CHAPTER - 5

Government Policies Regarding Banks

1. Introduction
2. Licensing of Banks and Their Branches
3. Policies Regarding Opening of Branches
4. Best International Practices
5. Capital Adequacy Norm
6. Non-Performing Assets
7. Weak Banks
8. Restructuring of Weak Public Sector Banks
9. Banks Investment
10. Administrative Interest Rate Regime
11. Recovery Management
12. Bank Supervision and Regulation
14. Priority Sector Lending
15. Kisan Credit Card
CHAPTER 5

GOVERNMENT POLICIES REGARDING BANKS

INTRODUCTION

Under the Banking Regulation Act 1949 banking means the accepting for the purpose of lending or investment deposits of money from the public repayable on demand or otherwise and withdrawable by cheque, draft order or otherwise but gradually the functions of banks have been extended to many other services and now they are not mearlly lending and deposit accepting services but carryout many other activities all of which are regulated by the Reserve Bank of India under the powers vested to it under Reserve Bank of India Act 1934 and Banking Regulation Act 1949. Thus the Reserve Bank of India has wide powers for controlling, guiding, supervising, banks and their funds
to safeguard the funds of depositors and public at large. Based with this objective Reserve Bank of India decides the policies about banking sector largely on its own but in some respects it is directed by the Government of India to take certain actions. The major areas of activities on which policy decisions have been taken by the RBI are described bellow.

**LICENSING OF BANKS AND THEIR BRANCHES**

In India no bank whether Indian or foreign can operate in India without approval of the RBI and licence from the RBI is compulsory for each bank and each of its branches. No bank branch can be opened or location of existing branch can be changed without approval of the RBI.

The RBI had restricted policies for allowing setting up of new banks till 1989 but after the liberalization of economy in 1990 now new banks can be set up. In January 1993 RBI
issued guidelines for licensing of new banks in the private sector and issued licences to ten banks. Based on a review of experience gained on the functioning of new private sector banks RBI revised guidelines which were issued in January 2001. The main provisions / requirements for licensing of new private sector banks are as under:

1. Initial minimum capital shall be Rs. 200 crores; this will be raised to Rs. 300 crores within three years of commencement of business.

2. Promoters contribution shall be a minimum of 40 per cent of the paid up capital of the bank at any point of time; their contribution of 40 per cent shall be locked in for 5 years from the date of licensing of the bank and excess stake above 40 per cent shall be diluated after one year of bank’s operations.
3. Initial capital other than promoters contribution could be raised through public issue or private placement.

4. While augmenting capital to Rs. 300 crores within three years, promoters need to bring in at least 40 per cent of the fresh capital which will also be locked for five years. The remaining portion of fresh capital could be raised through public issue or private placement.

5. NRI participation in the primary equity of a new bank shall be to the maximum extent of 40 per cent of the issued capital. In the case of a foreign banking company or finance company (including multilateral institutions) as a technical collaborator or co-promoter, equity participation shall be limited to 20 per cent within the 40 per cent ceiling. Shortfall in NRI contribution to foreign equity can be met
through contribution by designated multilateral institutions.

6. No large industrial house can promote a new bank, individual companies connected with large industrial houses can, however, contribute up to 10 per cent of the equity of a new bank, which will maintain an arms length relationship with company in the promoter group and the individual companies investing in equity. No credit facilities shall be extended to them.

7. NBFCs with good track record can become banks, subject to specified criteria.

8. A minimum capital adequacy ratio of ten per cent shall be maintained on a continuous basis from commencement of operations.

9. Priority sector lending target is 40 per cent of net bank credit, as in the case of other domestic banks, it is also
necessary to open 25 per cent of the branches in rural / semi-urban areas.

POLICIES REGARDING OPENING OF BRANCHES

When State Bank of India was set up in 1955 the RBI encouraged it and other banks to open large number of rural branches but when a particular level has been reached, RBI has become less restrictive to allow opening of large number of rural branches but new banks were forced to establish at least 25 per cent of their branches in rural and semi-urban areas. This was made applicable specially for new banks as already stated. Further, in case of foreign banks, the RBI had been restrictive to allow opening of large number of branches so that there may not be excessive or unfair competition with Indian banks but for the last few years foreign banks have been allowed to open
more branches but with caution to avoid unhealthy or unfair competition with Indian banks.

**BEST INTERNATIONAL PRACTICES**

The Government of India and the RBI has desired that Indian banks should follow international best practices. This in view the RBI has become a member of Best International Financial Practices organisation and had a policy to accept the norms as early as possible to safeguard the interest of depositors. With this in view first capital adequacy norm of 9 per cent was implemented but now banks are required to have capital adequacy norm of 10 per cent from the very beginning, later on capital adequacy norm was raised to ten per cent for all banks and now it is 11 per cent and all the banks have been required to achieve it at the earliest possible and to achieve it many public
sector banks had to raise their paid-up capital plus reserves.

Further, Banking Companies Regulation Act 1949 has provided that 20 per cent of profit should be transferred to reserve fund every year before any divided is declared. This legal compulsion has helped to build reserves.

**NON-PERFORMING ASSETS (NPA)**

NPA is a big problem for banks and financial institutions round the globe. Therefore, NPA norms have been fixed by BISF which are being followed by Indian banks. However, in view of different conditions in India to begin with it was laid down that those loans will be considered NPA who remain unpaid for 180 days or more whether principle or interest. Later on India accepted best practices and now
any installment or interest which remains unpaid for 90 days or more is NPA. Further, the RBI has directed all banks to classify their assets as:

(1) Standard where there are no overdues; (2) Substandard or Doubtful where there is default beyond stipulated period and default continues for six months or more (3) and bad assets which are difficult to be realized at all.

In order to safeguard interest of depositors bad asset are required to be fully provided in the year in which they occur. In case of doubtful debts 20 per cent of assets has to be provided each year and in case of standard assets 10 per cent of amount of assets has to be credited to reserves account.

**WEAK BANKS**
As a result of NPAs provision some public sector banks namely Indian Bank, United Commercial Bank and United Bank of India became weak because most of their capital and reserves were wiped off because of provisioning of NPAs. Therefore, to study problem of weak banks the RBI appointed a committee whose findings and suggestions are given below which helped to revive them and now they have become healthy. The problem was not confined to public sector banks only, many private sector banks also became weak which have been forced by the RBI from time to time to merge with other healthy banks. This policy kept the lending system healthy and for last many years there has been no run on banks to withdraw deposits.

**RESTRUCTURING OF WEAK PUBLIC SECTOR BANKS**
In 1997-98 and earlier some of the public sector banks had weak position due to high NPAs, low capital adequacy, high expenses on staff as related to operating income. The government desired that all public sector banks should be healthy and strong. Therefore, the Reserve Bank of India set up a working group in February 1999 under the Chairmanship of Shri M.S. Verma to suggest measures for the revival of weak public sector banks. The group made a number of suggestions and submitted its Report in October 1999 to the Reserve Bank of India. The major recommendations of the Report are listed below:

1. Seven parameters covering three areas have been identified by the Group. These are (1) capital adequacy ratio and coverage ratio; (2) earning capacity (return on assets and net interest margin; and (3) profitability (ratio of operating profit to
average working funds, ratio of cost to income and ratio of staff cost to net interest income plus all other income).

2. It was suggested by the Group that the definitions / tests provide by the Committee on Banking Sector Reforms should be supplemented by performance analysis based on seven parameters to identify weakness in banks.

3. The seven parameters can also be used to evolve benchmarks for competitive level of performance by public sector banks; to begin with three benchmarks may set at the medium levels of ratios pertaining to the 24 public sector banks (excluding the three identified weak banks viz Indian Bank, United Commercial Bank and United Bank of India).
4. Narrow banking cannot be itself be adopted as a long-term restructuring strategy.

5. Closure involves many negative externalities affecting depositors, borrowers and employees and should not be exercised unless all other options are exhausted.

6. Comprehensive restructuring can succeed but calls for firm and decisive actions in exercise of hard options. The government, management and employee unions must agree upon ever important condition of the proposed restructuring programme before it is begun.

7. Restructuring of weak banks should be a two stage operation; stage one involves operational, organizational and financial restructuring arrived at
restoring competitive efficiency, stage two covers options of privatization and / or merger.

8. Operational restructuring essentially involves building up capabilities to launch new products, attract new customers, improve credit culture, secure higher fee-based earnings, sell foreign branches (Indian Bank of UCO Bank) to prospective buyers including other public sector banks and pull out from the subsidiaries (Indian Bank), establish a common net working and procuring facility in the field of technology etc.

9. The action programme for handling NPAs should cover however of Government gambles, better use of compromises for reduction of NPAs based on recommendations of the Settlement Advisory
Committees, transfer of NPAs to ARF managed by independent AMC etc.

10. To begin with ARF may restrict itself to the NPAs of three identified weak banks to enable them to reach the medium level of ratio of staff cost to operating income.

11. In order to control staff cost the three identified banks should adopt VRS covering at least 25 per cent of the staff strength, for the three banks taken together, the estimated cost of VRS ranges from Rs. 1100 crores to Rs. 1200 crores.

12. The organizational structure includes delivering of the decision making process relating to credit, rationalization of branch net work etc.
13. Financial restructuring involves efforts to maintain CAR well above the minimum required level. Further recapitalization subject to strict conditionalities relating to operational and organizational restructuring of the recipient bank etc.

14. System restructuring may include setting up of an independent agency under a special Act of Parliament to approve bank specific restructuring programmes initiative their implementation and monitor their progress such an agency may be designated as the Financial Restructuring Authority (FRA).

15. The existing legal provisions, which are out of line with the present day realities, need to be
amended and new enactments relating to bankruptcy
force closures etc. made.

16. For speeding up the recovery process, a
mechanism should be worked out to make DRTs
more effective.

Most of these recommendations were accepted by the RBI
and management of weak banks. Now, all public sector
banks have become healthy and are doing well.

In order that banks do not risk their funds in speculative
activities the RBI has laid down guidelines for investments,
their classification, provisioning or sales of investments
and upper limit has been fixed for such investment. This is
discussed below.
BANK INVESTMENT

Norms based on the comments on the Reports of the Informal Group on Bank is Investment Portfolio, the Reserve Bank of India finalized the Guidelines on categorization and valuation of banks’ investment portfolio. These Guidelines are in conformity with international best practices and are affective from September 30, 2000. The salient features of the Guidelines are given below which has made banks’ investment more transparent in their balance sheets.

1. The entire investment portfolio is to be classified under three categories as under:

   (a) Held to Maturity (HTM)

   (b) Held for Trading (HFT)

   (c) Available for Sale (AFS)
HTM includes securities acquired with the intention of being held up to maturity. HFT includes securities acquired with the intention of being traded to take advantage of the short-term price/interest rate movements and AFS includes securities not included in HTM and HFT.

2. Banks have to decide the category of investment at the time of acquisition.

3. In the balance sheet investment will continue to be classified under six heads namely (i) Government Securities, (ii) Other approved securities; (iii) Shares; (iv) Debentures and bonds; (v) Subsidiaries and Joint Ventures, and (vi) others.

4. Investments classified under HTM need not be marked to market and will be carried at acquisition cost. These investments will be carried at acquisition cost. These investments will include (a) recapitalisation bonds, (b)
investment in subsidiaries and joint ventures and (c) investments in debentures deemed as a advance. HTM will also include any other investment identified for inclusion in this category subject to the condition that such investment will not exceed 25 per cent of the total investment excluding (a) to (c) cited above.

5. Banks which have already to market more than 75 per cent of their Statutory Liquidity Ratio (SLR) have the option to reclassify their investment under this category upto the permissible level.

6. Profit on sale of investment in the HTM category should be taken to the Profit and Loss Account before being appropriated to the Capital Reserve Account. Loss on sale should be recognized in the Profit and Loss Account.

7. Banks are free to decide on the extent of holdings under the HFT and AFS categories, based on relevant
considerations like tax planning, risk management capabilities and trading strategies. Individual scrip in the AEs need to be marked to market at the year end or at more frequent intervals. Individual scrip in the HFT category are to be revalued at least at monthly intervals.

8. Market price of the scrip available from the trades /quotes on the stock exchange price of SCL transactions or RBI price list would serve as the market value for investment in AFS and HFS.

9. Investment under the HFT category should be sold within 90 days, in the event of inability to sell due to adverse factors like tight liquidity, extreme volatility, or a unidirectional movement in market, the unsold securities should be shifted to the AFS category.

10. Profit or loss on the sale of investments in both HFT and AFS categories should be taken in the Profit and Loss Account.
11. Shifting of investment from / to HTM may be done with the approval of the Board once a year, normally at the beginning of the accounting year; investments from AEs to HFT may be done with the approval of the Board / ALCO / Investment Committee; shifting from HFT to AFS is generally not allowed.

12. Under all circumstances, the shifting of investments from one category to another should be done at lowest value among acquisition cost, book value or market value; depreciation, if any, should be fully provided for.

13. RBI no longer will announce the yield to Maturity (YTM) rates for unquoted government securities for the purpose of valuation of investments by bank.

The Banking Regulation Act 1949 has provided that banks cannot invest more than 30 per cent of their capital plus reserves in all shares and cannot hold more than 30 per
cent of paid-up capital of any company. This has been done to safeguard banks resources and reduce risks of depreciation in share prices.

**ADMINISTRATE INTEREST RATE REGIME**

Administrative interest rate regime existed during 1975-76 to 1994-95 to control lending rates and deposit rates. But with the liberalization of economy gradually administrative rates have been abolished to give freedom to banks to decide lending rates based on credit worthiness of borrowers except in case of priority sectors. Deposit rates have been freed from RBI control except savings banks interest which is fixed at 3.5 per cent per annum.

The lending rate of banks evolved in three phases during 1975-76 to 1980-81 the RBI prescribed both minimum lending rates (13.5 per cent) and the ceiling rate (19.5 per
cent). During 1981-82 to 1987-88 the RBI prescribed only the ceiling rate which was progressively reduced in three stages from 19.5 per cent upto 1982-83 to 16.5 per cent in 1987-88. During the third stage spreading 1988-89 to 1994-95 the RBI switched over from a ceiling rate to a minimum lending rate.

The minimum lending rate which was initially fixed at 16.0 per cent was raised to 19.30 per cent in 1991-92 in response to the rise in inflation rate to 13.7 per cent with the deceleration of inflation rate to 5-6 per cent per annum the minimum lending rate was lowered to 14.0 per cent in 1993-94.

With effect from October 18, 1994 the lending rate has been deregulated in respect of all loans above Rs. 2 lakhs. This has been a big relief to banks and now they can determine
rate of lending based on their assessment of risk in lending to different parties and for different purposes.

**RECOVERY MANAGEMENT**

Recovery of banks dues from borrowers is a big challenge for banks for which debt recovery tribunals have been set up and gradually their number has been increased to help faster recovery of bank overdues. The government also passed Recovery of Debts Due to Banks and Financial Institutions Act which helped greater and faster recoveries and helped in reduction of NPAs. Public Sector Banks set up Settlement Advisory Committees for compromise settlement of chronic NPAs of the Small Scale industrial sector. However, the RBI was not satisfied with their performances. Therefore, the RBI issued revised guidelines in July 2000 covering all sectors, to provide for a simplified non-discriminatory mechanism for recovery of NPAs with
outstanding balances of up to Rs. 5 crores; under these revised guidelines public sector banks realised considerable amount of their dues.

**BANK SUPERVISION AND REGULATION**

In line with international best practices the RBI initiated steps to ensure consolidated supervision incorporating risk weights in respect of the assets of subsidiaries in the balance sheets of parent banks. Banks have also been asked to earmark additional capital in their books of account in a phased manner beginning from the end of 2000-01 financial year. This measure has been designed to obviate possible impairment to the net worth of parent banks during the period of transition to a unified balance sheet for the group as a whole. The principal bank in the group has been made responsible for monitoring the group operations, including filing of returns prescribed by the RBI for subsidiaries.
Information to be furnished for individual subsidiaries relates to capital adequacy, large credit exposures, asset quality, ownership and control, profitability and contingent liabilities. The public sector banks have also been asked to annex the balance sheets of their subsidiaries to their own balance sheets beginning from the year ending March 31, 2000.

Effective regulation also implies comprehensive risk containment measures. It has been recognized by the RBI that the Asset Liability Management by scheduled commercial banks can be effective only if proper Management Information System are put in place.

This, however, been rendered difficult in many banks due to the low level of computerization. The RBI, taking all the factors into consideration has been given more time to
scheduled commercial banks for covering 100 per cent of assets and liabilities.

Responding to the increasing competition and diversification of operations in the Indian banking sector, the RBI has decided to adopt a macro prudential framework for financial stability review. In order to orient the system to the requirements of the Indian banking sector, the framework relies on a set of indicators based on (1) peer group analysis with focus on key financial ratios and [(1) a supervisory rating system for banks. Efforts are also on to operationalise a prompt corrective action framework, based on parameters like CRAR, net NPAs and return on assets. In response to increasing globalisation, initiative have been taken for the Bankruptcy of road maps and time frame with regard to international financial standards and codes which have been gradually adopted after detailed

The RBI has also implemented system of comprehensive reporting and inspection of banks so that actual state of affairs may be analysed and corrective steps taken at the earliest possible.

**SECURITIZATION AND RECONSTRUCTION OF FINANCIAL ASSETS AND ENFORCEMENT OF SECURITY INTEREST ACT, 2002**

In order to help banks to recover their dues from borrowers in 2002. Securitization and Reconstruction of Financial
Assets and Enforcement of Security Interest Act was passed; the main features of the Act are as under

A securitisatin company or reconstruction company having own funds of not less than Rs. 2 crores or such other amount exceeding 15 per cent of total financial assets acquired or to be acquired as specified by the RBI can commence business after obtaining a certificate of registration subject to fulfilling certain conditions and complying with the prudential norms set by the RBI.

The securitization and reconstruction company may acquire assets of any bank or financial institution by issuing a debenture or bond or any other security for consideration agreed upon between such company and the bank or the financial institution.
Notice of acquisition of a financial asset may be sent by bank or a financial institution to an obligor. The obligor on receipt of such notice will make payment to the securitization company concerned.

A securitization company may raise funds from qualified institutional buyers by formulating schemes for acquiring financial assets.

In the event of non-realisation of financial assets qualified institutional buyers of a securitization company holding not less than 75 per cent of the total value of securities issued by such company are entitled to call for a meeting of all institutional buyers and the resolution passed in such a meeting is binding on the company.
A securitization or a reconstruction company may provide for the proper management of the business of the borrower, sale or lease of a part or whole of the business of borrower, settlement of dues payable by the borrower and taking possession of secured assets within the frame work each of guidelines framed by the RBI.

Other functions of securitization company include acting as an agent for any bank or financial institution for the purpose of recovery of dues.

Secured creditor is entitled to enforce any security interest created in its favour without the intervention of the court or tribunal.
In case of non-performing debts, the secured creditor is entitled to serve a notice to the borrower to discharge his liabilities within 60 days.

In case of failure to discharge the liabilities in the stipulated period, the secured creditor is entitled to take possession of secured assets, takeover the management of secured assets and to appoint any person to mange the same.

Borrowers are entitled to prefer an appeal with the Debt Recovery Tribunal after depositing 75 per cent of the amount claimed by the secured creditor. Borrowers aggrieved by the order of the Debt Recovery Tribunal may prefer on appeal to the Appellate Tribunal within 30 days from the date of receipt of the order of Debts Recovery Tribunal.
PRIORITY SECTOR LENDING

The Government of India and the RBI consider agriculture, small scale industries, rural artisans and weaker sectors as priority sectors. It has been made mandatory on scheduled banks to lend 40 per cent of their net credit to priority sectors. In case of foreign banks this limit has been fixed at 30 per cent of net credit. If any bank does not fullfills its obligation it is required to pay penalty to the RBI. The RBI has fixed subtargets under priority sector which is 18 per cent of net bank credit to agriculture and ten per cent of net bank credit to weaker sectors. There is no sub-target for small scale industries sector.

KISAN CREDIT CARDS

The RBI has introduced the scheme of kisan credit card in 1998-99 which has increased farmers access to short-term bank credit. The objective of the scheme is to provide
adequate and timely support from the banking sector to the farmers for their cultivation needs including purchase of inputs in a flexible and cost effective manner. The scheme is being operated by cooperative banks, regional rural banks and scheduled commercial banks. Throughout the country loans disbursed under Kisan Credit Cards are covered under Rashtriya Krishi Beema Yojna of the General Insurance Corporation. Kisan Credit Card Holders are being provided personal accident insurance cover of Rs. 50,000 for accidental death and Rs. 25,000 for permanent disability.