CHAPTER-II

PART- A

THEORETICAL FRAMEWORK

This chapter presents historical & contemporary picture of Banking in India and the theoretical framework for asset-liability management by commercial banks in India and the related regulatory requirements. As is known, "Banking" is, at least, as old as civilization. In every society, there were some households generating surplus by consuming less than they earned (net savers) and always looked for ways and means not only to hold on to it, but also to think whether they could grow this savings, many times, for a rainy day in future. In the same society, there were also many others-individuals, businessmen, business houses, government bodies etc.(net borrowers), who needed such savings and were prepared to offer an incentive to the former for postponing immediate consumption of that savings. However, for reasons of many limitations, like physical movements, geographical distances, absence of needy information etc., not all borrowers could go in search of savers; neither could all savers go in search of borrowers. Thus, there was a need for an intermediary called the bank.

Moneylenders were different from bankers. Moneylenders are elder to bankers, in the sense that there was money-lending business very much in existence much before formal banking evolved. A moneylender always lent his own money. In his original (ab-initio) style, he would normally never accept deposits from others for his business.
2.A.1. Origin of Modern Banking:

Records reveal that the origin of modern banking in India dates back to 1770 when the first joint stock bank, by name The Hindustan Bank was started by the English Agency House of Alexander & Co. in Calcutta. This bank mainly met the requirements of the entire civil and military services, and of shipmasters and the personnel of the merchant navy of the East India Company. This bank, however, was wound up in 1832 as the Agency Houses came to grief. Some banks came up subsequently to fill the gap of banking requirements, but many of them were also wound up midway.

It was the turn of the government next to establish banks to meet the banking needs of the government and the society. Three banks were established viz. Bank of Bengal (1806), Bank of Bombay (1840) and Bank of Madras (1843) with major share-holding by the government. Thus, these banks enjoyed the monopoly of government banking business. They were renamed, later, as 'Presidency Banks' by an Act of the Parliament in 1876 as these were located at the presidencies of Bengal, Bombay and Madras.
2.A.2. Swadeshi Movement and Emergence of Indian Private Banks (Pre-independence era):

1860 was a landmark in the history of Indian Banking. The principle of limited liability was applied, for the first time, to the joint stock banks. Hence, a number of banks came up. Prominent among them are Allahabad Bank in 1865 and Punjab National Bank in 1895.

Swadeshi Movement in 1905 inspired establishment of many more banks, some of which are prominent public sector banks today. The Bank of India Ltd. (1906); The Canara Bank Ltd. (1906); The Canara Banking Corporation (Udupi) Ltd., (now known as Corporation Bank)(1906); The Indian Bank Ltd. (1906); The Bank of Baroda Ltd. (1908); The Central Bank of India Ltd. (1911) – all came up during this period of 1906 – 1913. In addition, ‘multi-national’ banks also opened their branches in India (which were called ‘exchange banks’).

The great boom of banking growth was followed by severe banking crises during periods of 1913-17, 1922-36 and 1937-48, which is elaborated elsewhere in the paragraphs supra. The crises gave scope for consolidation and many amalgamations/mergers came through. Prominent among these amalgamations is the amalgamation of three Presidency Banks into one by the Imperial Bank of India Act, 1920. The Bank came into existence in 1921 and took over all the three Presidency Banks as ‘going concerns’ under the name ‘The Imperial Bank of India’.

The Imperial Bank of India continued to be the banker for the government and also performed certain central banking functions till the Reserve Bank of India came into existence on April 1, 1935 following the Reserve Bank of India Act, 1934. The Reserve Bank of India was initially a private sector bank. After independence, it was logical to nationalize the central bank of the country and hence, the Reserve Bank (Transfer to Public Ownership) of India Act, 1948 was passed. The Reserve Bank of India thus became a State owned institution from January 1949. The government had empowered the Reserve Bank of India, under the Banking Regulation Act to intervene in the event of crisis in a Bank, in order to protect the interests of the depositors/public.

2.A.3. Nationalisation of The Imperial Bank of India:

The Imperial Bank of India was nationalized by an Act of the Parliament viz. the State Bank of India Act, 1955 which was brought into force effective July 1, 1955. The objects of this nationalization as stated in the preamble to the State Bank of India Act read as follows: "the extension of banking facilities on a large scale, more importantly in the rural and semi-urban areas, and for diverse other public purposes". This nationalization was the result of the acceptance of the recommendations of the All India Rural Credit Survey Committee (AIRCS) by the Government of India for creation of "one strong integrated, State-sponsored, State-partnered, commercial banking institution with an effective machinery of branches spread over the whole country".

2.SBI Act, quoted by Bedi, H.L. and others, 'Practical Banking Advances' New Delhi, UBS Publishers' Distributors Pvt Ltd., 2004 p.2
This act of Government was a pioneering attempt in introducing public sector banking in the country and thus it stands as an outstanding mammoth bank with 9036 branches and deposits and advances aggregating Rs.569421 crore as on March 31, 2005.

The State Bank of India (Subsidiary Banks) Act was passed in 1959, by which the following eight banks (which were earlier constituted by the former Governments of the bigger princely states of India) were also nationalized and made subsidiaries of the State Bank of India.

1. The Bank of Bikaner
2. The Bank of Jaipur
3. The Bank of Indore
4. The Bank of Mysore
5. The Bank of Patiala
6. The Bank of Hyderabad
7. The Bank of Saurashtra
8. The Bank of Travancore

The SBI and the remaining subsidiaries came to be identified under the class State Bank Group and the subsidiaries were later came to be called Associates of State Bank of India. The State Bank of Bikaner and the State Bank of Jaipur were amalgamated in 1963 under the name of the State Bank of Bikaner and Jaipur.

2.A.4. Social Control of Banks in India:

Born, with Indian independence, was the concept of 'democratic socialism' through organized economic planning, aiming at rationalization of income generation, decentralization of economic power and creation of employment opportunities and earning of foreign exchange. The government, therefore,
desired all the banks to join hands in realizing this dream. But, to its dismay, it was found, on comparison with the performance of the SBI and its subsidiaries, other banks did not have any noticeable concern for the development of some sectors of economy like agriculture, small scale industry, exports, etc. Hence, the control of joint stock banks by mere legislation was found ineffective and insufficient. The entire banking system was accordingly sought to be brought under public ownership and control.

2.A.5. Nationalisation of Banks:

The Social Control of banks had ultimately ended up giving some directions and guidelines. The desired transformation in the philosophy and functioning of the commercial banks had not taken place, while the efficiency of the State Bank of India on the other hand had continued to be cited as an example by advocates of widening the state sector in banking. The response of the private sector banking to the multifarious needs of the community at large continued to be slow, dissuading and halting. Thus, the government was convinced that nationalization is the only solution and route to gain control over the commanding heights of the economy and to utilize the banking system as an effective instrument to bring about the desired economic development. Eventually, on July 19, 1969, through promulgation of an Ordinance, the Government of India nationalized the following 14 major commercial banks, which had deposits of over Rs.50 crores then.
1. The Allahabad Bank Ltd.
2. The Bank of Baroda Ltd.
3. The Bank of India Ltd.
4. The Bank of Maharashtra Ltd.
5. The Canara Bank Ltd.,
6. The Central Bank of India Ltd.
7. The Dena Bank Ltd.
8. The Indian Bank Ltd.,
9. The Indian Overseas Bank Ltd.
10. The Punjab National Bank Ltd.
11. The Syndicate Bank Ltd.
12. The Union Bank of India Ltd.
13. The United Bank of India Ltd., and,
14. The United Commercial Bank Ltd.

With this nationalization, the share of the public sector in Indian Banking in terms of branch offices, deposits and assets was 79.7 percent, 82.7 percent and 83.7 percent respectively.\(^4\)

The following objectives\(^5\) of nationalization were enunciated in the Parliament.

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1. "The nationalization of major banks was a significant step towards mobilisation of people's savings and canalizing them for productive purposes in accordance with our plans and priorities.

2. The Government believed that public ownership of major banks would help in the most effective development of national resources so that Government's objectives could be realized with a greater degree of assurance.

3. Even after nationalization, the legitimate credit needs of private industry and trade, big or small, would be met.

4. Government would try to ensure that the needs of productive sectors of the economy and in particular those of farmers, small-scale industrialists and self-employed professional groups were met in an increasing measure.

5. It would be one of the positive objectives of nationalized banks to actively foster the growth of new and progressive entrepreneurs and to create fresh opportunities for hitherto neglected and backward areas in different parts of the country.

6. Public ownership would help to curb the use of bank credit for speculative and other unproductive purposes.

7. The step would bring about the right atmosphere for the development of adequate professional management in the banking field.

8. The interests of depositors of the nationalized banks would not only continue to be fully safeguarded but would now have the backing of the State itself."

The Banking Commission established in 1969 had opined in its Report (1972) that "In the large and complex situation in the field of rural credit in India, there will remain a large gap even after the maximum possible branch expansion has been tried by the commercial banks" and had recommended setting up of 'rural banks' to take care of such credit gaps.

This was true and despite the efforts of SBI and its subsidiaries, and the efforts of the nationalized commercial banks, there was a credit gap in the rural sector.

Subsequent, thereafter, the Government of India appointed a Working Group on Rural Banks, headed by Mr. M. Narasimham to examine in detail the issues involved in the establishment of new rural banks as subsidiaries of the public sector banks to deal with the problems of rural credit. Based on the recommendations of the Report of this Committee, the Government of India instituted the Regional Rural Banks in October 1975 under the Regional Rural Banks Ordinance 1975, promulgated by the President of India on Sept. 26, 1975. Thus, came-in the Regional Rural Banks into the fold of Schedule Commercial Banks in India.

On April 15, 1980, the following six more Indian scheduled banks with deposits over Rs. 200 crore then, were also nationalized:

1. The Andhra Bank Ltd.
2. The Corporation Bank Ltd.
3. The New Bank of India Ltd.
4. The Oriental Bank of Commerce Ltd.
5. The Punjab and Sind Bank Ltd., and,
6. The Vijaya Bank Ltd.

With this second nationalization, the share of public sector in Indian banking business exceeded 90%. The New Bank of India was later merged with Punjab National Bank in the year 1993.
The Banking System in India thus assumed the Structure as shown below:

**Chart - 2.1**  
**Indian Banking System**

Reserve Bank of India

- Scheduled Banks
  - State Co-op. Banks
  - Commercial Banks
- Non-Scheduled Banks
  - Central Co-op Banks & Primary Credit Societies
  - Commercial Banks

- Indian
- Foreign

- Public Sector Banks
- Private Sector Banks

- SBI & its Subsidiaries
- Other Nationalised Banks
- Regional Rural Banks

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One of the major objectives of bank nationalization was to extend the reach of banking service both geographically and functionally. As a sequel, Banks were encouraged to open large number of branches. Agriculture, small scale industry, transport and other sectors which had been neglected till then were designated 'priority sectors'. Banks were required to earmark a portion of their advances exclusively for financing priority sector projects shifting the focus from security orientation to purpose orientation. Schemes like Differential Rate of Interest (DRI), 20 Point Economic Programme [TPEP], Integrated Rural Development Programme (IRDP) and National Rural Employment Programme (NREP) etc., were introduced with budgetary allocations from government for subsidies / margin money etc., for these programmes. Priority sector was extended preferential treatment while lending viz., by lowering interest rates, relaxing security norms, reducing margin on loans and extending longer repayment periods. 'Loan-melas' were held as the banks were asked to make a success of these directed credit programmes.

Thus, the nationalization process catalysed the banking sector and there was no looking back. There was a real geographical penetration in branch expansion and phenomenal development in all the spheres of banking activities and the growth was unabated and the commercial banks grew to be the biggest and the most effective financial intermediaries in India as can be inferred by a glimpse of the growth parameters of the Indian commercial banking sector as provided at the following Tables 2.1, 2.2 and 2.3.
### Table-2.1

**Growth Parameters of Commercial Banking in India, 1969 - 1991**

(Amount in Rs.crores)

<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td>1. No. of Scheduled Banks other than RRBs.</td>
<td>73</td>
<td>73</td>
<td>79</td>
<td>76</td>
</tr>
<tr>
<td>2. Number of RRBs</td>
<td>-</td>
<td>-</td>
<td>102</td>
<td>196</td>
</tr>
<tr>
<td>3. Total no. of Sch. Banks</td>
<td>73</td>
<td>73</td>
<td>181</td>
<td>272</td>
</tr>
<tr>
<td>4. No. of Non-Sch. Banks</td>
<td>16</td>
<td>12</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>5. No. of all Commercial Banks (3+4)</td>
<td>89</td>
<td>85</td>
<td>184</td>
<td>275</td>
</tr>
<tr>
<td>6. Deposits of all RRBs –Rs</td>
<td>-</td>
<td>-</td>
<td>232*</td>
<td>4560**</td>
</tr>
<tr>
<td>7. Credit of all RRBs –Rs</td>
<td>-</td>
<td>-</td>
<td>285*</td>
<td>3497**</td>
</tr>
<tr>
<td>8. Deposits of all Scheduled Commercial Banks –Rs</td>
<td>4646*</td>
<td>5906*</td>
<td>37988*</td>
<td>192541**</td>
</tr>
<tr>
<td>9. Credit of all Scheduled Commercial Banks –Rs</td>
<td>3599*</td>
<td>4684*</td>
<td>25371*</td>
<td>116301**</td>
</tr>
</tbody>
</table>

* as on last Friday of March  **as on last reporting Friday of March


### Table -2.2

**Geographical Reach of Commercial Bank Offices in India,1969-1991**

<table>
<thead>
<tr>
<th>Classification of Geographical location based on population*</th>
<th>June 1969</th>
<th>% to total</th>
<th>June 1981</th>
<th>% to total</th>
<th>March 1991</th>
<th>% to total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Rural (places with a population of up to 9,999)</td>
<td>1833</td>
<td>22.2</td>
<td>17656</td>
<td>49.4</td>
<td>35206</td>
<td>58.5</td>
</tr>
<tr>
<td>2. Semi-Urban (Places with a population between 10,000-99,999)</td>
<td>3342</td>
<td>40.4</td>
<td>8471</td>
<td>23.7</td>
<td>11344</td>
<td>18.8</td>
</tr>
<tr>
<td>3. Urban (Places with a population between 1 lakh – 9,99,999)</td>
<td>1584</td>
<td>19.2</td>
<td>5454</td>
<td>15.3</td>
<td>8046</td>
<td>13.4</td>
</tr>
<tr>
<td>4. Metropolitan/Port Towns (places with a population of 10 lakhs and over)</td>
<td>1503</td>
<td>18.2</td>
<td>4126</td>
<td>11.6</td>
<td>5624</td>
<td>9.3</td>
</tr>
<tr>
<td><strong>Total no. of offices</strong></td>
<td><strong>8262</strong></td>
<td><strong>100</strong></td>
<td><strong>35707</strong></td>
<td><strong>100</strong></td>
<td><strong>60220</strong></td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>


Both Tables compiled by the Researcher
Table-2.3

<table>
<thead>
<tr>
<th>Sector</th>
<th>Amount Outstanding</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>End-June 1969</td>
<td>% to total bank credit</td>
<td>End-Dec. 1981</td>
<td>% to total bank credit</td>
<td>End-Mar. 1991</td>
<td>% to total bank credit</td>
</tr>
<tr>
<td>1 Agriculture:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>(a) Direct Finance</td>
<td>162</td>
<td>5.37</td>
<td>3771</td>
<td>14.86</td>
<td>17334</td>
<td>14.90</td>
</tr>
<tr>
<td>(b) Indirect Finance</td>
<td>40</td>
<td>1.32</td>
<td>2888</td>
<td>11.38</td>
<td>16145</td>
<td>13.88</td>
</tr>
<tr>
<td>(c) Small-scale Sector:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(a) Road &amp; Water transport operators</td>
<td>122</td>
<td>4.05</td>
<td>883</td>
<td>3.48</td>
<td>1189</td>
<td>1.02</td>
</tr>
<tr>
<td>(b) Small Scale Industries</td>
<td>257</td>
<td>8.52</td>
<td>4997</td>
<td>19.70</td>
<td>20677</td>
<td>17.77</td>
</tr>
<tr>
<td>(c) Industrial Estates</td>
<td>6</td>
<td>0.20</td>
<td>997</td>
<td>3.92</td>
<td>2679</td>
<td>2.30</td>
</tr>
<tr>
<td>2 Total priority</td>
<td>251</td>
<td>8.32</td>
<td>3953</td>
<td>15.58</td>
<td>17938</td>
<td>15.42</td>
</tr>
<tr>
<td>3 Total bank credit</td>
<td>441</td>
<td>14.62</td>
<td>8504*</td>
<td>33.52</td>
<td>42915</td>
<td>36.90</td>
</tr>
</tbody>
</table>

*Figure pertains to March 1981
Compiled by the Researcher

The Government of India hailed such spectacular progress after nationalization and particularly the directed credit programme as a great success. With such an impressive achievement, the objectives of nationalization were achieved and the government succeeded in bringing in the desired transformation in the philosophy, attitude and the profile of the Indian Banking Sector.

The public sector banking in India, thus emerged as an effective tool of socio-economic change in the country. But, the banks had paid a heavy price for this achievement, in terms of fall in quality of loans owing to insufficient attention...
towards credit disbursement and recovery follow up and monitoring. Over-dues were mounting and profitability nose-diving.

The 'loan-melas' had led to degenerated culture (operational) practices in the banks. "The intended socially oriented credit in the process, degenerated into irresponsible lending"9 was the comment made by the Narasimham Committee that was constituted by the Government of India (later in 1991) to examine all aspects of financial system in India. Similarly, regarding IRDP loans to the poor and economically weaker sections, the Committee stated, "In many cases of IRDP lending, banks have virtually abdicated their responsibilities in undertaking need based credit assessment and appraisal of potential viability and instead, have tended to rely on lists of identified borrowers prepared by Government authorities"10.

2.A.6. Need for Reformation:

The various factors like directed lending (to priority sectors), directed investments (towards CRR, SLR etc.), political and administrative interferences, mounting expenditure of banks (both operational and administrative) etc., ultimately landed the Indian banking sector in serious difficulties as can be seen from the data given hereunder.

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### Table 2.4

Profitability of Public Sector Banks in India

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</tr>
</thead>
<tbody>
<tr>
<td>Net profit as % of Operating Income</td>
<td>5.3</td>
<td>2.7</td>
<td>1.7</td>
<td>1.3</td>
<td>1.7</td>
<td>2.0</td>
<td>1.5</td>
<td>1.5</td>
</tr>
<tr>
<td>Net Profit as % of Working Funds**</td>
<td>0.25</td>
<td>0.26</td>
<td>0.14</td>
<td>0.11</td>
<td>0.15</td>
<td>0.17</td>
<td>0.13</td>
<td>0.14</td>
</tr>
</tbody>
</table>

* As at year end December, up to 1987 and year end March, for 1990 and 1991

** The amount of Working Funds (total assets – contra items, up to 1987) is generally comparable to Total Assets.

*** Figures for 1989 have not been furnished as they represent performance for a period of 15 months from Jan., 1988 to March, 1989 and therefore, are not comparable.

Compiled by the Researcher,

Sources:
2. ‘Highlights of Performance - Public Sector Banks’, 1987; 1990-91
   Mumbai, Indian Banks Association, (for data from 1986 to 1991)

### Graph 2.1 - PSBs' Profitability - NP as % of Operating Income
As can be seen, productivity and efficiency of public sector banks had suffered, portfolio deteriorated and profitability eroded. Customer service was on the lowest ebb and technology outmoded. Many banks were running at loss or on very low profits. The entire macro financial system was under severe stress. Indian Bonds had been rated junk. International credit ratings of the country were downgraded and as a result, access to external borrowings was denied. Confidence of International Financial Community had eroded. The instance of India pledging gold with the Bank of England and the Bank of France in 1991 for a short-term loan of $405 million\textsuperscript{11} was a testimony of India’s weak Balance of Payments position and also of the lack of confidence of the international financial community. There was therefore, no other option for India, but to act swift to restore and improve upon its economic position and to redress the imbalances. Various reformatory measures were therefore, undertaken in the fields of foreign trade, tax system, industrial policy, financial and other sectors.

It was at such a time that, the Government of India set up a high level committee in August 1991 under the chairmanship of a former Governor of Reserve Bank – Mr. M. Narasimham, to examine all aspects relating to structure, organization, functions and procedures of the entire financial system. The Committee made a detailed study and submitted its Report in Nov.1991 recommending an array of revolutionary measures for revitalising the Indian banking sector. Recommendations were also made on primary and secondary stock markets, government securities market, external sector policies, and on the system as a whole.

2.A.7. The Era of Banking Reforms, 1991-97:

That was the beginning of the era of banking reforms. The recommendations of the Committee on banking sector reforms included, among other things, gradual reduction of SLR to 25 percent of net DTL and CRR (from 15 percent) to as small as 3 or 5 percent, over a period of next five years; to phase out directed credit over a period of time and to redefine the concept of priority sector fixing not more than 10 percent of bank credit to that sector; to restructure and deregulate interest rates to enable banks take-on market forces and competition; to effect a thorough reorganization of the structure of banking sector itself by reducing multiplicity and number of banks through mergers so as to allow a few large banks, and to restrict local banks and Regional Rural Banks (RRBs) only to take care of the specific objectives for which they are established; to empower individual banks for their autonomous functioning; to introduce prudential norms for income recognition, classification of assets and provisioning for bad debts etc., to move towards implementing Basel-I norms.
(discussed in the following paragraph) by March, 1996; to enable the State Bank of India and other nationalized banks to access capital market; to extend budgetary support for weak banks; to permit foreign banks to operate in the country, etc. The Narasimham Committee charged the Government of India and the Finance Ministry for the sad state of affairs of the public sector banks. It further opined that even the employees and the unions of banks had misused and abused the banking sector. Despite stiff opposition from various segments of the economy and society (including bank unions), the Government of India accepted and implemented most of the major recommendations of the Committee and effected reforms.

In accordance with the implementation of the recommendations, the Reserve Bank of India stipulated\(^\text{12}\) that, the banks (including the foreign banks) should fall in line with the recommendations of the **Basel Accord**, initiated in July 1998 by the Committee on Banking Regulation and Supervisory Practices (Basel Committee). The main reason for this initiative was to provide a level playing field to all the Banks all over the world to have a meaningful competition in the globalised environment. This Basel Accord, also called the Basel- I norms, refers to a set of recommendations of agreed uniform framework on international convergence of capital measure and capital standards. The RBI, thus, required the banks to maintain unimpaired minimum capital of 8% of aggregate of risk-weighted assets and other exposures on an ongoing basis.

\(^{12}\) Reserve Bank of India, Bombay, *Capital Adequacy Measures* DBOD No.BC.117/21.01.002/92, April 22, 1992
This had to be achieved by foreign banks operating in India by March 31, 1993, and by Indian banks having branches abroad, latest by March 31, 1994. Other banks, with branches only in India were required to achieve a capital adequacy of 4% by March 31, 1993, and the 8% norm by 31st March 1996.

Almost simultaneously the Reserve Bank of India required the banks to implement the 'prudential norms' for 'Income recognition, asset classification and provisioning and other related matters' so as to ensure that books of the commercial banks reflect a true and correct picture of their financial position to be in accordance with internationally accepted accounting practices.

In terms of prudential norms the banks were required to make provision of 100 percent of bad and doubtful debts and 10% general provision for sub-standard assets and the RBI permitted this to be done in two years – 30 percent in 1992-93 and the balance in 1993-94, considering the weak 'reserves' position of the Indian Banks, then. It was estimated that the banks would incur a loss of about Rs.10,000 crore, which the GOI planned to fund out of budgetary allocations.

With such prudential norms regarding income recognition and provision for bad and doubtful debts, the banks were in real difficult times to make necessary provisions. 1993 was a depressing year for the bankers. The balance sheets for fiscal 1992-93 had been finalized and the sorry state of public sector banks became clear. 13 banks were in the red, with aggregate losses of over Rs.3368 crore.15

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13. RBI, Bombay, "Income recognition, asset classification and provisioning and other related matters" DBOD No.BP.BC129/21.04.043-92, April 27, 1992
The accounts revealed that the figures could look worse next year (1994).

Struggling to manage a capital adequacy of 4 percent by March 1994, bankers were virtually clamping down on fresh loans, trying to reduce the non-performing assets by intensified recovery measures.

Around the same time, the economy had opened up and liberalized. New private sector banks and foreign banks emerged on the scene with high technology, improved products and delightful customer service. It was only now that the public sector banking in India woke up, for the first time, to the real challenges of banking business. On the one-front they had to take-on a cultural competition with new generation banks and on the other, make a successful come back from their sorry state of affairs.

On the world scene, in the meantime, the Basel Committee witnessed subsequent mishaps like Japanese Banking Crisis in 1990, Barings Bank debacle in 1995, large-scale failure of banks in Southeast Asian countries in 1997 and such similar ones. These were eye openers for the entire world and the concept of "one size fits all" (capital requirement of 8% of risk-weighted assets) approach was found grossly inadequate considering the various other risks that the banks face. The Basel Committee, therefore, initiated further discussions for amendment of Basel Accord and came out with the improved Capital adequacy framework called **Basel-II Accord** with strong emphasis on requirement of risk management in banking business and provision of capital charge thereof.

In the meantime, in India, the Government, possibly owning the moral responsibility, infused some capital to strengthen the capital structure of the
public sector banks which had eroded mainly because of the government sponsored schemes (particularly the loan-melas. 19 Nationalised banks were recapitalised with Rs.5700 crore on Jan.1\textsuperscript{st}, 1994.

An amount of Rs.5292.37 crore was released in 1994-95 and Rs.850 crore in 1995-96 for further recapitalisation. Despite all these efforts, the Capital Adequacy Ratio was below 4 percent in respect of five banks and between 4 and 8 percent in respect of three banks\textsuperscript{16} by March 31, 1996. Hence, the Government of India further released Rs.1,509 crore in 1996-97; Rs.2,700 crore in 1997-98 and Rs.400 crore in 1998-99. The total amount so directly subscribed by Government of India towards recapitalisation came to the extent of Rs 20,446.12\textsuperscript{17} crore by March 1999. This includes capital subscription to the extent of Rs.4000 crore up to 1992-93.

\textbf{2.A.8. Post Reforms Progress and Stability:}

It is now about 15 years that the Banking Reforms were set in pace. Public Sector Banks have staged an excellent came back and have proven their commitment to the Government and shareholders (owners) and to the society (beneficiaries). They have successfully taken on market competition and have proved being second to none in having introduced innovative banking practices.

While credit cards, debit cards, electronic transfers, have already become very common, ATM, core banking facility, internet banking, tele-banking are the order of the day and Public Sector Banks have offered stiff competition in the market. Their dominant market share vis-à-vis all scheduled commercial banks in India and the entire Indian Banking Sector including RRBs and co-operative Banks, as on 31.03.2005 as depicted at Tables 2.5, 2.6 and 2.7 is the testimony in proof.

Table 2.5

<table>
<thead>
<tr>
<th>Sl. No.</th>
<th>Sector / Sub-Sector</th>
<th>Amount Rs. in crore</th>
<th>% to sub-total</th>
<th>Amount Rs. in crore</th>
<th>% to Gross-total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>i) Public Sector Banks</td>
<td>1435852</td>
<td>78.2</td>
<td>(1435852)</td>
<td>(74.0)</td>
</tr>
<tr>
<td></td>
<td>ii) Private Sector Banks</td>
<td>314630</td>
<td>17.1</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>iii) Foreign Banks</td>
<td>86505</td>
<td>4.7</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>All Scheduled Commercial Banks - sub total</td>
<td>1836987</td>
<td>100</td>
<td>1836987</td>
<td>94.7</td>
</tr>
<tr>
<td>2</td>
<td>Regional Rural Banks</td>
<td></td>
<td></td>
<td>62143</td>
<td>3.2</td>
</tr>
<tr>
<td>3</td>
<td>Co-operative Banks</td>
<td></td>
<td></td>
<td>40946</td>
<td>2.1</td>
</tr>
<tr>
<td></td>
<td><strong>Gross Total</strong></td>
<td><strong>1940076</strong></td>
<td><strong>100</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Compiled by the Researcher
Table 2.6
Sectorwise Business Comparison – Advances as on 31.03.2005

<table>
<thead>
<tr>
<th>Sl. No.</th>
<th>Sector / Sub-Sector</th>
<th>Amount Rs. in crore</th>
<th>% to sub-total</th>
<th>Amount Rs. in crore</th>
<th>% to Gross-total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>i) Public Sector Banks</td>
<td>854671</td>
<td>74.3</td>
<td>(854671)</td>
<td>(70.7)</td>
</tr>
<tr>
<td></td>
<td>ii) Private Sector Banks</td>
<td>221149</td>
<td>19.2</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>iii) Foreign Banks</td>
<td>75318</td>
<td>6.5</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>All Scheduled Commercial Banks - sub total</td>
<td>1151138</td>
<td>100</td>
<td>1151138</td>
<td>95.3</td>
</tr>
<tr>
<td>2</td>
<td>Regional Rural Banks</td>
<td></td>
<td></td>
<td>31803</td>
<td>2.6</td>
</tr>
<tr>
<td>3</td>
<td>Co-operative Banks</td>
<td></td>
<td></td>
<td>25092</td>
<td>2.1</td>
</tr>
<tr>
<td>Gross Total</td>
<td></td>
<td>1208033</td>
<td>100</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Compiled by the Researcher

The mind-boggling dominance of the public sector banks is evident from a scrutiny of the Tables 2.5 and 2.6. The market share of the Public Sector Banks has come down from that of 1980s and 1990s because of the emergence of new private sector banks in the wake of the banking reforms initiated in early 1992 and more particularly because of conversion of one big All India Financial Institution (ICICI) as a commercial bank. Nevertheless, the Public Sector Banks enjoy 74 percent share of the deposits and 70.7 percent of the advances of the entire banking sector of the country. Even within the Scheduled Commercial Banking Sector, the Public Sector Banks enjoy a dominant 78.2 percent in respect of deposits and 74.3 percent in respect of advances.

The financial performance of the public sector banks after liberalization, but prior to implementation of asset-liability management system (for 8 years) by
banks and that for a period of 7 years after implementation of Asset-Liability Management system is summarized at Table 2.7.

The reduction in Net Profit percentages to the Operating Income and Total Assets is mainly because of steep fall in non-interest (other) income (percentage) during the year 2004-05, (as was true with the banking industry as a whole), as shown below at Table No.8.1. Nevertheless, the consistency in improved performance in all the parameters in general, for a majority of the period is quite evident. Consistent reduction in expenditure and decrease in NPA levels need special mention. The Capital Adequacy Ratio is also higher than the present statutory requirement of 9 percent (since March, 2000) by more than 40 percent.
Table No.2.7

Financial Performance of Public Sector Banks in India, 1992-2006

<table>
<thead>
<tr>
<th>Sl. No.</th>
<th>Performance parameter / end March</th>
<th>Net profit as % of operating income</th>
<th>Net profit as % of total assets (TA)</th>
<th>Operating expenses as % of TA</th>
<th>Net NPA as % of TA</th>
<th>Net NPA as % of advances</th>
<th>CAR</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>1992</td>
<td>2.33</td>
<td>0.28</td>
<td>2.61</td>
<td>NR</td>
<td>NR</td>
<td>NR</td>
</tr>
<tr>
<td>2</td>
<td>1993</td>
<td>-9.33</td>
<td>-0.99</td>
<td>2.63</td>
<td>NA</td>
<td>NA</td>
<td>*</td>
</tr>
<tr>
<td>3</td>
<td>1994</td>
<td>-11.66</td>
<td>-1.15</td>
<td>2.65</td>
<td>NA</td>
<td>NA</td>
<td>*</td>
</tr>
<tr>
<td>4</td>
<td>1995</td>
<td>2.60</td>
<td>0.25</td>
<td>2.83</td>
<td>4.00</td>
<td>10.70</td>
<td>*</td>
</tr>
<tr>
<td>5</td>
<td>1996</td>
<td>-0.68</td>
<td>-0.07</td>
<td>2.99</td>
<td>3.60</td>
<td>8.90</td>
<td>*</td>
</tr>
<tr>
<td>6</td>
<td>1997</td>
<td>5.14</td>
<td>0.57</td>
<td>2.88</td>
<td>3.65</td>
<td>9.18</td>
<td>*</td>
</tr>
<tr>
<td>7</td>
<td>1998</td>
<td>7.42</td>
<td>0.77</td>
<td>2.66</td>
<td>3.27</td>
<td>8.15</td>
<td>11.6</td>
</tr>
<tr>
<td>8</td>
<td>1999</td>
<td>4.13</td>
<td>0.42</td>
<td>2.66</td>
<td>3.14</td>
<td>8.13</td>
<td>11.3</td>
</tr>
<tr>
<td>9</td>
<td>2000</td>
<td>5.62</td>
<td>0.57</td>
<td>2.53</td>
<td>2.94</td>
<td>7.42</td>
<td>10.7</td>
</tr>
<tr>
<td>10</td>
<td>2001</td>
<td>4.17</td>
<td>0.42</td>
<td>2.72</td>
<td>2.72</td>
<td>6.74</td>
<td>11.2</td>
</tr>
<tr>
<td>11</td>
<td>2002</td>
<td>7.10</td>
<td>0.72</td>
<td>2.29</td>
<td>2.42</td>
<td>5.82</td>
<td>11.8</td>
</tr>
<tr>
<td>12</td>
<td>2003</td>
<td>9.60</td>
<td>0.96</td>
<td>2.25</td>
<td>1.93</td>
<td>4.53</td>
<td>12.6</td>
</tr>
<tr>
<td>13</td>
<td>2004</td>
<td>12.03</td>
<td>1.12</td>
<td>2.21</td>
<td>1.28</td>
<td>2.99</td>
<td>13.2</td>
</tr>
<tr>
<td>14</td>
<td>2005</td>
<td>10.70</td>
<td>0.87</td>
<td>2.09</td>
<td>0.95</td>
<td>2.06</td>
<td>12.9</td>
</tr>
<tr>
<td>15</td>
<td>2006</td>
<td>10.51**</td>
<td>0.82</td>
<td>2.06</td>
<td>0.72</td>
<td>1.30</td>
<td>12.2</td>
</tr>
</tbody>
</table>

NR – 'not relevant' – as the NPA concept was introduced in 1992-93.

NA – Not Available

* Not possible to average as some banks have CAR less than the regulatory requirement.

** Includes IDBI which transformed itself into a bank with effect from 01.10.2004

Compiled by the Researcher


2. *Highlights of Performance - Public Sector Banks*, 1992-93, Mumbai; Indian Banks Association,
Graph 2.2 - PSBs' Net Profit as % of Operating Income

Graph 2.3 - PSBs' Operating Expenses as % of Total Assets
With such a spectacular come back, India now witnesses a GDP growth rate of 8.5 percent\textsuperscript{18} in 2003-04 as against global GDP growth rate of 5.1 percent, favourable sentiment in international financial markets, upgradation of the sovereign rating by Standard and Poor's Rating Services in 2004-05 and recording the fifth largest accumulated stock on international reserves in the world (sufficient to finance about 14 months of imports) by March, 2005 at $26.2 billion, a total reversal of the sorry state of affairs of the economy in 1991 as elaborated at page 54 of this thesis.

The focus of the first phase of the banking reforms in India between 1991–97 was strengthening the banking system by arresting the qualitative deterioration in performance of banks in terms of profitability that encompassed building up of operational efficiency. Implementation of these reforms made Indian Banking System internationally competitive as has been seen in the foregoing paragraphs. The task was only the beginning and it required logical continuation in response to the changing demands and challenges of the banking sector in the late 1990s. This led to the second generation reforms called Narasimham Committee II Recommendations on Banking Sector Reforms 1998, which encompassed adoptability to then evolving newer challenging requirements of the expanding economy that arose because of continued interaction with international economy, as Indian banking could not be immune to the developments in the international markets. The recommendations mainly included issues on (i) capital adequacy (ii) asset quality, NPAs and directed credit, and (iii) prudential norms and disclosure requirements.

The recommendations with regard to **Capital Adequacy** covered providing for capital charge for Market Risk and Credit Risk, for Open-position in Foreign Exchange operations, providing risk-weightage for Government and approved securities; and raising Capital Adequacy Ratio for banks to 9 percent and 10 percent in a phased manner.
Recommendations on Asset Quality, NPAs and Directed Credit involved stricter classification for various classes of assets from standard to doubtful; ban on evergreening of loans; fixing stricter target levels for NPAs down to 5% and 3% over a period of time; hiving off NPAs to clean up Balance Sheets of Banks; setting up of a Asset Reconstruction Company; stoppage of further recapitalisation of banks, etc.

Recommendation on Prudential Norms and Disclosure Requirements included stricter norms for income recognition (to be on par with international standards), all prudential norms to be applied in respect of government guaranteed advances and disclosure of maturity pattern of assets and liabilities – both domestic and foreign currency – and movement of provision accounts and NPAs, etc.

As a follow up of implementation of these recommendations, the Reserve Bank of India subsequently issued guidelines addressing internal financial management of banks, which would ensure satisfactory compliance of the aforesaid three parameters. The main components of upgrading such internal financial management of banks involved the following –

i. Rigorous prudential accounting norms relating to various portfolios of banks and to capital adequacy

ii. Scientific Asset - Liability Management (ALM) Systems in banks for effective management of market risks, credit risks, operational risks, etc.

iii. Instituting a mechanism by which recovery efforts of banks become more effective.
Rigorous Prudential Regulations were only a continuation of the previous practices of the banks and the revised guidelines of the Reserve Bank of India were to make them more stricter and more objective oriented including, of course, enhancement of the capital adequacy ratio to 9% with effect from March 31, 2000.

Regarding instituting ALM System, the Reserve Bank of India issued extensive guidelines covering liquidity and interest rate risk management in Feb. 1999 advising banks to implement the guidelines from April 1999. The guidelines regarding credit risk management and market risk management followed subsequently in October 2002.

Regarding a mechanism to make recovery efforts of the banks more effective the Government of India passed the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act in 2002 empowering the banks to takeover the hypothecated / mortgaged / charged assets of defaulters / defaulting borrowers without the necessity of intervention of Court and to sell them to realize the dues.

Thus, the ball was now in the court of the banks. They had to put to use all the strategies available to prove their efficiency. The action under SARFAESI Act was straightforward, simple; case bound and time bound (short) and covered only default accounts and NPAs of the banks. The strategies under the ALM System, on the other hand were fairly time consuming and an ongoing action for all time to come and for all the businesses of the banks.
2.B.2. Perception of Risk – Types of Risks:

Banks being financial intermediaries, even traditionally were engaged in much more than the simple and straight act of lending and borrowing viz., bringing together savings and uses of funds. It was coordinating independently, of course, between savers and users of funds. This job further involved, as a process of intermediation, certain other jobs like deposit – loan transformation, maturity transformation and risk transformation. Each of these involves certain 'Risks', characteristic of its nature. In short, thus, risks are inherent in banking business, as they are in any other business.

Of late, with growing complexity and newer faces of banking businesses like derivatives trading, securities underwriting and trading, online electronic banking, etc., the risk profile of banking business has also undergone and grown substantially complex and multi dimensional. A simpler and the most common version of the major risks confronting banking business can broadly be classified into three categories viz. Market, Credit and Operational risks as shown at Chart – 2.2 here below and explained briefly thereafter.
A) Market risk, in general, can be defined as possibility of loss to a bank caused by changes in the market variables. Thus, market risk is the risk to the banks profitability and earnings and its consequent effect on the capital due to changes in the levels of interest rates in the market and due to volatility of such changes.

Market risk involves liquidity risk, interest rate risk, commodity price risk, currency / forex risk and equity price / investment / trading risk.

i. Liquidity Risk is the risk that a sudden surge in liability withdrawals may leave a bank in a position of having to liquidate assets in a very short period of time and at low prices compared to their fair values.

ii. Interest Rate Risk is the risk where changes in market interest rates might adversely affect a bank’s financial position.

iii. Currency Risk or Foreign Exchange Risk means the risk that exchange rate changes can affect the value of bank’s assets and liabilities.
iv. Treasury Risk/Equity Price Risk arises out of banks' exposure to capital market instruments. Banks invest directly and also finance their constituents through fund based and non-fund based facilities and expose themselves to market risks in this regard. As these investments come out of the treasury of the banks and ultimately lead to trading of these securities, this category of risk is also generally referred to as "Investment Risk" or "Treasury and Trading Risk".

v. Commodity Price Risk represents the risk of loss in the value of commodities held/traded by banks. Examples of such commodities are agricultural products, metals, minerals, gas, etc.

As Indian banks rarely go for Commodity Trading, this aspect of Commodity Price Risk Management is not considered under the Study. Although, some banks hold gold for trading, gold is treated as a foreign currency (under the Basel Committee Guidelines) and hence is not classified under commodity.

B) Credit Risk in very simple terms is the risk that the promised cash flows from loans and securities held by the banks may not be received in full and on time.

C) 'Operational Risk' as defined by the Basel Committee 'is the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events' 19

While managing all the risks in an integrated manner is all-important, the first focus is on how to manage and contain liquidity risk and interest rate risk. The mismatches and disproportionate changes in the levels of assets and liabilities cause both liquidity and interest rate risks. This apart, historical but the prominent of all the risks is the credit risk which if not managed properly will pose threat to the very existence of the bank. Thus, is the importance Asset-Liability Management. Hence, the banking business today has realized, than ever before, the need for 'Risk Management.'

Asset-Liability Management is the first step in the direction of the long run goal of an institution and is, therefore, considered the most important financial risk management function. Asset-Liability Management is an integrated strategic approach of managing the total balance sheet dynamics having regard to its complexity and size in such a way that the net earnings are maximized, keeping with the overall risk philosophy and preference of the institution without affecting its safety, stability and financial soundness. Asset-Liability Management is, therefore, also seen as a trade-off strategy between risk and return and is done by appropriately managing the levels and maturity of assets and liabilities and the risks associated therewith.

There are some more risks that are not very common (as other risks discussed above) in the routine business of a bank. They are Country Risk or Sovereign Risk and Insolvency Risk details of which are as under:

**Country Risk or Sovereign Risk** is the risk that repayments from foreign borrowers may be interrupted because of interference of foreign government.
Insolvency Risk is a consequence or outcome of one or more of the risks already described above. It is the risk that a bank may not have enough capital to offset a sudden decline in the value or its assets relative to its liabilities. Some bankers refer to this risk also as Capital Risk.

While some common risks are explained above, an array of all kinds of risks associated with banking business conceptualised by James T Gleason as 'The Spectrum of Risks' is reproduced at figure 2.1.

Figure-2.1: THE RISKS AND THEIR CONTOURS

Adopted from: RISK – The New Management Imperative In Finance
2.B.3. Risk Identification:

The next step in setting up asset liability management function is to decide upon how to identify and measure risks. Volatility in operating environment like changes in interest rates / exchange rates, changes in competition, changes in micro / macro economic factors, etc., are examples of risk identification factors and these factors will make risks volatile.

2.B.4. Risk Measurement:

Risk measurement can be classified to be taking place at two stages. Viz., primary and final. As primary measurement tools the banks must have some specific procedures and ‘limits and triggers’ for every kind of risk within which all routine operations are conducted and quantified. Deviations from such procedures and limits are indicative of excessive exposure to risk of that particular kind.

The ultimate of all business operations is the financial result-profits and so is that of a bank. The ultimate effect of volatility of all risks is their effect on profits – both short term and long term; and on the wealth of the bank leading to stability. The risk measurement parameter designed and selected to measure risks should be capable of capturing the volatility of such risks and be able to transform such volatility into measurable / quantifiable financial parameter. Thus the risk parameter should be able to insulate the ‘spread’ from moving in adverse direction. ‘Spread’, at this stage, can be broadly understood as the difference between price and cost – more precisely, as difference between interest income and interest expenses, in the given context of a banking organization.
The other factor which bank would be interested in, is called the 'burden' – defined as the difference between non-interest expense and non-interest income and the objective of every bank would be to most minimize this 'burden'. The risk measuring parameter, thus, has to explore how to maximize 'spread' and minimize 'burden'. There are mainly three such parameters, as under, which satisfy this requirement:

1. The first flash, to all bankers is 'net interest margin' (NIM) which is the ratio of net interest income to the total assets – which measures the impact of volatility on short-term profits. Hence, in order to stabilize or improve upon short-term profits, the least that banks will be looking for will be to insulate NIM from moving in the adverse direction.

2. The next, is the Market Value of Equity (MVE) representing the long term profits of the banks – measured as the difference between the marked to market values of the banks' assets and liabilities. MVE is a measure of the risk that lies in the banks’ balance sheet due to maturity mis-matches in its assets and liabilities over the future years and their sustained marketability.

These aforesaid two parameters capture the short-term and the long-term balance sheet risks.

3. The third one, which is perhaps more important when seen as the combined result of the first two – is the economic equity ratio or also called the capital adequacy ratio (CAR). It is the ratio of the networth of the bank to the total assets and assesses the sustenance capacity of a bank. As is known,
stabilizing this parameter and maintaining it continuously is a statutory requirement.

Targetting any one parameter, will have an impact on the other, and, thus, the responsibility of Asset-Liability Management is an exercise balancing between risk profile of the bank and long-term profits leading to successful sustenance.

2.B.5. Risk Monitoring:

Risk monitoring is a robust mechanism, which enables continuous and constant supervision of the movements of the risk parameters by the senior management periodically to ensure that things do not go out of control any time. The frequency of such monitoring is primarily influenced by the volatility of the risk profile of bank's balance sheet. Changes in volatility of interest rates, business environment, statutory regulations, etc., are the factors, which influence the volatility of the risk profile of a bank. Availability of data, of course, is a prerequisite for effective monitoring. Some specific models have been developed for ensuring effective risk monitoring.

2.B.6 Risk Reporting is an important tool. There has to be a Risk Policy Committee or Risk Management Committee and a periodic reporting of risk measurement and a review by an organisational framework.

2.B.7. Risk Management - Perception and implementation by Indian Banks:

Risk management is the responsibility of top management and should not be delegated downwards. Some observers say that in course of time, 'it will be the Chief Risk Officer and not the Chief Executive Officer who will call the shots'.
Management of all risks in general is at four levels as under, as per Chart – 2.3

1. The Board of Directors (BOD),
2. The Risk Management Committee (RMC),
3. The Asset-Liability Management Committee (ALCO), and
4. The Asset-Liability Management Support Group / Market Risk Group

(i) The Board of Directors should bear the overall responsibility for risk management and decide the risk management policy of the bank and set limits for liquidity, interest rates, foreign exchange and equity price risks i.e. various types of risks and their acceptable levels should be clearly communicated. This is called the risk philosophy and preference of the bank.

The Board should also make sure of putting in place the required software and measurement systems and expertise to periodically monitor and report these risks. The Board is also responsible for bank’s compliance of any statutory requirements.

(ii) The Risk Management Committee (RMC) is a Board level sub committee including the CEO and heads of Credit, Market and Operational Risk Management Committees. This Committee will decide the policy and strategy for integrated risk management. The responsibilities of RMC include, among other things, appointment and posting of qualified and competent staff.
Chart 2.3
TYPICAL ORGANISATIONAL STRUCTURE FOR RISK MANAGEMENT

BOARD OF DIRECTORS
(Decide overall risk management policy and strategy)

RISK MANAGEMENT COMMITTEE
Board Sub Committee including CEO and Heads of Credit, Market and Operational
Risk Management Committees
(Policy and Strategy for Integrated Risk Management)

CREDIT MANAGEMENT COMMITTEE

ASSET-LIABILITY COMMITTEE (ALCO)
Headed by CEO/CMD/ED, including Chief of Investment,
Credit, Resource/Funds.
Ensure adherence to the limits, monitoring and control,
articulating interest rate view / funding / transfer pricing
policy, etc. and submit to RMC

OPERATIONAL RISK MANAGEMENT COMMITTEE

CREDIT RISK MANAGEMENT DEPARTMENT (CRM/)

CREDIT ADMINISTRATION DEPARTMENT (CAD)

ALM SUPPORT GROUP / RISK MANAGEMENT GROUP
Consisting of operating staff.
Responsible for analyzing, monitoring and reporting the
risk profiles to ALCO, prepare forecasts / simulations on
possible changes in market conditions and recommend
action on bank's limits

MIDDLE OFFICE
Consisting of experts in market risk management, economists, statisticians
and general bankers.
Responsible for independent risk assessment which is critical to ALCO's
key-function of controlling and managing market risks in accordance
with the mandate established by the Board / Risk Management Committee,
Track the magnitude of market risk on a real time basis, aggregate total market
risk exposure assumed by bank at any point of time.

20. Reserve Bank of India, DBOD Guidance Note on Market Risk
Management, 2002 (October 9, 2002), http://www.rbi.org.in
(ii) The Asset-Liability Management Committee, popularly known as ALCO consisting of top management including CEO should be responsible for strategic management of risks. ALCO is further responsible to adhere to the guidelines issued by the Board of Directors and the statutory body and to design appropriate business strategy within the overall risk philosophy and preference, and the 'limits and triggers' set by the bank. ALCO will also have to make sure of the risk management capability of the bank.

To ensure commitment of the top management and timely response to market dynamics, the CEO / CMD or the ED should head the ALCO. The chiefs of Investment, Credit, Resources Management, Funds Management, Treasury, International Banking, and Economic Research can be members. Head of Technology Division should be a permanent invitee for building up of MIS and related computerization. Some banks may even have sub committees and sub groups.

(iv) The sub-committees and sub-groups are called ALM support groups / Market Risk Group (MRG) which consist of operating staff who will be responsible for analyzing, monitoring and reporting the risk profiles to the ALCO. The MRG should prepare forecasts showing the effect of various possible variations in market conditions to the balance sheet and recommend necessary action.
2.B.8 Scope and Objectives of ALM:

The scope and objectives of a sound ALM System can broadly be classified into the following five strategic functions.

i. provide liquidity management within the bank,

ii. quantify various risks in the balance sheet by –

(a) reviewing credit portfolio and credit risk management practices

(b) reviewing investment portfolio and related risk management practices

(c) reviewing FOREX portfolio, foreign exchange operations and risk thereof,

iii. preserve and enhance the networth of the bank by –

(a) constantly reviewing interest rate outlook and deciding there-upon the product pricing of both assets and liabilities,

(b) developing new business / new product policy for approval by Board to enhance profitability,

(c) performance review in respect of interest spread, net profit and B/S ratios,

iv. plan for actively and judiciously leveraging the balance sheet for maximizing the profits by budgeting and strategic planning,

v. ensure management of regulatory capital.
2.B.9 The Road Ahead

The Reserve Bank of India formulated extensive Guidelines\textsuperscript{21} to serve as benchmark for those banks in India, which lacked a formal ALM System. These guidelines for liquidity risk management and interest rate risk management which form good handholding is reproduced as ANNEXURE-III to this thesis. The Guidelines for other Market Risks Management and Credit Risk Management were issued subsequently in Oct'2002. The extent and seriousness of compliance to these RBI Guidelines for ALM System of a bank is the subject matter of this research work. Hence references have been made appropriately and brought back for discussion under chapters V, VI & VII.

An exercise of understanding implementation of ALM System by banks demands ready knowledge of the profile of the banks under study, which is the next step. Hence, Profile of the Study Units is presented at the next Chapter -III and analysis of practical implementation of the ALM System is presented at the Chapter – IV following thereafter.