, the universal banks do not dominate the market. The evidence from Germany indicates that universal banking does not result in limited sources of credit or other financial services. In Germany, both universal banks and specialised institutions offer their services to the public. For that matter, in no country, universal banks seem to have been able to eliminate specialised institutions from business.

2.20 In Germany, a 1979 Banking Commission Report (Gessler Commission) did not find universal banks exerting excessive influence. The checks and balances implicit in market competition among 4,000 financial institutions as well as insurance companies and other non-banks, together with German banking and commercial law, were found to be sufficient safeguards. The Gessler Commission, however, did find that universal banks had the information advantage obtained by them in the course of their credit business.

2.21 Regarding the overall efficiency of investment, Boyd, Chang and Smith [1998] found that under universal banking a larger portion of the surplus generated by externally financed investment accrues to banks and loss accrues to the originating investors. This clearly can have far-reaching implications for aggregate investment activity. They also demonstrated that problems of moral hazard in investment will often be of greater concern under universal banking than under commercial banking. In sum, the authors suggested universal banking can easily have adverse consequences for the overall efficiency of investment.

2.22 As can be seen from above, empirical evidence does not establish clearly either overwhelming advantages or disadvantages of universal banking.

Universal Banking: Regulatory and Supervisory Challenges

2.23 Universal banking generally implies complexity of regulation and supervision. Following deregulation, domestic financial markets become closely inter-linked and a wide range of innovations and new products are introduced. These together with integration with international financial markets add one more dimension to sector activities and increase the problems of effective control by national regulators. These developments throw up policy challenges that are often too technical and for adequate understanding of their implications, detailed data and information are required. As the participants innovate newer products to circumvent the applicable regulatory constraints, more and more complex legal and administrative arrangements are required to be put in place for effective response. Correspondingly, regulatory institutions also need to be equipped with sufficient policy guidelines and resources to analyse and interpret vast amount of data and information very quickly.

2.24 Regulatory institutions and frameworks in many countries on the other hand, are traditionally compartmentalised and geared to overseeing specialised financial service providers. Rapid expansion in the size and the variety of financial activity, let alone its complexity following deregulation, easily overwhelms the resources as well as the legal framework for regulation. The resultant lack of adequate supervision of the liberalised financial sector leads to serious distortions and
malfunctioning.

2.25 A notable development in the 1980s and 1990s is the emergence of financial conglomerates providing a large range of financial services in various locations and this also includes banking, non-banking financial services, insurance, securities, asset management, advisory services, etc. Consequently, the job of the regulators becomes difficult because failure in any particular segment could easily spread to other parts and finally this could become systemic. The level of preparation of the regulatory mechanism to meet such contingencies also becomes challenging. In countries like Britain, efforts have already been made to move towards a unified regulatory authority for financial regulation with the responsibility for bank supervision, securities market, investments and insurance regulation. With further financial liberalisation reforms, the expectations of depositors and investors also increase. The experience to a greater extent suggests that with a view to minimising the contagion, it becomes imperative that the regulators adopt conglomerate approach to financial institutions.

2.26 Another important consideration that advocates caution in moving to universal banking relates to the possible impact of "non-core" banking activities on "core" banking activities. The "core" banking activities comprise accepting unsecured deposits from public and providing payment services as an integral part of the payment system in the economy. The central bank's obligation to act as the 'lender of the last resort' and maintain safety net to support banks in times of trouble follows from this relationship. Mixing of financial services and other banking activities with the "core" banking activities may result in substantial increase in the burden on the central bank on two counts. It might create expectation among public as well as investors that central bank's safety net may be extended to all the activities of a bank in times of need. This would place far too much demand on the central bank's resources, besides aggravating the problem of 'moral hazard'. Second, commercial bank's ability to fulfill its obligation in respect of its non-core activity (say, mutual fund) might affect depositors' confidence in the bank, causing a run on the bank with possible adverse effects on the entire banking sector.

2.27 It is to maintain a distinction between the "core" and "non-core" banking activities that many authorities insist on a formal separation by requiring the two sets of activities to be carried out under separately capitalised subsidiary of a holding company. However, recent experience in the U.K. and the U.S. casts doubts on the efficacy of 'firewalls' due to market perceptions as well as interdependencies between the two sets of activities when undertaken too closely together within a group structure [Borio and Filosa, 1994].

Are Banks 'Special'?

2.28 Historically, banks have been considered 'special' for various reasons. In the evolution of financial sector in any type of economy, *viz.*, industrial, developing and transition, banks are the first set of institutions to develop, followed by others, *viz.*, investment banks, security houses, capital markets, insurance companies, etc. Hence due to their age, they are considered as a vital segment. Secondly, they mobilise deposits and hence are a major contributor in enhancing financial savings of the economy. In this context, the vast area of network they have, no doubt, helps them to mobilise savings not only from the urban centres, but also from the remote corners of the country. Thirdly, they assume an important position in the payment and settlement mechanism. In recent years, it has been the common practice to measure the strength of the economy by the effectiveness of payment and settlement mechanism. Hence the soundness of banks is continuously evaluated and remedial policies are put in place once any kind of weakness is identified. Even the IMF, World Bank and other international organisations give importance for banking soundness due to banks' effective role in the payment and settlement system. Fourthly, banks are the principal source of non-market finance to various segments of the economy.

2.29 The experience the world over shows that major banks everywhere have increasingly diversified the products and services they offer, such as, investment banking, life insurance, etc., either in-house or through separate subsidiaries. However, even these developments have not fundamentally altered the special characteristics of banks. On the liability side, although some close substitutes for deposits, such as, money market mutual funds have taken place which have eroded banks' market share as a repository for liquid asset holdings, such erosion has generally been very small and bank deposits still constitute a single largest source of liquid asset holdings. Even though in recent years some new facilities have been developed for making payments, such as, debit cards or credit cards, most transactions are still settled through banks. On the asset side, there is some evidence of a gradual erosion of the role of banks in financial intermediation. For instance, in the U.K., bank lending to the corporate sector declined from 27 per cent of total corporate borrowing outstanding in 1985 to less than 17 per cent recently, due mainly to larger corporate borrowers accessing domestic and international capital markets directly. Small corporates, on the other hand, continue to remain heavily dependent upon bank finance.

2.30 Thus, while there certainly have been important changes affecting banks and the environment in which they work, they have not yet been such as to substantially alter their key functions or the importance of those functions to the economy; nor have they altered fundamentally the distinctive characteristics of either the banks' liabilities or their assets. In some respects, they may be less special than they were, they remain special nonetheless. They continue to remain special in terms of the particular characteristics of their balance sheets, which are necessary to perform those functions [Eddie George, 1997].

2.31 If banks continue to remain special for systemic reasons, they are more so in developing countries, due to a number of factors. Banks in India have extensive branch network; they are the single largest source of domestic savings, and the main source of finance for small-scale, agriculture, trade, especially the foodgrains, exports and other priority sectors. This dominant position is likely to continue in the medium to long-term requiring distinct treatment in terms of regulatory and supervisory framework.

Universal Banking: Evolving Process and Contextual

2.32 Notwithstanding the foregoing, experience in Germany and Switzerland seems to assure that universal banking is not incompatible with the maintenance of the safety of financial system or with protecting the central bank against excessive demands as the lender of last resort. The answer lies perhaps in that, in these countries, universal banking evolved gradually over a long period of time, giving time for appropriate institutions, practices, experience, and conventions to

be developed, and a body of formal as well as non-formal guidelines for regulatory purposes to be established. The stage of development of the financial markets also presents an important issue in considering the pace of financial deregulation and movement towards universal banking. To realise efficiency gains from universal banking, ideally financial markets need to operate in a relatively competitive environment.

2.33 Universal banking can exist in different organisational settings, under varying regulatory regimes, and with varying degrees of specialisation or universalisation of financial services, especially commercial and investment banking, by the participants concerned. Finally, the practice is both evolving and contextual – especially in the country context. The focus for policy purpose, therefore, has to be on the country practices and institutional structure as well.

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[3] The term 'Development Financial Institutions (DFIs)' in this paper has been used to denote Industrial Development Bank of India (IDBI), ICICI Ltd., Industrial Finance Corporation of India Ltd.(IFCI), Industrial Investment Bank of India Ltd.-IIBI (formerly IRBI), Tourism Finance Corporation of India (TFCI) and Export Import Bank of India (Exim Bank). The term 'Refinancing Institutions (RFIs)' has been used to denote Small Industries Development Bank of India (SIDBI), National Bank for Agriculture and Rural Development (NABARD) and National Housing Bank (NHB). The term 'FIs' refers to both DFIs and RFIs.

3. PRACTICE OF UNIVERSAL BANKING AND THE POSITION IN INDIA

Practice of Universal Banking

3.01 The traditional home of universal banking is central and northern Europe, in particular, Germany, Austria, Switzerland and Scandinavian countries. Universal banking in countries like Germany, Austria and Switzerland evolved in response to a combination of environmental factors besides regulation. The direct involvement of German banks in industry through equity holdings was the result partly of banks converting their loans into equity stakes in companies experiencing financial pressures. A combination of environmental factors and unique historical events enabled banks in different European countries to establish themselves in particular segments of the corporate financing market [Gardener and Molyneux, 1994].

3.02 While countries like Germany and Switzerland never imposed any restriction on combining commercial and investment banking activities, the U.S. passed the Banking Act, 1933 (Glass-Steagall Act has come to mean those sections of the Banking Act, 1933 that refer to bank's securities operations), whereby banks were prohibited from combining investment and commercial banking activities. The Glass-Steagall Act was enacted to remedy the speculative abuses that infected commercial banking prior to the collapse of the stock market and the financial panic of 1929-33 [Benston, 1990]. The legal provisions of the Banking Act, 1933 (Glass-Steagall Act) established a distinct separation between commercial banking and investment banking and made it almost impossible for the same organisation to combine these activities.

3.03 The competition in the banking industry has intensified following financial deregulation and innovations and introduction of new information technologies. Regulators in many countries have decompartmentalised their credit systems by extending the range of permissible activities and removing legal and other restrictions.

3.04 The restrictions on banks engaged in securities business have been relaxed considerably worldwide during the last two decades. Three groups of countries can be distinguished. While countries, such as Germany, the Netherlands, and several Nordic countries, have imposed very little restriction on the combination of traditional banking and securities business, Canada and most European countries have entirely removed barriers to acquisition of securities firms and hence access to stock exchanges [Borio and Filosa,1994]. Even in the U.S., where commercial and investment banking have been legally separated, market participants have tried to take advantage of some of the loopholes in the Glass-Steagall Act. For example, taking advantage of

Section 20, banks have already been allowed to step into securities underwriting through separate affiliates. In comparison with deregulation concerning the combination of commercial and investment banking activities, deregulation relating to combination of banking and insurance business has been limited [Borio and Filosa, 1994].

3.05 Universal banking usually takes one of three forms, *i.e*., in-house, through separately capitalised subsidiaries, or through a holding company structure. Universal banking in its fullest or purest form would allow a banking corporation to engage 'in-house' in any activity associated with banking, insurance, securities, etc. That is, these activities would be undertaken in departments of the organisation rather than in separate subsidiaries [Saunders and Walter, 1994]. Three well-known countries in which these three structures prevail are Germany, the U.K. and the U.S. In Germany, banking and investment activities are combined, but separate subsidiaries are required for certain other activities. Under German banking statutes, all activities could be carried out within the structure of the parent bank except insurance, mortgage banking, and mutual funds, which require legally separate subsidiaries. In the U.K., broad range of financial activities are allowed to be conducted through separate subsidiaries of the bank. The third model, which is found in the U.S., generally requires a holding company structure and separately capitalised subsidiaries. Apart from the U.S. and Japan, where the separation between commercial banking and investment banking has been more rigid, there have been many other countries which continue to have restrictions on combining of commercial banking and investment activities. A synoptic view of universal banking practices prevailing in various countries including India is presented in Statement 1.

3.06 The following general observations can be made from Statement 1 on the practice of Universal Banking (UB).

First, the practice of UB varies across different countries.

Second, for convenience, it is possible to differentiate between UB in the narrow sense and in broader terms. The narrow definition of UB would combine lending activities and investment in equities and bonds/debentures. The broader definition would include all other financial activities, especially insurance.

Third, it is possible to envisage UB activities in-house or through subsidiary route, or even through a combination of in-house and subsidiary route.

Fourth, where it is predominantly through subsidiary route, it can be inferred that a conglomerate approach to financial services is invoked.

Fifth, in India, the regulatory environment permits provision of a range of financial services in-house in a bank subject to some restrictions. Banks have the option of undertaking investment activity, etc. through subsidiaries. DFIs have also been permitted to set up banking subsidiaries. DFIs are also permitted to operate at the short end of the market, by performing bank like functions, such as, providing working capital finance or tapping deposits, subject to some restrictions. In brief, both banks and DFIs are permitted, in a limited way, to undertake a range of financial services, at their option, in-house and through subsidiaries.

3.07 To get a clear picture of status of banking business in India, it would be necessary to outline the status of the financial system, with special reference to the banking system during pre-reform period and currently. While deregulation and securitisation have effaced traditional distinctions between commercial and investment banks in other countries, commercial banks in India have developed subsidiaries engaged in regular security issues and trading. This is depicted in Statement 2. It is clear therefrom that the financial system has undergone substantial changes towards liberalisation mainly in line with the recommendations of the Narasimham Committee on Financial Sector Reforms, and the major features relevant to the current discussion are:

First, diversification of ownership has been permitted in respect of public sector banks. Out of 27 banks, 8 banks accounting for 50.5 per cent of assets of public sector banks have already diversified ownership.

Second, competition has been enhanced by allowing new private sector banks. More foreign banks have been allowed entry.

Third, in terms of banking environment, most deposit and lending rates have been deregulated, statutory pre-emptions have been reduced and banks have been given freedom to decide on most of their operations.

Fourth, banks have been subjected to prudential norms relating to income recognition, asset classification, provisioning, capital adequacy requirements, exposure limits, etc. almost on par with international standards.

Fifth, with respect to DFIs also, substantial changes have occurred. The ownership pattern has changed as elaborated in statement 7, leading to further diversification of ownership. There has been in some cases a transformation of the organisational structure, i.e., statutory bodies have been converted into companies under the Companies Act, 1956. There have been changes in the operating environment for DFIs, especially with regard to Long Term Operation (LTO) Funds and government guaranteed bonds. Similarly, there have also been changes in the regulatory

environment for DFIs – IDBI and ICICI, etc. have been brought under the regulatory framework of the RBI.

Sixth, the environment under which the NBFCs are operating has changed. The regulatory framework relating to NBFCs has also seen substantial changes.

3.08 More specifically, diversification of business by banks into investment banking and beyond has been occurring. Statement 3, which narrates the ownership pattern of banking subsidiaries in the Indian context, provides interesting insights.

First, in respect of banks, some have 100 per cent ownership in subsidiaries, while in others they have majority holding and sometimes minority holding. Within the banking system, a few private sector banks too have a stake in subsidiaries. Among the banks covered, out of 37 subsidiaries, 19 have 100 per cent ownership by banks. The major share-holding by a single bank is observed in respect of 18 cases. Even where the majority equity is held by a bank in respect of 18 cases, the rest of the shares are held by other banks in 2 cases. There are some cases such as, SBI Factors and Commercial Services Ltd., CanBank Factors Ltd., BOB Housing Finance Ltd., AllBank Housing Finance Ltd., ViBank Housing Finance Ltd. and CentBank Home Finance Ltd., where bank subsidiaries have some shareholding by FIs. It may be observed that in respect of Discount and Finance House of India (DFHI) and Securities Trading Corporation of India (STCI) banks own majority of shares, while the RBI, after disinvestment holds a minority shareholding.

Second, subsidiaries have been set up by banks for undertaking various activities, such as, investment banking, factoring, primary dealership, mutual funds, credit card business, housing finance, securities exchange, securities trading and custodial services, etc. Activities in which 100 per cent ownership of banks are observed relate to mutual fund, merchant banking, leasing, hire-purchase, credit card business, housing finance, primary dealership, broking business. Activities in which minority shareholding of banks are observed relate to merchant banking, factoring, primary dealership, broking business, credit card business, leasing, hire-purchase, housing finance, share clearing and stock holding, development of software and computer related activities and trusteeship.

Third, maximum number of subsidiaries (6) are noticed in the case of State Bank of India (SBI), which encompass 8 activities.

Fourth, some non-bank finance activities, such as, credit cards are undertaken by some banks through subsidiaries, while in some others they are undertaken in-house also.

Fifth, many banks have shareholding in Regional Rural Banks jointly with Government on a uniform basis at 30 per cent of equity.

Sixth, there are subsidiaries where DFIs/RFIs and banks are co-partners. Such instances prevail at least in 6 cases.

Seventh, though there is no mention in the statement, there are some instances when the parent bank had to rescue its subsidiary/sponsored institution. For instance, Canara Bank agreed to buy units from unit holders of CanBank Mutual Fund at a price higher than the repurchase price to meet the obligation of assured returns. This resulted in a net outgo of Rs.507.10 crore which was directly written off from its additional capital of Rs.600 crore provided by the Government of India in 1997-98. Indian Bank had to infuse Rs.48.01 crore into IndFund Management Ltd. (IFML) to enable the latter to honor its commitment to its unit holders. SBI had to infuse additional capital of Rs.25 crore to SBI Fund Management Ltd. (SBIFML) for enabling it to meet commitments in respect of two mutual fund schemes.

3.09 Similarly, DFIs have been diversifying their business into other activities. It will be seen from Statement 4 that DFIs have subsidiaries either with 100 per cent shareholding, majority shareholding or minority stake.

First, in respect of DFIs, IDBI, ICICI and IFCI account for 12 subsidiaries with 100 per cent shareholding. IDBI have 100 per cent stake in 3 and majority holding in 2 subsidiaries. ICICI has 100 per cent and majority stake in 6 and 3 subsidiaries, respectively. IFCI has 3 wholly owned subsidiaries and one majority holding subsidiary.

Second, activities of subsidiaries with 100 per cent ownership of DFIs include investment banking, capital market services, refinancing to SSI sector, investor services, custodial services, primary dealership and off-shore equity fund. Activities of subsidiaries with majority ownership relate to commercial banking, mutual fund, factoring, leasing, infrastructure financing and venture capital.

Third, it may be highlighted that IDBI as a promoter has controlling share-holding in IDBI Bank, while ICICI as a promoter has controlling interest in ICICI Banking Corporation Ltd.

Fourth, there are few cases where FIs have some share-ownership of banks (for example, ICICI in ICICI Banking Corporation Ltd., Federal Bank Ltd., South Indian Bank Ltd.).

Fifth, there is also evidence of indirect holding of a bank by a DFI through an NBFC promoted by the DFI. For instance, ICICI has single largest share in Housing Development Finance Corporation (HDFC) - a NBFC which owns and controls HDFC Bank.

Sixth, some refinancing institutions also have substantial stakes in other entities.

3.10 Further, both banks and DFIs have been permitted to combine, in a restricted way though, traditional banking and investment banking functions. It may be observed from Statement 5 that apart from diversification through the subsidiary route as indicated above, diversification of activities has also taken place in-house. To illustrate, banks are undertaking a number of core non-banking activities, such as investment banking, hire-purchase, leasing, credit cards, etc., as an in-house departmental activity or through subsidiaries.

3.11 As a result of reform, the operating environment has changed considerably both for banks and DFIs. Statement 6 depicts the changing pattern of the resource mobilisation and deployment of funds of banks and FIs.

First, in the past, banks have been permitted and encouraged to undertake term-lending and even equity financing. However, it has not been a widespread practice among banks to extend term loans and invest in equity shares on a large scale. More recently there has been a liberalisation of the operating environment as banks are permitted to undertake term-lending activities without any restriction.

Second, the advent of DFIs in working capital finance is a very recent phenomenon.

Third, DFIs have been permitted to access short-term resources, subject to some restrictions.

Fourth, while restriction on bank-like activities of DFIs is on the liabilities side, restriction on activities of banks is mainly from the asset side.

4. FUTURE ROLE OF DFIs IN INDIA AND FINANCING NEEDS OF INDUSTRY: SOME ISSUES

4.01 In India, a well-knit structure of Financial Institutions (FIs) has developed over the years. The Industrial Finance Corporation of India (IFCI) was established in 1948 under an Act of Parliament to meet the medium and long-term financial needs of industrial concerns in India. To take care of the financial needs of smaller units at the state-level, State Financial Corporations (SFCs) were set up under the State Financial Corporation Act in 1951. In 1955, Industrial Credit and Investment Corporation of India (ICICI) was set up as a public limited company under the Companies Act with the primary objective of providing foreign currency loans to industrial projects and promote industries in the private sector. In 1964, Industrial Development Bank of India (IDBI) was created as the apex body for catering to the growing and diverse needs of medium and large scale industries. State Industrial Development Corporations (SIDCs) established under the Companies Act, 1956 act as catalyst for promotion and development of medium and large scale industries in their respective states.

4.02 Industrial Investment Bank of India-IIBI (formerly the Industrial Reconstruction Bank of India - IRBI), which is wholly owned by the Government of India was set up in 1985 under the IRBI Act, 1984, as the principal credit and reconstruction agency for aiding rehabilitation of sick and closed industrial units. However, in March 1997, IRBI was converted from a statutory body into a public limited company and since then it has been acting as a full-fledged all-purpose development financial institution. SIDBI was set up in 1990 as the principal financial institution for promotion, financing and development of industry in the small, tiny and cottage sectors.

4.03 Apart from specialised financial institutions in the industrial sector, FIs were also set up in the export-import, agriculture and rural sector, and the housing sector. National Bank for Agriculture and Rural Development (NABARD) was set up in 1982 as an apex development bank for promotion of agriculture, small-scale industries, cottage and village industries, handicrafts and other activities in rural areas. Export-Import Bank of India (EXIM Bank) established in 1982 acts as the principal financial institution for financing, facilitating and promoting India’s foreign trade. National Housing Bank was set up in 1988 under the National Housing Bank Act as the principal agency to promote housing finance institutions and to provide financial and other support to such institutions. In January 1997, Infrastructure Development Finance Company (IDFC) was incorporated under the Companies Act, 1956 to provide impetus to the infrastructure sector.

4.04 All the above-referred FIs, except NABARD, EXIM Bank and SIDCs, have been notified as ‘public financial institutions’ (PFIs) under Section 4A of the Companies Act, 1956. There are

some FIs which have been notified as ‘public financial institutions’ under Section 4A of the Companies Act, 1956, such as, Power Finance Corporation (PFC), which perform the functions of DFIs but are subject to the NBFCs regulation. The Reserve Bank following its ‘Mid-term Review of Monetary and Credit Policy for the year 1998-99’ has treated some PFIs selectively for the purpose of applying 20 per cent risk weight on investments in bonds/debentures of such PFIs. Thus, there is some ambiguity regarding the constituents of ‘Development Financial Institutions’. However, for convenience, as mentioned earlier, ‘DFIs’ in this paper refer to IDBI, ICICI, IFCI, IIBI (IRBI), EXIM Bank and TFCI, while ‘RFIs’ refer to SIDBI, NABARD and NHB.

4.05 Thus, over the years, a wide variety of DFIs/RFIs have come into existence and they perform the developmental role in their respective sectors. Apart from the fact that they cater to the financial needs of different sectors, there are some significant differences among them. While most of them extend direct finance, IDBI extends direct finance as well as refinance. IDBI also extends finance by discounting and rediscounting of bills/promissory notes arising out of sales/purchase of machinery/equipment on deferred payment basis. IDBI also refinances term loans given by State level institutions/banks to medium scale units. Thus, IDBI has a sizeable share of indirect finance (refinance of industrial loans, loans and investments in shares and bonds of other FIs, etc.), which ICICI and IFCI do not have. IDBI also exercises supervisory role over State level institutions. SIDBI, NABARD and NHB are mainly refinancing institutions. SIDBI’s activities include refinancing of term loans granted by SFCs/SIDCs/commercial banks and other eligible institutions and direct discounting/rediscounting of bills arising out of sale of machinery/capital equipment/components by manufacturers in the small scale sector. Two of the three refinancing institutions, *viz*., NABARD and NHB have supervisory role. NABARD supervises Regional Rural Banks and other institutions engaged in financing the agriculture and the rural sector. NHB supervises housing finance companies. Even in case of three major financial institutions in the industrial sector, i.e., IDBI, ICICI and IFCI, there is a difference in the focus. For instance, ICICI has historically maintained a relatively higher share of foreign loan portfolio as compared with that of IDBI and IFCI.

4.06 While FIs are homogenous in the sense that they are all engaged in the promotion and development of their respective sectors, there are some significant differences among them which make them heterogeneous in more than one sense. In fact, the ownership pattern and the organisational structure apart from operating environment are varying and have also been changing as part of reform. The current status is presented in Statement 7. It is evident that:

First, among DFIs, there is a diversity of ownership except with respect to IIBI and Exim Bank. IIBI has recently been converted from a statutory body into a company under the Companies Act, 1956. Apparently, the condition of the balance sheet of IIBI has not permitted its profitable diversification.

Second, among DFIs, Government has majority ownership in IDBI.

Third, in respect of refinancing institutions, while NABARD is owned both by the Government and the RBI, NHB is fully owned by the RBI and SIDBI by IDBI.

Fourth, only IDBI and EXIM Bank among DFIs are under statutes although they perform functions similar to ICICI/IFCI.

Fifth, all the refinancing institutions, *viz.*, NABARD/NHB/SIDBI are under statutes.

Sixth, as regards supervisory framework, IDBI carries out supervisory functions of the State level institutions, NABARD of RRBs and other institutions engaged in rural lending and NHB of housing finance companies.

4.07 The KWG recommended that a full banking licence be eventually granted to DFIs. In the interim, DFIs may be permitted to have banking subsidiaries (with holdings up to 100 per cent), while the DFIs themselves may continue to play their existing role. It also recommended that management and shareholders of banks and DFIs should be permitted to explore and enter into gainful mergers. These mergers should be possible not only between banks but also between banks and DFIs, and not only between strong and weak though viable entities but even between two strong banks and DFIs.

4.08 On the same subject, the Narasimham Committee observed that it took 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. With such convergence of activities between banks and DFIs, the Committee was of the view that DFIs should, over a period of time, 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 acquire a banking licence within a stipulated time it would be categorised as a non-banking finance company. A DFI which converts into 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.

4.09 The Narasimham Committee further observed that mergers between banks and DFIs and NBFCs need to be based on synergies and location and business specific complementarities of the concerned institutions and must obviously make sound commercial sense. 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".

4.10 The Narasimham Committee recommended that 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 focussed attention to the work of State Financial Corporations, IDBI shareholding in them should be transferred to SIDBI, which is currently providing refinance assistance to them. To give it greater operational autonomy, SIDBI should also be delinked from IDBI.

4.11 With regard to State level institutions (SLIs), the KWG recommended that the agenda for their reform should incorporate the following:

i) Eventual merger of SFCs, SIDCs and SSIDCs in each state into a single entity. While the consolidation of SLIs should form part of the short-term agenda of reforms in the financial sector, an immediate-term imperative is the corporatisation of these entities to improve their competitive efficiency.

ii) Following restructuring/reorganisation, strong SFCs could be encouraged to go public by making IPOs. In the process, the State Government's holding in these Corporations may be allowed to be brought down to below 50 per cent.

iii) Since the credit requirements of small-scale industries are being taken care of by SIDBI since its establishment in 1990, it would be desirable to transfer the present shareholding of IDBI in these SLIs to SIDBI. It should be vested with the overall responsibility for enacting policy and procedural guidelines with regard to the operations of SFCs.

iv) SIDBI should be accorded the same role and status as the nodal/co-ordinating agency for financing of small (and medium) industries as is now available to NABARD in the field of agricultural development. Ownership in SIDBI should, as a logical corollary, stand transferred to the RBI/Government on the same lines as NABARD.

v) SIDBI's role in the State level institutions should be both as stakeholder as well as resource provider. For this purpose, SIDBI should have access to assured sources of concessional funding from the RBI.

4.12 Financial institutions have historically played a very significant role in financing the long-term requirements of funds of the economy as the alternative sources of long-term funds, i.e., capital market, particularly debt segment, had not developed. However, in the recent years significant developments have taken place in the capital market and as a result the relative importance of capital market in meeting the long-term requirements of funds has certainly increased notwithstanding the present depressed conditions. However, capital market in India has not yet developed to a stage where it could immediately meet long-term requirement of funds on an ongoing basis.

4.13 There are also constraints on supply of long-term funds. Household sector is the major source of savings. However, most of the savings in the long-term instruments, such as, LIC policies, pension and provident funds are still subjected to heavy pre-emption by the Government of India. Such savings constitute the largest source of long-term funds for industry in industrial countries.

4.14 It can be argued that the cross-country experience concerning DFIs (Industrial Bank of Japan, Korean Development Bank and the Development Bank of Singapore) from the East-Asia region shows that declining involvement in the term business by DFIs did not adversely affect the availability of finance for projects. It is necessary to appreciate that, in these countries, the transition in their role took place against the background of very high rates of growth in the GDP and domestic savings, strong inflows of foreign capital and rapid expansion of capital markets. In India, savings rate and FDI inflows are not as high and capital market, particularly for debt finance, is yet to be developed. Thus, there are gaps in the long-term finance which could be met by DFIs as long as the gap exists. At the same time, it is necessary to recognise that over longer term, DFIs may have to adapt to the changing needs and move either towards greater specialisation or greater universalisation - a process that may involve mergers, acquisitions and diversification.

4.15 Insofar as commercial banks are concerned, their asset structure is different from that of development financial institutions. While banks' asset portfolio consists largely of short-term assets, that of DFIs comprises long-term assets. This difference stems mainly from the reason that banks' major sources of funds are of short to medium-term in nature. For instance, as at end-March 1996 (the latest period for which data are available), term-deposits with maturity up to 3 years constituted 71.4 per cent of total term deposits. Deposits with 'more than 3 years and up to 5 years' maturity constituted 16.9 per cent and those with maturity 'above 5 years' constituted 11.7 per cent. Predominance of short to medium-term deposits of banks constrain their ability to

enlarge long-term commitments on a large scale. Term transformation by the banking system is kept within the prudent limits by the RBI.

4.16 Further, over the years, DFIs have emerged as the pre-eminent source of expertise and experience in term-lending and have developed considerable specialisation in project formulation, risk management and project monitoring.

4.17 Developing capabilities necessary for term-lending is a costly and time-consuming process. For this reason, it is also beyond the resources of many small and weak bank participants.

4.18 Likewise, capital markets also cannot be relied upon to provide project finance adequately due to lack of a well-developed long-term debt market in the country. All of this is likely to lead to significant under-supply of term-lending activity in the event of DFIs moving away from it prematurely.

4.19 Banks have played an important role in mobilisation of financial savings of the household sector and purveying of credit on short and medium term basis not only for agriculture, trade and industry but also for small-scale industries and weaker sections of the society. DFIs were set up with a specific mandate to provide long term finance to industry, agriculture, housing, trade and commerce and these institutions operate mainly in the urban and metropolitan centres. Drastic changes in their respective roles at this stage may have serious implications for financing requirements of funds of crucial sectors of the economy. Given the unique position of DFIs in relation to term-lending at this stage, it is desirable that they remain engaged in term-lending activity even as they diversify into new opportunities opened to them by progressive desegmentation of the sector.

4.20 At the same time, it is necessary to recognise that the role of DFIs, in an increasingly market-oriented economy, will have to be redefined, *i.e.*, differentiating clearly supervisory, refinancing, investment banking and other functions on the one hand, and specialised activity and universal banking on the other. Indeed, the real challenges for a DFI in due course are, as envisaged by the Narasimham Committee, to decide whether to be an NBFC or a bank and managing of transition, *i.e.*, how to transform itself to be either of the two. Similar logic would be equally applicable to State level institutions except that their constitution under a statute limits flexibility in transition.

5. ROLE OF BANKS AND DFIs - OPERATIONAL ISSUES

5.01 DFIs traditionally had access to long-term sources of funds in the form of Government guaranteed bonds and LTO Funds of the RBI. After these sources were withdrawn in the early 1990s, DFIs started raising resources from the capital market largely by way of debt. In order to provide them with some flexibility in their resource management, DFIs were given access to term deposits, CDs and the term money market within the limit stipulated for each institution and under some other terms and conditions. Subsequently, instrument-wise limit was replaced with an umbrella limit (comprising term deposits, CDs, borrowings from the term money market and inter-corporate deposits) linked to net owned funds (NOF) in respect of select DFIs. The maturity period of term deposits was stipulated from 1 to 5 years and those of CDs from 1 to 3 years. Borrowings from the term money market were allowed in a maturity range of 3 to 6 months.

5.02 The KWG recommended that overall ceiling for DFIs' mobilisation of resources by way of term money borrowings, Certificate of Deposits (CDs), term deposits and inter-corporate deposits at 100 per cent of NOF of DFIs may be removed. The maturity ceiling of five years on deposits from the public, the capping of interest rate on deposits of DFIs at interest rates offered by SBI for similar maturities and the restriction relating to minimum size of deposits that may be accepted by DFIs may also be removed. The current restriction with regard to premature withdrawal not being permitted for two years may be reduced to one year. With the introduction of the above relaxations and having regard to the minimum maturity of one year for fixed deposits from the public, the KWG recommended that a suitable level of SLR may be stipulated for DFIs on incremental outstanding fixed deposits raised from the public (excluding inter-bank deposits). It recommended that CRR should not be applicable to DFIs under the present structure where they are not permitted to access cash and cash-like instruments.

5.03 The KWG recommended that (a) the application of CRR should be confined to cash and cash-like instruments; (b) CRR should be brought down progressively within a time bound frame to international levels; (c) SLR should be phased out in line with international practice; and (d) definition of priority sector should be widened to include the whole industry/class of activities. Infrastructure lending should not be included in 'net bank credit' while computing priority sector obligations. To facilitate efficient loan disbursals, the priority sector obligations should be linked to the net bank credit at the end of the previous financial year.

5.04 In addition, the KWG recommended that banks may be permitted to exclude from group exposure limit its investments in SLR securities issued by DFIs. A Standing (co-ordination)

Committee be set up on which banks and DFIs would be represented. DFIs should be granted full Authorised Dealer's licence.

5.05 To manage risks, the KWG recommended (a) a prudent risk-return optimisation strategy; (b) a clear strategy approved by the Board of Directors as to their risk management policies and procedures; and (c) an integrated treasury and pro-active asset-liability management and robust (internal) operational controls.

5.06 It recommended that IT systems and MIS of international standards be established. In respect of human resources management, the KWG recommended (a) prescient management and leadership with accent on teamwork; (b) broad-based recruitment both at entry level from campus as well as lateral entry of professionals at higher levels; (c) systematic training programme; (d) skill building and upgradation; (e) market-related compensation packages; (f) viable and enforceable exit option for employees; and (g) special vigilance machinery exclusively for the financial sector on the lines of Serious Frauds Office (SFO) in the UK.

5.07 The above recommendations may be broadly divided into the following:

(a) DFIs' access to short-term funds, cap on interest rates and access to money market;

(b) Statutory obligations, *viz.*, CRR, SLR, risk weights and exposure norms;

(c) Directed credit, *viz.,* priority sector lending;

(d) Authorised Dealer's licence;

(e) Risk management issues;

(f) Internal management issues, such as, Information Technology, MIS and HRD.

5.08 Statement 8 gives, in a summary form, the current status in regard to each of them. It is clear therefrom that discernible progress has been made with respect to some of the recommendations of the KWG and the Narasimham Committee, both with respect to banks and DFIs. These are:

First, SLR has been reduced and brought to the statutory minimum level of 25 per cent. CRR has also been reduced, but moving to the statutory minimum of 3 per cent is a medium to long-term goal. Any further reduction in CRR will depend on the fiscal, monetary and exchange rate situation.

Second, prudential norms, which comprehensively cover banks have been introduced. As regards DFIs, asset classification and provisioning norms as well as exposure norms relating to a single/group of borrowers have been introduced.

Third, draft Asset-Liability Management (ALM) guidelines have been finalised in discussion with banks. In regard to DFIs, draft ALM guidelines are under preparation in consultation with DFIs.

Fourth, with regard to enhancing and rationalising access to short-term funds for DFIs, the matter is being resolved through discussion with DFIs.

Fifth, technology issues are being accorded top priority in banks and DFIs. The RBI is in the process of expediting the installation of VSAT network. The RBI is also monitoring Y2K compliance. Commrecial banks are also being encouraged to put in place risk management systems, which will be formalised when the ALM system is introduced.

6. REGULATORY, SUPERVISORY AND OTHER RELATED ISSUES

6.01 The KWG recommended a function-specific regulatory framework that targets activities and is institutional-neutral. In view of the increasing overlap in functions being performed by various participants in the financial system, the KWG recommended the establishment of a 'super-regulator' to supervise and coordinate the activities of these multiple regulators in order to ensure uniformity in regulatory treatment.

6.02 It also recommended that the Supervisory Authority should undertake primarily off-site supervision based on periodic reporting by the banks or DFIs as the case may be. On-site supervision should be undertaken only in exceptional cases, mainly to oversee the quality of self-regulation by financial sector participants. The assistance of statutory auditors may be taken by the Supervisory Authority to get special reports on selected areas of supervision every year. The emphasis of the supervisory system should be more on macro-management and health of the institution rather than on micro-level regulation at the individual transaction/account level.

6.03 It recommended that the banks/DFIs should be supervised on a consolidated basis. Future accounting standards must consequently include rules on consolidated supervision for financial subsidiaries and conglomerates. Further, as domestic financial entities assume an international character, banking supervisors should adopt global consolidated supervision (instead of mere national regulation). For meaningful consolidated supervision – both domestic and global – the Group recommended the development of a "risk-based supervisory framework" along the lines of the Report of the Task Force on Conglomerate Supervision, published by the Institute of International Finance, in February 1997.

6.04 The KWG recommended that the State level institutions should be brought under the supervisory ambit of the RBI.

6.05 The Narasimham Committee observed 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) and the agency (Board for Financial Supervision) be renamed as the Board for Financial Regulation and Supervision (BFRS). For effective supervision, it observed that there is a need for formal accession to 'core principles' announced by the Basle Committee. It observed that 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 suggested that all regulatory and supervisory functions over rural credit institutions should vest with the Board for Financial Regulation and Supervision (BFRS).

6.06 As long as DFIs were mostly instruments of providing capital in line with plan priorities and industrial licensing regime of the Government of India, funded through concessional sources, they were not subject to market discipline or the RBI's supervisory regime. It was in 1990 that the RBI started overseeing the operations of major all-India financial institutions for bringing about better functioning of the financial system and to achieve greater coordination between banks and financial institutions. In March 1994, the RBI prescribed prudential guidelines relating to income recognition, asset classification and provisioning and capital adequacy standards to major DFIs.

6.07 The regulatory and supervisory regimes for DFIs and banks differ, the main features are summarised in Statement 9. In view of the recommendation of the Narasimham Committee that DFIs have to be either NBFCs or banks, the Statement 9 indicates the regime for NBFCs also. The salient features are listed below:

First, banks are required to obtain a licence to commence business. DFIs/RFIs barring ICICI were set up under the Acts of Parliament. Though ICICI was set up as a company under the Companies Act, 1956, it was notified as a 'public financial institution' under Section 4A of the Companies Act. IRBI and IFCI have since become companies. Thus the status of DFIs in this respect is rather nebulous. NBFCs are public limited companies under the Companies Act, 1956.

Second, asset classification and provisioning norms replacing the health code system for banks exist since April 1992. These norms for DFIs and NBFCs were prescribed in 1994.

Third, banks and DFIs/RFIs are required to maintain 8 per cent risk weighted capital adequacy ratio. This ratio has been increased
to 9 per cent to be achieved by March 31, 2000. NBFCs are required to maintain a capital adequacy ratio of 12 per cent with effect from March 31, 1999.

Fourth, exposure norms have been prescribed for banks/DFIs and NBFCs.

Fifth, currently, while CRR and SLR have been prescribed for banks, there are no such prescriptions for DFIs. NBFCs too have liquid asset prescription.

Sixth, while banks have prescription for priority sector advances, there is no such prescription for DFIs and NBFCs.

Seventh, with regard to banks, ALM guidelines are being finalised. In respect of DFIs, guidelines are being finalised in consultation with them.

Eighth, banks are subject to on-site and off-site supervision. DFIs have been brought under BFS but off-site supervision is yet to be put in place. The on-site supervisory approach for banks and NBFCs is structured on the basis of CAMELS. This rating system is yet to be put in place for DFIs.

7. DRAFT PROPOSALS

7.01 As brought out in the earlier sections of this Discussion Paper, the financial sector was characterised by a number of administrative regulations/controls in the 1970s and early 1980s. Although some reforms were introduced in the late 1980s, major thrust to the financial sector reforms was given in 1990s. Consequently, a number of changes were witnessed in external constraints, operating environment, organisational pattern, ownership, relative roles of financial intermediaries etc., leading to significant deepening and strengthening of the financial sector.

7.02 Development financial institutions (DFIs) and refinancing institutions (RFIs) were by and large conceived, developed and nurtured by the Government and the Reserve Bank to meet specific sectoral needs and also to provide long-term resources at concessional terms, while the commercial banks in general, by and large, confined themselves to the core banking functions of accepting deposits and providing working capital finance to industry, trade and agriculture. Consequent to the recent liberalisation and deregulation of financial sector, there has been some blurring of distinction between providers of various financial services. In particular, the traditional distinction between the commercial banking and investment banking has tended to narrow somewhat.

7.03 With a view to move ahead with the reform process, it is essential to identify the steps that should be taken now in the field of financial integration, which would recognise the need to rationalise and harmonise the relative roles of banks and DFIs in future. The draft proposals given below address three main issues: approach to universal banking, meeting the long-term capital requirements of the corporate sector and the future role of DFIs and RFIs. In addition, the issues of regulatory and supervisory framework and ownership and organisational structures, which arise out of the main issues, are discussed. Besides, two other issues especially flagged by the KWG, which have immediate operational significance, *viz.,* harmonisation and efficiency are also covered.

Approach to Universal Banking

7.04 The approach to universal banking should be guided both by international experience and domestic requirements. As observed in the Narasimham Committee Report, the global trends in banking are marked by the twin phenomena of consolidation and convergence. Even in those countries where there are legal or regulatory impediments to provide a combination of commercial, investment and other banking services, relaxation of restrictions is being contemplated at present. There has also been a blurring of the boundaries among suppliers of various products and services. Some of these trends are already visible in India. As noted earlier,

banks are already providing a range of financial services, such as, investments, merchant banking, leasing and hire-purchase and project finance, either in-house or through the subsidiary route. Likewise, DFIs are already undertaking bank like activities, such as, short-term non-project lending and retail deposit taking, either in-house or through the subsidiary route.

7.05 The process of enabling, both by banks and DFIs, the provision of diversified services, either in-house or through the subsidiary route as a conglomerate, should continue, *albeit* in a gradual and orderly fashion, subject to appropriate regulation and supervision.

Meeting the Long-Term Capital Requirements of the Corporate Sector

7.06 An important consideration in financial sector reforms is ensuring that long-term capital requirements of the economy, especially corporate sector, are met in an efficient manner. It is sometimes argued that merely engaging in term-lending and participation in equity may not be a viable proposition for some DFIs. However, until the long-term debt market improves, in terms of liquidity and depth, there is a special role for DFIs in the financial system. Small and medium-sized firms continue to depend on DFIs for long-term financing. DFIs have acquired special skills in project appraisal which banks are yet to fully develop. DFIs have proved to be innovative and agile in meeting diverse requirements of their customers. Thus, in the medium-term at least, there is a definite role for DFIs in the long-term development finance.

7.07 However, DFIs should have the freedom to become NBFCs by specialising as a DFI or become a bank over a period as envisaged by the Narasimham Committee. There are a number of options, as implicitly or explicitly recognised by both the Narasimham Committee and the KWG, of DFIs getting into banking activity. One option is to pursue banking activity in-house by becoming a bank, but DFIs may not have adequate network to compete successfully with the existing banking system. Mergers and acquisitions may help overcome this constraint. Another option for a DFI is to have a 100 per cent owned subsidiary.

Future Role of DFIs

'.08 It has to be recognised that in the present institutional infrastructure, DFIs will continue to have a special niche carved out for them, as mentioned above. Therefore, DFIs should have the freedom to remain DFIs, specialising in their own activities. However, if a DFI chooses to become a bank, venturing into commercial banking activities, that option should also be available. In that case,

however, the “converted” DFI should be prepared to fully conform to all prudential, regulatory and supervisory norms which are applicable to banks.

7.09 The important question is what is the opportune time for a DFI to consider the transformation into a bank. To answer this, one must take into account the position which DFIs are enjoying in the financial sector, the expectation of the users of their services, alternative institutional arrangement to fill the gap in case most or all of the DFIs vacate the scene, etc.

7.10 The question of transformation of a DFI into a bank should ideally be considered after a period, say of five years from now, in view of the following reasons. Firstly, as explained earlier, DFIs will continue to be an important source of finance for the capital needs of the industries till the capital market, especially debt market is fully developed. Secondly, DFIs have project appraisal capabilities, which other financial intermediaries are yet to develop. Thirdly, the financial sector has to develop along with financial markets to provide adequate competitive services among all financial intermediaries. Fourthly, DFIs themselves will have to plan and acquire necessary expertise in offering various banking services in-house and develop an appropriate branch network. Finally, the policy environment as well as regulatory and supervisory framework should also be evolved for such a transformation of DFIs into banks.

7.11 When a DFI chooses to transform itself into a bank, the transitionary arrangements, on a time-bound basis, could be worked out, after a detailed examination by the RBI, on a case by case basis. This case by case approach is essential because each DFI would be in a unique position in terms of its capacity to transform into a bank, necessitating a transition period and tailor-made transition path would need to be worked out. However, if a DFI can demonstrate its capacities to transform into a bank sooner and conform to the totality of regulatory framework of a bank, there should be no objection to such transformation.

7.12 There is no particular advantage in stipulating a time limit, even after five years, on DFIs to exercise an option to become a bank in as much as it could always continue as an NBFC, subject to all the regulatory requirements of NBFCs. Thus, depending on the evolving situation, a DFI could choose to provide specialised services as an NBFC or continue to adopt the conglomerate route with a banking subsidiary or transform itself into a bank.

7.13 Some DFIs have already invested in banks and have promoted banks, which are now their subsidiaries. If a DFI chooses to provide bank like services by itself, through a wholly owned subsidiary route, permission to set up a fully owned subsidiary could also be considered by the RBI. However, whenever there is a bank, as a subsidiary of a DFI

or in a conglomerate with a DFI, as detailed later, adoption of a consolidated approach for regulation and supervision of such institutions, is essential in view of the special status of banks in the financial sector.

Regulatory and Supervisory Issues

7.14 Banks have a special role to play in the economy, in general, and in the financial system, in particular, as the repository of liquidity, recipient of non-collateralised deposits, and on account of their role in the payments system. Hence, adequate and appropriate prudential norms on their activities will have to continue.

7.15 It may, therefore, be desirable to evolve a general policy towards reflecting the activities of bank/DFI subsidiaries in the parent bank's/DFI's accounts particularly in the light of the proven link between the liabilities of a subsidiary and its parent, as for example, in respect of subsidiaries engaged in mutual fund activities.

7.16 The Narasimham Committee had recommended that the RBI should direct banks to publish, in addition to financial statements as independent entities, a consolidated balance sheet to reveal the true financial position 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 bank's creditors, investors and rating agencies to get a true picture of its functioning – an important requirement in a market driven financial sector. This observation of the Narasimham Committee is equally applicable to DFIs, especially when there is a bank directly under its umbrella.

7.17 This recommendation is at present being examined in consultation with the Institute of Chartered Accountants. Currently, private sector banks are required to disclose alongside their balance sheets, the final account of their subsidiaries. With diversified ownership, the public sector banks are not necessarily 100 per cent owned by the government. The ultimate objective should, therefore, be to move towards a consolidated balance sheet in respect of each public sector bank also.

7.18 There is no clear cut identification of what constitutes DFIs though the major DFIs are easily identifiable to the extent that these are public financial institutions (PFIs). RFIs are performing many functions of DFIs. Some institutions like Power Finance Corporation (PFC), as mentioned earlier, are performing functions of a DFI, but subject to NBFC regulations. Hence, it

will be necessary to identify those DFIs/RFIs, which are yet to be subjected to NBFC regulations, and have a category which would be well defined.

7.19 The Narasimham Committee had recommended that, in future there should be only two categories, *viz.*, banks and NBFCs. While the approach is valid, given the size and special role envisaged for DFIs, it will not be proper to equate them straightaway with traditional NBFCs as they are operating today. Hence, identified DFIs will have to be treated for sometime at least, as a special category financial institutions to be brought under the regulatory/supervisory framework as applicable to NBFCs under the RBI Act. However, in the special category, each DFI should be given specific relaxations from application of identified regulatory regime. These relaxations could be time-bound, and monitorable. This process would facilitate achieving the objective of a DFI becoming a full-fledged NBFC at an appropriate stage. A corporate structure of DFI/RFI, as discussed later, would facilitate such an approach to regulate/supervise them. This classification would bring all DFIs and RFIs under a more focussed regulatory/supervisory regime than now.

7.20 Under the present set up, some of the DFIs, *viz.*, Industrial Development Bank of India (IDBI), National Bank for Agriculture and Rural Development (NABARD), National Housing Bank (NHB) are also performing supervisory functions over State Finance Corporations (SFCs), Regional Rural Banks (RRBs), and housing finance companies, respectively. The Narasimham Committee had, though in a restricted context, recommended that the supervisory/regulatory functions of the entities engaged in dispensation of credit be brought under the overall framework of Board for Financial Supervision (BFS). This recommendation needs to be accepted, in principle, by bringing RRBs being supervised by NABARD, housing finance companies being supervised by NHB, and SFCs being supervised by IDBI, under a common overall framework. Such a framework will enable RFIs to focus better on developmental and refinance functions, while ensuring regulatory consistency between banks, DFIs and NBFCs. The question whether the supervisory responsibility should rest with the BFS, as presently conceived, or whether a separate supervisory structure has to be devised would also need to be considered in due course. For such a common supervisory mechanism to work effectively, it is necessary to confine supervision to strengthening the internal control measures of banks/FIs and to a few identified financial parameters. It may also be necessary to rely to a greater extent on stricter auditing and disclosure standards so that depositors can make informed judgements and accept greater responsibility for their investment decisions.

Ownership and Control

7.21 The Narasimham Committee had recommended that in order to provide much needed flexibility in its operation, IDBI should be corporatised and converted into a joint stock company under the Companies Act on the lines of ICICI, IFCI and IIBI.The KWG also echoed similar sentiments and also advocated corporatisation of SFCs. Both these proposals deserve to be accepted and acted upon and, in fact, a similar route may be recommended for all RFIs.

7.22 Furthermore, both the Narasimham Committee and the KWG advocated mergers and acquisitions and emphasised that such mergers between banks and DFIs and NBFCs need to be based on synergies and locational and business specific complementarities of the concerned institutions. Such mergers and acquisitions are best achieved through flexibility available in corporate environment (i.e., under Companies Act) rather than under other arrangements. Hence, the possibility of corporatising all statutory bodies engaged in purveying credit including State level institutions needs to be expedited.

7.23 It must be made clear that corporatisation does not imply taking a view on the extent of public ownership. Without prejudice to the extent of public ownership, these institutions could certainly be converted into companies under the Companies Act. The extent of public ownership is, of course, also an important issue, on which necessary decisions would have to be taken by the Government and the Parliament.

7.24 The KWG also recommended that for providing focussed attention to the work of SFCs, IDBI shareholding in SFCs should be transferred to SIDBI and that in order to give it greater autonomy, SIDBI should also be delinked from IDBI. Keeping in view the need for separation of the ownership and regulatory functions, the transfer of ownership of SIDBI and other RFIs to the Government needs to be examined. With a view to enable the RBI to concentrate on its supervisory/regulatory functions, the ownership of RFIs could ideally be delinked from the RBI, through transfer of such ownership to the Government from the RBI.

Harmonisation Issues

7.25 Given the requirements of the industry for long-term financing and the flexibility required by DFIs for conducting their operations profitably, access to both long-term and short-term funds by DFIs becomes essential, though the accent will have to be on maximising long-term funds. In the current circumstances, the terms of borrowings by DFIs must also be in alignment with the interest rate structure in money and Government securities markets and also consistent with the overall ALM framework for these institutions. Keeping these in view, it is necessary to have a framework for DFIs to access such funds. At the current juncture, a tentative framework is under consideration in consultation with DFIs.

7.26 A Committee, as recommended by the KWG, could be formed as a voluntary and purposeful self-regulatory organisation. It may also be formal or *ad-hoc* as warranted by the circumstances. The decision to form such a Committee or revamp existing arrangements should be left with banks and DFIs. The RBI should be available to actively interact with such a Committee without being intrusive or diluting its role as a regulator and supervisor.

7.27 As regards the recommendation of the KWG on priority sector obligations, this issue is relevant mainly for banks and needs to be reviewed separately. The present practice of restricted Authorised Dealer's license is serving DFIs well and the issue of granting full license could also be considered separately as part of overall policy of financial sector reforms.

Efficiency Issues

7.28 Organisational redesign, risk management, information technology, etc. are internal in nature and hence, on these issues, banks/DFIs are to be encouraged to deliberate among themselves and take necessary decisions urgently.

Architecture of Financial System of the Future

7.29 In brief, the architecture of the financial system for the future is envisaged on the following lines:

First, the approach to universal banking should be guided by international experience and domestic requirements. The process of enabling the provision of diversified services both by banks and DFIs, either in-house or through the subsidiary route as a conglomerate, should continue *albeit* in a gradual and orderly fashion, subject to appropriate regulation by the Reserve Bank.

Second, in terms of institutions, ultimately there should be only banks and re-structured NBFCs.

Third, in the meantime, however, the special role of DFIs is recognised and a transitional path is envisaged for them to become either a full-fledged NBFC or a bank.

Fourth, since banks are special, any conglomerate, in which a bank is present, should be subject to a consolidated approach to supervision and regulation.

Fifth, a corporate form of organisation under the Companies Act is preferred to provide the financial intermediaries, necessary flexibility for mergers, acquisitions and diversification to meet the needs of the evolving situation.

Sixth, the supervisory functions are to be delinked from refinancing institutions and brought under a consistent supervisory framework.

Seventh, the ownership role should be transferred from the RBI to the Government of India in respect of financial intermediaries so that there is a focussed attention by the RBI on its supervisory/regulatory functions.

Eighth, the harmonisation in the working of various institutions should be at the initiative of the organisations themselves, with the RBI being available for guidance and consultation.

Ninth, various efficiency issues pertaining to each organisation have to be addressed individually by the banks/DFIs and they are encouraged to deliberate among themselves and take necessary decisions urgently.

ANNEXURE I

MAJOR RECOMMENDATIONS OF THE WORKING GROUP FOR HARMONISING THE ROLE AND OPERATIONS OF DFIs AND BANKS (KHAN WORKING GROUP)

The main recommendations of the Khan Working Group are set out below:

A. CHANGES IN ROLE, STRUCTURE AND OPERATIONS

i) A progressive move towards universal banking and the development of an enabling regulatory framework for the purpose.

ii) A full banking licence be eventually granted to DFIs. In the interim, DFIs may be permitted to have a banking subsidiary (with holdings up to 100 per cent), while the DFIs themselves may continue to play their existing role.

iii) The appropriate corporate structure of universal banking should be an internal management/shareholder decision and should not be imposed by the regulator.

iv) Management and shareholders of banks and DFIs should be permitted to explore and enter into gainful mergers.

v) The RBI/Government should provide an appropriate level of financial support in case DFIs are required to assume any developmental obligations.

B. CHANGES IN REGULATORY AND LEGAL FRAMEWORK

i) A function-specific regulatory framework must develop that targets activities and is institution-neutral with regard to the regulatory treatment of identical services rendered by any participant in the financial system.

ii) The establishment of a 'super-regulator' to supervise and co-ordinate the activities of multiple regulators in order to ensure uniformity in regulatory treatment.

iii) A speedy implementation of legal reforms in the debt recovery areas of banks and financial institutions should be given top priority. A thorough revamp of the 1993 Act on Recovery of Debt from Banks and DFIs.

iv) There is a need to redraft other codified laws impacting operations of DFIs/banks.

v) For effective computerisation, amendments to the Banking Companies (Period of Preservation of Records) Rules, 1985 and other suitable enactments on the lines of Electronic Fund Transfer Act in USA be examined for implementation.

C. CHANGES IN SUPERVISORY PRACTICES

i) The supervisory authority should undertake primarily off-site supervision based on periodic reporting by the banks or DFIs as the case may be. On-site supervision should be undertaken only in exceptional cases.

ii) DFIs/banks should be supervised on a consolidated basis. Future accounting standards must consequently include rules on consolidated supervision for financial subsidiaries and conglomerates. Further, as domestic financial activities assume an international character, banking supervisors should adopt global consolidated supervision.

iii) A "risk-based supervisory framework" along the lines of the Report of the Task Force on Conglomerate Supervision, published by the Institute of International Finance, in February 1997 may be adopted.

D. STATUTORY OBLIGATIONS

i) The application of CRR should be confined to cash and cash-like instruments. CRR should be brought down progressively within a time-bound frame to international levels.

ii) It may be useful to consider phasing out SLR in line with international practice.

iii) Rather than imposing the priority sector obligation on the entire banking system, there is a need for an alternate mechanism to be developed for financing these sectors. Such a mechanism will aim to balance the need for funds with the need to bring better-suited structures and specialised skills to bear in dealing with the sectors. The concessional funding for certain sectors can be provided by specifically targeted subsidies to that sector.

iv) In the interim, the following modifications may be done in priority sector lending: (a) infrastructure lending should be excluded from the definition of 'net bank credit' used in computing the priority sector obligations, (b) to facilitate efficient loan disbursals, the priority sector obligation should be linked to the net bank credit at the end of the previous financial year, and (c) the definition of the priority sector may be widened to enable the inclusion of the whole industry/class of activities.

E. RE-ORGANISATION OF STATE-LEVEL INSTITUTIONS (SLIs)

i) While the consolidation of SLIs should form part of the short-term agenda of the financial sector reforms; an immediate term imperative is the corporatisation of these entities to improve their competitive efficiency.

ii) Following restructuring/re-organisation, strong SFCs could be encouraged to go public by making IPOs.

iii) It would be desirable to transfer the present shareholding of IDBI in these SLIs to SIDBI.

iv) Ownership in SIDBI should, as a logical corollary, stand transferred to RBI/Government on the same lines as NABARD.

v) SIDBI's role in State Level Institutions should be both as stake holder as well as resource provider. For this purpose, SIDBI should have access to assured sources of concessional funding from RBI.

vi) SLIs should be brought under the supervisory ambit of RBI.

F. HARMONISING THE ROLE, OPERATIONS AND REGULATORY FRAMEWORK OF DFIs AND BANKS

i) A Standing (Co-ordination) Committee be set up on which Banks and DFIs would be represented.

ii) The extant overall ceiling for DFIs' mobilisation of resources by way of term money/bonds (having maturities of 3-6 months), Certificates of Deposits (maturities of 1-3 years), Term Deposits (fixed deposits from the public with maturity of 1-5 years) and inter-corporate deposits at 100 per cent of net owned funds (NOF) of DFIs may be removed. A suitable level of SLR may be stipulated for DFIs on incremental outstanding fixed deposits raised from the public (excluding inter-bank deposits).

iii) The restrictions stipulated by the RBI, whereby bond issues by DFIs with either a maturity of less than 5 years or maturity of 5 years and above but with interest rate not exceeding 200 bps over the yield on Government of India securities of equal residual maturity require prior approval should be withdrawn.

iv) CRR should not be applicable to DFIs under the present structure, where they are not permitted to access cash and cash-like instruments.

v) A uniform risk weightage of 20 per cent may be assigned for investment made by commercial banks in bonds of "AAA" rated DFIs.

vi) Banks be permitted to exclude investments in SLR securities issued by a DFI while calculating the exposure to that DFI.

vii) The DFIs should be granted full Authorised Dealer's licence.

G. ORGANISATION REDESIGN

i) Best practices in the area of corporate governance such as imparting full operational autonomy and flexibility to managements and Boards of Banks and DFIs should be implemented.

ii) A complete redesign of the business system of banks/DFIs, with the Top Management spelling out the strategic objectives for principal stakeholders (clients, employees, shareholders, etc.), a proactive relationship-based approach in corporate culture, a consensus-driven committee-based approach for loan sanctions and decisions on organisation structure based purely on commercial judgement.

H. RISK MANAGEMENT

i) There should be a clear strategy approved by the Board of Directors as to their risk management policies and procedures.

ii) An Integrated Treasury and a proactive Asset-Liability Management (ALM), including both on-and off-balance sheet items.

iii) Robust internal operational controls, including audit must be in place.

I. INFORMATION TECHNOLOGY AND MIS

i) Existing laws may not be adequate or have the clarity to deal with some of the key issues that are likely to emerge following introduction of computerisation and technologically advanced communications in banking. There is compelling logic to revisit the legal framework in information technology area and render it compatible with the requirements of a technology-driven banking environment.

ii) DFIs/banks should urgently establish, create employee/customer awareness and familiarity with e-mail, Internet and Intranet Banking, Smart Cards and Electronic Data Interchange (EDI) in a strategically sequenced fashion.

iii) A perspective plan/blue print for automation of financial sector be prepared.

J. HUMAN RESOURCE DEVELOPMENT

i) Prescient management and leadership with accent on teamwork.

ii) Broad-based recruitments, both at entry level from campus as well as lateral entry of professionals at higher levels to fill skill gaps in critical areas.

iii) Systematic training programmes.

iv) Skill building and upgradation.

v) Market-related compensation packages.

vi) Viable and enforceable exit option for employees.

vii) A Special Vigilance Machinery exclusively for the financial sector on the lines of Serious Fraud Office (SFO) of the U.K may be set up.

ANNEXURE II

MAJOR RECOMMENDATIONS OF THE COMMITTEE ON BANKING SECTOR REFORMS (NARASIMHAM COMMITTEE-II)

The main recommendations of the Narasimham Committee-II insofar as they relate to DFIs are set out below.

i) With convergence of activities between banks and DFIs, the DFIs should over a period of time, convert themselves into banks. There would then be only two form 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.

ii) A DFI which converts into 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.

iii) Mergers between banks and DFIs and NBFCs need to be based on synergies and locational and business specific complementarities of the concerned institutions and must obviously make sound commercial sense. Merger 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”.

iv) 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 de-linked from IDBI.

v) 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 (BFRS).

vi) For effective supervision, there is a need for formal accession to ‘core principles’ announced by the Basle Committee in September 1997.

vii) 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) and the agency (Board for Financial Supervision) be renamed as the Board for Financial Regulation and Supervision (BFRS).

viii) To have in place a dedicated and effective machinery for debt recovery for banks and financial institutions.

ix) With the advent of computerisation, there is a need for clarity in the law regarding the evidentiary value of computer generated documents. Also, issues regarding authentication of payment instruments, etc. require to be clarified. A group should be constituted by the Reserve Bank to work out the detailed proposals in this regard and implement them in a time-bound manner.