CHAPTER II

An Overview of Banking Reforms

1991-92 was a landmark year for India in terms of undertaking strong policy measures to quickly stabilize the economy and also introducing a process of basic reforms. This can be considered as the starting point for reforms in India, though the initiatives started even earlier in smaller measures in that direction. Economic reforms in the real sectors of the economy may not realize their full potential without a parallel reform of the financial sector. Financial sector reform, therefore, was a necessary concomitant of the trade and industrial policy. The objective of the banking sector reforms was to improve the efficiency of the banking system in the country and to match it with the international standards.

The reform measures in banking sector are furnished in the following paragraphs to elaborate the perspective of this research work. The progress in banking sector reforms is furnished in chronological order. Explanation and reasoning for some of the reform initiatives is given for clarity.

Major recommendations of the Committee on Financial System -1991

The Committee headed by M. Narasimham made wide ranging recommendations with a view to ensure that the financial sector operates on the basis of operational flexibility and functional autonomy, thereby enhancing efficiency, productivity and profitability.

The Committee was of the view that the statutory liquidity ratio (SLR)¹ instrument should be deployed in conformity with the original intention regarding it as a prudential requirement and should not be viewed as a major instrument for financing the deficit. In line with the Government's decision to reduce the fiscal deficit to a level consistent with macro-economic stability the Committee recommended that the SLR be brought down in a phased manner to 25 per cent over a period of about five years.

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As regards the cash reserve ratio (CRR), the Narasimham Committee had observed that the Reserve Bank should have the flexibility to operate this instrument to serve its monetary policy objectives. The Committee, therefore, recommended that the Reserve Bank should consider reducing progressively the cash reserve ratio from its high level.

Prior to reforms, banks were required to maintain high level of SLR; at one time it reached even 38 per cent of net demand and time liabilities (NDTL). CRR had reached a level of 15 per cent. Commercial banks were not compensated at market related interest on these regulatory preemptions. The returns/yields on these resources were very low affecting the profitability of banks. Only remaining funds were available for commercial deployment. Even, part of these funds had to be lent to priority sector at subsidized rate decided by the regulator. This situation led to poor profitability of banks. This researcher was a witness to this regime and strongly believes that such excess control of banking resources led to poor performance of banks and dampened the spirit / scope of any innovation in banking during the pre-reform era.

The Narasimham Committee proposed that the interest rate paid to banks on their SLR investments and on CRR in respect of impounded deposits above the basic minimum should be increased.

As the reforms progressed, Government started fixing the coupon rate of SLR securities at market related rate. Further, the RBI started paying reasonable interest on funds kept as CRR by banks. CRR and SLR requirements were brought down to 4.5 per cent and 25 per cent respectively by August 2004. Both the measures have helped commercial banks to improve profitability since more funds are left in the hands of banks for lending at better rate of interest.

Prior to reforms, opening of new bank branches was subject to permission from Reserve Bank of India. The Narasimham Committee suggested abolition of branch licensing policy. Considering that the objective of providing adequate banking infrastructure throughout the country, particularly in rural areas, had
been broadly achieved with the completion of the branch expansion policy for the period 1985-90, the Reserve Bank decided to give greater freedom to banks to rationalize their existing branch network by re-locating branches, opening of specialized branches, spinning-off of business at other locations, setting up of controlling offices/ administrative units, and establishing extension counters, etc. Initially, under the liberalized branch licensing policy, only those banks which attained the revised capital adequacy norms and prudential accounting standards were given freedom to set up new branch offices/upgrade the extension counters into full-fledged new branches without the prior approval of the Reserve Bank. Till such time banks attained the revised capital adequacy norms and until they were specifically advised in this regard, they should continue to obtain prior approval for opening new branches or converting extension counters into full-fledged branches. Later banks were permitted to close down branches other than in rural areas, as well as swap non-remunerative branches or those in remote areas.

In 1992-93, a number of developments took place in the banking sector having a significant impact on the growth and efficiency of the financial system. Many of these developments are in the context and consequence of financial sector reforms and relate to a wide array of areas: monetary and credit policy, prudential guidelines and norms, development of the Government securities market, competition through the entry of new banks, merger, setting up of supervisory and surveillance mechanisms and in-house strengthening of banks. The implementation of prudential norms and guidelines constituted a significant step towards introduction of transparency in accounting practices and of bringing the norms to internationally accepted standards. This probably helped to build up confidence in the efficacy of the Indian financial system, improve the competitive position of the industry and enhance public accountability.

Entry of new private sector banks
Banking sector was dominated by PSBs during post nationalization era. This had led to deterioration in service, poor financial performance and a sense of complacency in banking industry. Such a state of near monopoly seems to
have led to lack of innovation, scarcity of customer oriented products and approach.

The spirit of reforms was to allow the competition and increase the efficiency. There had been increasing recognition of the need to introduce greater competition in banking by allowing the entry of private sector banks. The Reserve Bank has accordingly formulated guidelines for the establishment of new banks in the private sector. The minimum paid-up capital of the new private sector bank was fixed at Rs 100 crore and these new generation banks were to observe prudential norms and capital adequacy of 8 per cent right from the beginning. Presently the limit stands revised to Rs 500 crore and 9 per cent respectively.

Debt Recovery Tribunals (DRT)
One of the problems faced by banks, during pre-reform period was the low rate of loan recoveries. Poor recovery in banks was a major cause of concern. Until reforms, legal infrastructure for recovery of bank dues was poor; there was no focused thrust for recovery of banks' dues. The legal process for realizing banks' dues was not conducive for quick recoveries. There were no dedicated courts to examine cases involving bank dues. Even the processes were long drawn and frustrating. Defaulters took full advantage of the system. This led to such poor recovery culture. In this context, the "Recovery of Debts due to Banks and Financial Institutions Act, 1993", was passed in August 1993, that facilitated establishment of Debt Recovery Tribunals.

Thus reforms paved the way for banks to approach alternative bodies such as DRT, Lok Adalats and Asset Reconstruction companies for recovery of dues. A Credit Information Bureau was set up for sharing the information on the borrowers of credit institutions. The RBI provided indicative guidelines for compromise settlement of chronic NPAs in small-loans. Settlement Advisory Committees were formed at Regional office and Head office levels. Another development which came into being was Corporate Debt Restructuring (CDR). The objective of CDR was to ensure a timely and transparent mechanism for
restructuring of the corporate debts of viable corporate entities affected by internal and external factors, outside the purview of BIFR, DRT or other legal proceedings, for the benefit of all concerned.

To alert the banks and financial institutions against defaulting borrowers of other lending institutions, the Reserve Bank announced in April 1994 a scheme for disclosure of information regarding defaulting borrowers of banks and FIs with outstanding aggregating to Rs one crore and above as on March 31 and September 30, every year. These steps improved the recovery climate and to enforce payments discipline among all borrowers.

System of supervision
A strong system of supervision become necessary in order to ensure that prudential regulations are observed. In order to ensure that prudential regulations are implemented and banks take steps to improve their viability it became necessary to have a separate institutional apparatus that is dedicated to supervision and surveillance of the entire financial system. A Board for Financial Supervision (BFS) was set up to supervise the operations of commercial banks, term-lending institutions and non-bank financial intermediaries.

In order to exercise integrated supervision over the financial system, the BFS with its Advisory Council was constituted in November 16, 1994 under the Reserve Bank of India (BFS) Regulations, 1994. This is intended to develop specific approaches for supervision of banking groups. The Working Group to Review the System of On-site supervision over Banks (Chairman: Shri S. Padmanabhan) in its report submitted in November 1995, recommended far reaching changes in bank inspections, including, inter alia targeted appraisals of major portfolios and control systems along with periodical full scope statutory inspections, discriminative approach to supervision and inspections by separating sound and problem banks with focus on the latter, introduction of a rating methodology for the banks on the lines of the widely adopted Capital Adequacy, Asset Quality, Management, Earnings and Liquidity (CAMEL)
model and a focused approach to follow up on inspection reports and for supervisory interventions.

**Branch licensing policy**

In April 1992, the branch licensing policy of commercial banks was liberalized. Banks were given authority to shift offices and spin-off business, etc. Banks were permitted to shift their existing branches within the same locality, open specialized branches, open extension counters, provide safe deposit lockers at these counters and convert the existing rural branches into satellite offices if the existing branches are found non-viable after complying with certain minimum formalities.

**Interest rate structure**

One of the major achievements of banking sector reforms is rationalization of the structure of interest rates. The number of prescribed lending rates were brought down. The term deposits rate was subject to a single ceiling of 10 per cent, and within this cap, banks were made free to fix the maturities and rates. An important development was that the interest rates on Government securities were coming increasingly close to market determined rates.

Until 1993-94, the rate structure on advances was still directed by the regulator. A major policy announcement during second half of 1994-95 was the abolition of the Minimum Lending Rate (MLR). Effective October 18, 1994, each bank was required to fix its own prime lending rate for credit limits above Rs 2 lakh.

Introduction of the concept of Prime Lending Rate (PLR) on October 18, 1994 was a major step towards further freeing of interest rates on advances. Prime Lending Rate was the benchmark or index for the actual rates. Other rates were tagged to this rate depending on the risk perception of the bank and the pricing strategy. Deposit rates were further liberalised by authorizing the banks to fix their own interest rates on deposits above 46 days.
An important area in which reforms progressed during 1995-96 related to further deregulation of interest rates, especially on the deposits side for banks as well as non-banking financial companies which met certain criteria on interest rate deregulation.

Interest rates were further deregulated during 1997-98. With a view to give banks full freedom to determine the interest rates on term deposits of different maturities, effective October 22, 1997, interest rates on domestic term deposits of 30 days and above were deregulated. The minimum period of maturity of term deposits was reduced from 30 days to 15 days in April 1998 and interest rates on them too were deregulated. Banks were permitted to determine their own penal interest rates for premature withdrawal of domestic term deposits and banks were advised to ensure that depositors were made aware of the applicable penal rate along with the deposit rate. Restriction on banks that they must offer the same rate on deposits of the same maturity irrespective of the size of such deposits was removed for domestic term deposits of Rs 15 lakh and above. In order to remove the disincentive to the flow of credit to small borrowers, effective April 29, 1998, the interest rates on loans upto Rs 2 lakh were not to exceed PLR which was the rate available to the prime borrowers with credit limits of over Rs 2 lakhs of the concerned bank.

With a view of giving more freedom to banks to determine the interest rates, banks were allowed in October 1997 to prescribe separate Prime Term Lending Rates (PTLRs) with the approval of their Boards, for term loans of 3 years and above, apart from the freedom to fix separate PLRs for cash credit and loan components.

Diversification in banking
Reforms even widened the scope of banking activities. The Indian financial system witnessed diversification in its activities. This has been reflected, inter alia, in a marked shift in asset preference from monetary assets to other financial assets leading to some degree of financial disintermediation. In keeping with the liberalization process in the financial system, in February
1994, banks were allowed departmentally to undertake para-banking activities like equipment leasing, hire purchase financing and factoring.

The disintermediation process in the financial sector has further led to setting up of various other service agencies by banks. Many banks participated in strategic investment in the equity of institutions like Credit Analysis and Research Ltd (CARE), National Stock Exchange (NSE), Over the Counter Exchange etc. Banks were allowed to take up Primary Dealership to exclusively deal in Government securities. Other activities like Depository Participants business, wealth management, housing finance become focused financial services of banking sector.

**Computerisation**
Adoption of computer and communication technologies forms an integral part of the financial sector reform process. This was identified as one of the key strategies for bringing about operational efficiency and improvements in customer service. Computerisation of branch operations got a major boost in 1993-94 consequent on the agreement between the Indian Banks Association and Employees’ Union in October 1993. Computerization was not progressing due to resistance from the employees’ unions.

Enhanced level of computerization to provide customer service, cost effective MIS generation and multiple channels of service delivery are the fruits of initiatives taken during the reforms. The Committee on technology issues in the Banking Industry (Chairman: Shri W.S Saraf), submitted its report on December 9, 1994. The Committee suggested far reaching changes relating to the payments system, cheque clearing and securities settlement technology related issues and training in technology for the banking industry.

An efficient payment and settlement system was a prerequisite of any financial system. Introduction of Negotiated Dealing System for Government securities and Real Time Gross Settlement System were the other major initiatives of Reserve Bank of India during early years of the decade. While the former is
already operational since 2002 for dealing in Government securities, the latter is operational with effect from 26th March 2004.

Banking Ombudsman Scheme

There was no machinery for resolution of customer complaints in banks prior to reforms. For expeditious and inexpensive resolution of customer complaints against deficiency in banking services, including non observance of the Reserve Bank directives on the loans and advances and other specified matters, the RBI announced in June 1995, the Banking Ombudsman Scheme, under the provisions of the Banking Regulation Act 1949. The scheme, which came into effect from June 14, 1995, provided an opportunity to the public to approach the Banking Ombudsman for grievances against a bank which were not resolved to their satisfaction by the said bank within a period of two months provided their complaints pertain to any of the matters specified in the Scheme. The Banking Ombudsman looks into complaints concerning deficiency in service such as (i) non-payment/ inordinate delay in the payment or collection of cheques/drafts/bills, etc; (ii) non-acceptance of small denomination notes tendered for any purpose without sufficient cause and charging of commission for handling of such notes; (iii) non-issue of drafts to customers and others; (iv) non-adherence by bank branches to prescribed working hours; (v) failure to honour guarantee / letter of credit commitments by banks; (vi) claims in respect of unauthorized or fraudulent withdrawals from deposit account etc; (vii) complaints pertaining to the operations in savings, current or any other account maintained with banks, such as delay, non credit of proceeds to parties' account, non-payment of deposit or non observance of the Reserve Bank directives, if any applicable to the rate of interest on deposits; (viii) complaints from exporters in India, such as, delays in receipt of export proceeds, handling of export bills, collection of bills, etc; and (ix) complaints from non-resident Indians having accounts in India in relation to their remittances from abroad, deposits and other bank related matters.
Introduction of prudential norms

Banks followed accrual basis for income recognition until the reforms started. This led to arrival of distorted profit figures. Under the system, even a bad asset would continue to earn interest income even though the chances of recovery of principal and interest of such loan were quite remote! The system of asset classification and provisioning as per the international best practices were quite unheard of in our banking industry. The reform initiatives ended this archaic, illogical system of accounting in banks. The new prudential norms brought legitimacy and dependability on the profit figures of banks in India.

Identifying the causes for the deterioration in the financial health of the banking system over time, the Narasimham Committee recommended various remedial measures which included *inter alia* capital adequacy norms, prudential norms for income recognition and provisioning for bad debts. The Committee recommended that classification of assets of banks should be done on the basis of objective criteria which would ensure a uniform and consistent application of the norms, that a policy of income recognition should be objective and based on record of recovery rather than on any subjective considerations, and that provisioning should be made on the basis of classification of assets into different categories.

Cleaning the balance sheets of banks was one of the priorities of financial sector reforms. This was sought to be achieved through the introduction of the prudential norms. There was no uniform system of classification of assets based on their health till the reforms started taking shape. The income recognition was on the basis of accrual. There was no concept of provisioning for bad debts in the banks. This resulted in lack of transparency in balance-sheet of banks and improper reflection of financial position of banks.

In April 1992, it was decided to implement the recommendation of the Committee on prudential norms in a phased manner over a three year period commencing from the accounting year beginning April 1, 1992. Banks were
instructed to treat an amount in respect of term loans, overdrafts and cash credit accounts, bills purchased and discounted and other accounts as 'past due' when it has not been paid on the due date. Banks faced practical difficulties in implementing these norms. Banks were required to make 100 per cent provision in respect of loss assets and not less than 30 per cent of the total provisioning needed in respect of sub-standard and doubtful advances and advances with outstanding balances less than Rs 25000 for the year ended March 31, 1993. From 1996-97 onwards banks were required to classify small loans into the usual four asset categories and accordingly make provisioning in line with the NPAs with outstanding balance of Rs 25000 and above.

As part of reform process, banks were required to make full provisioning for bulk of their non-performing assets by the end of March 1996. The reform process placed commercial banks under increasing pressure to improve their performance including the quality and content of their banking business. Banks demonstrated considerable resilience in adjusting to the new operating environment and acquiring higher levels of business strength. The turnaround has been facilitated by the focus on recovery and reduction of NPAs, which lowered provisioning requirements, and the growth of non-fund based business.

The banks were advised on April 3, 1995 that interest accrued and credited to income account during the year ended March 1994 in respect of accounts identified as non-performing assets for the first time during the year ended March 31, 1995 should be reversed or provided for as on that date. The provisioning requirement for advances with balances of less than Rs 25000 was raised from 5 per cent of the aggregate amount outstanding to 7.5 per cent for the year ended March 31, 1995 and further to 10 per cent for the year ended March 31, 1996.

Introduction of capital adequacy norms
In April 1992, the Reserve Bank introduced a risk-asset ratio system for banks (including foreign banks) in India as a capital adequacy measure. Under the
system, the balance sheet assets, non-funded items and other off-balance sheet exposures were assigned risk weights according to the prescribed percentages and banks were required to maintain unimpaired minimum capital funds equivalent to the prescribed level of the aggregate risk-weighted assets and other exposures, on an ongoing basis. All banks with international presence were required to achieve the norm of 8 per cent as early as possible and in any case by March 31, 1993. Foreign banks operating in India were to achieve this norm of 4 per cent by March 1, 1993 and 8 per cent norm by March 31, 1996. The total of Tier II capital element will be limited to a maximum of 100 per cent of total of Tier I capital elements for the purpose of compliance with the norms.

Introduction of classification and valuation norms for investments

As regards accounting standards for investments, investments in approved securities were to be bifurcated into 'permanent' and 'current' investments. 'Permanent' investments are those which banks intend to hold till maturity and 'current' investments were those which banks intend to deal in; i.e., buy and sell on a day-to-day basis. To begin with, banks had to keep not more than 70 per cent of their investments in the 'permanent' category from the accounting year 1992-93 but this ratio had to be brought down to 50 per cent in due course. While the depreciation in respect of 'permanent' investment was not likely to affect their realizable value and therefore need not be provided for, depreciation in 'current' investments was to be fully provided for. 'Permanent' investments could be valued at cost unless it is more than face value, in which case the premium had to be amortised over the period remaining for maturity of the security. Banks were not expected to sell the securities in the 'permanent' category freely, but if they do so, any loss on such transactions in securities in this category has to be written off. Besides, any gain should be taken to capital reserve account.

The 'marked to market' proportion of the approved securities was enhanced further from 50 per cent for 1996-97 to 60 per cent for 1997-98 with a view to moving towards the international practice of marking all investments to the
market. As a further reform, during the year 2000 banks were advised to classify the investments into three categories; viz., Held to Maturity (HTM), Available for Sale (AFS) and Held for Trading (HFT). Appropriate valuation and accounting norms had been prescribed to reflect true picture of the balance sheet.

Recapitalisation of nationalised banks
As per the prudential norms, commercial banks were required to maintain unimpaired capital funds equivalent to the prescribed ratio on the aggregate of the risk weighted assets and other exposures on an ongoing basis from the financial year 1992-93 onwards. Out of 27 public sector banks, 18 banks achieved the stipulated 4 per cent norm as at March 31, 1993. With recapitalisation of 19 nationalised banks to the tune of Rs 5700 crore on January 1, 1994 all the Public Sector Banks (PSBs) had achieved the norm of 4 percent as on that date. The programme of recapitalisation of banks was supplemented by a stipulation of time bound 'performance criteria' for each public sector bank.

The release of capital by the Government was subject to the participating PSBs' undertaking certain performance obligations and commitments. The obligations were generally in respect of parameters such as changes in operational policies and in organizational structure of banks and use of upgraded technology to ensure an improvement in viability, and profitability of these banks. Moreover, banks were to chalk out plans to ensure excellence in customer service and maintenance of a high level of efficiency in providing various services; to improve their position through repayment and additional securities, documentation, etc. in respect of all non-performing assets above Rs. One crore; formulate liability management/ investment management and loan policies, outline capital expenditure and human resource development policies.

By an ordinance in October 1993, State Bank of India (SBI) was permitted private shareholding which paved the way for going public. The SBI was the
first PSB to access the capital market and it raised Rs 2210 crore in the form of equity and Rs 1000 crore through bonds. The Banking Companies (Acquisition and Transfer of Undertakings) Act 1970/80 were also amended to enable the nationalized banks to raise capital funds from the market by public issue of shares.

As at the end of March 1994, out of the 27 PSBs eight banks had attained the CRAR of 8 per cent. At the end of March 1995, thirteen had attained the CRAR of at least 8 per cent, eleven banks at least 4 per cent and 3 banks less than 4 per cent.

The Union Budget 1994-95 provided for Rs. 5600 crore for further capitalization of nationalized banks. As against the budgeted amount of Rs 5600 crore for capitalisation, an amount of Rs 5287.12 crore was released by the Government to the nationalized banks towards recapitalisation. Oriental Bank of Commerce tapped the market with an equity issue of Rs 360 crore in October 1994.

Equity base of number of profit making nationalised banks was oversized in relation to the projected stream of earnings, whereas the banks with cumulative losses were not able to set off their losses against their capital. As this came in the way of quite a few nationalized banks accessing the capital market and the loss making banks in adjusting their cumulative losses, the Banking Companies (Acquisition and Transfer of Undertakings) Act 1970/1980 was amended enabling banks to reduce their paid-up capital.

A sum of Rs 850 crore was allocated as capital during 1995-96 among six select nationalized banks. Government of India contributed during 1996-97, Rs 1509 crore towards the capital of six nationalized banks. Out of the 27 PSBs, 25 banks achieved the minimum capital to risk weighted assets ratio (CRAR) of at least 8 per cent as at the end of March 1997. In order to shore up their earnings per share (EPS), three PSBs, viz., Bank of Baroda, Corporation Bank and Bank of India together returned Rs 504.47 crore of their capital to the
Government while three more public sector banks accessed the capital market during 1996-97.

Out of the 27 PSBs, 25 banks achieved the minimum CRAR as at the end of March 1997. The Government contributed a sum of Rs 2700 crore during 1997-98 towards capitalization of three banks. Three more banks accessed the capital market during the year.

Out of the 27 PSBs, 26 banks achieved the minimum capital to risk weighted assets ratio (CRAR) of at least 8 per cent by March 1998. While 19 banks had CRAR exceeding 10 percent, 7 banks had CRAR between 8 and 10 per cent. Following the announcement in monetary and credit policy in October 1998, banks have been advised to maintain a minimum CRAR of 9 per cent by end-March 2000. During 1998-99, the Central Government contributed a sum of Rs 400 crore to the capital of three nationalized banks.

The overall capital contributions by the Government to nationalized banks as at end-March 1999 amounted to Rs 20,446 crore, out of which Rs 642 crore was returned to the Government by four banks. The Government wrote down a sum of Rs 2066.64 crore during 1998-99 from the existing capital base of four nationalized banks against the accumulated losses of equivalent amount. The consequent reduction of Government's investments in these banks would enable them to go for an early public issue. So far, investments of 10 nationalised banks amounting to Rs 6037.2 crore were permitted to be written down by the Government against accumulated losses. Banks were given autonomy to raise rupee denominated subordinated debt as Tier II capital in February 1999.

The implementation of the recommendations of Narasimham Committee on financial sector reforms has progressed satisfactorily. An attempt is made to depict the whole of the banking sector reforms during 1991-92 to 1996-97 in a tabular form in Appendix 2.1 furnishing the element of reform, pre-reform status, measures taken and the present status.
**Agenda of second phase of banking sector reforms**

The Committee on Banking Sector Reforms (Chairman: Shri M Narasimham) was constituted on December 26, 1997 to review the progress of financial sector reforms recommended by Narasimham Committee on Financial System (1991) and to suggest remedial measures for strengthening the banking system, covering areas of banking policy, institutional structure, supervisory system, legislative and technological changes. The Committee submitted its report in April 1998. The recommendations of the Committee, were considered in consultation with the Government of India and some of the decisions were announced on October 30, 1998 as part of 'Mid-Term Review of Monetary and Credit Policy for 1998-99'.

Recommendations of the Committee on Banking Sector Reforms, April 1998, are given in the following paragraphs.

**Strengthening the banking system**

For strengthening the banking system, the Committee recommended an increase in the minimum capital adequacy ratio (CRAR) to 10 per cent by 2002. Besides, the entire portfolio of Government securities should be marked to market in three years. Also, a 5 per cent weightage was to be assigned to Government and other approved securities to hedge against market risk. Net NPAs had to be brought down to below 5 per cent by 2000 and to 3 per cent by 2002. However, banks with international presence should reduce gross NPA to 5 per cent by 2000 and to 3 per cent by 2002 and net NPAs to 3 per cent and 0 per cent respectively by the said time frame. The Committee proposed Asset Reconstruction Company (ARC) to tide over the backlog of NPAs. In case of prudential norms relating to income recognition, the norm of 180 days should be brought down to 90 days in phased manner by 2002. As regards asset classification, an asset may be classified as 'doubtful' if it is in the substandard category for 18 months in the first instance and eventually for 12 months and 'loss' if it had been so identified but not written off. These norms which should be regarded as the minimum, may be brought into force in a phased manner.
The Committee suggested a reduction in the minimum stipulated holdings of the Government/Reserve Bank in the equity of nationalised banks/State Bank of India to 33 per cent. In regard to tenure of a Chief Executive of a bank, the Committee indicated a minimum period of three years but the reasonable length of tenure to be not less than five years.

**Systems/methods in banks**

To bring about efficiency in banks, the Committee recommended a number of measures. These included, revision of operational manual and its regular updation, simplification of documentation systems, introduction of computer audit, and evolving of a filtering mechanism to reduce concentration of exposures in lending and drawing geographical/industry/sectoral exposure norms with the Board’s concurrence. Besides, the Committee suggested induction of one more whole-time director in nationalized banks in view of the changing environment. As outsourcing of services would improve productivity it suggested the same may be introduced in the field of building maintenance, cleaning, security, dispatch of mail, computer-related work, etc., subject to relevant laws.

**Structural issues**

The Committee recommended that after the convergence of activities between Development Financial Institutions (DFIs) and banks over a period of time, they should get converted into banks, resulting in the existence of only two intermediaries viz, banks and non-banks. While mergers between strong financial institutions would make sense, the weak banks in the system will have to be given the revival package subject to a set of criteria. The licensing of new private sector banks needed a review for their enhancement, while foreign banks will have to be encouraged to extend their operations on certain norms.
Regulation and supervision

The Committee made a suggestion that the 'Basle Core Principles of Effective Bank Supervision' should be regarded as the minimum to be attained. It should be made obligatory for banks to take into account risk weights for market risks to facilitate soundness and stability of the system.

For effective conduct of monetary policy by the Reserve Bank, separation of supervision/regulation from monetary policy was required implying that the executive associated with monetary authority should not be in the Supervisory Board, to avoid weakening of monetary policy or banking regulation and supervision.

By the time of second phase of reforms, the supervisory strategy comprised both off-site surveillance and on-site inspections. A detailed off-site surveillance system based on ‘prudential’ supervisory reporting framework on a quarterly basis covering capital adequacy, asset quality, loan concentration, operational results and connected lending was made operational. This was combined with a verification of prudent practices and financial condition of banks through on-site examination. The new approach to annual financial inspection based on CAMELS framework commenced from July 1997. It essentially focused on the evaluation of total operations and performance of the banks under the CAMELS system, i.e. Capital adequacy, Asset quality, Management, Earning, Liquidity and internal control Systems. The main endeavor of this system was to detect problems before they manifest themselves.

Legal and legislative framework

The Committee recommended the amendment of RBI Act and Banking Regulation Act with regard to formation of Board for Financial Regulation and Supervision (BFRS). It also gave more autonomy and powers to Public Sector Banks. As wide ranging changes in the legal framework affecting the working of the financial sector were sought by the Committee, an expert Committee could be constituted comprising representatives from Ministry of Law, Banking Division, Ministry of Finance, the Reserve Bank and some outside experts.
Risk management

The Basle Capital Adequacy accord was introduced in 1988 as a means of setting minimum capital asset ratio for international banks. Post Basle 1988, international banking witnessed a gradual blurring of functional distinction among financial intermediaries. The original accord emphasised only the credit risk aspect of banking operations, ignoring the other relatively important risk factors like interest rate risk and operational risk. This seems to have compelled the Basle Committee on Banking Supervision to propose the new Basle Norms.

The Basle Committee on Banking Supervision, in April 1997, released the Basle Core Principles for effective banking supervision, a set of twenty-five basic principles which it advocated for a supervisory system to be effective. The twenty-five core principles represent the basic elements of an effective supervisory system and cover pre-conditions for effective banking supervision, licensing and structure, prudential regulations and requirements, methods of ongoing banking supervision, information requirements, formal power of supervisors and cross-border banking. The Bank for International Settlements (BIS) endorsed the twenty-five core principles for adoption by all countries.

In the process of providing financial services, banks assume various kinds of financial risks viz., credit risk, interest rate risk, foreign exchange risk and liquidity risk. To some extent these risks could be eliminated through sound business practices and the others through a combination of product design and pricing. In the past, banks had concentrated solely on asset management with liquidity and profitability being regarded as two opposing considerations. In order to proactively address the risks, banks were advised to undertake a comprehensive Asset Liability Management (ALM) strategy. The Monetary and Credit Policy for the second half of 1997-98 emphasised the need for banks to put in place a comprehensive ALM system. This encompassed a process of continuous management in terms of planning, organizing and controlling of
asset and liability volumes, rates and yields and incorporating the maturities of assets and liabilities into consideration as well.

The experience of Asian crisis had reiterated the need for sound regulatory and supervisory system in the course of financial liberalization. The role of supervision was to promote financial market stability and minimize systemic risk. The Committee for second phase of banking sector reforms in India, suggested that the supervisory responsibility would need to guide the banking system in the chartered path so as to achieve the desired goals. The key elements of this strategy include (a) sound capital adequacy standards, (b) market discipline, and (c) a dynamic risk-focused approach to supervision.

Important recommendations for second phase of reforms are tabulated below:

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<tr>
<th>Capital Adequacy</th>
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<tr>
<td>Capital adequacy ratio to be raised from 8 per cent to 10 per cent by 2002</td>
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<tr>
<td>100 per cent fixed income portfolio marked to market by 2001 (up from 70 per cent)</td>
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<tr>
<td>5 per cent market risk weight for fixed income securities and open foreign exchange position</td>
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<td>Commercial risk weight (100 per cent) to government-guaranteed advances (previously treated as risk-free)</td>
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Asset quality
- Banks should aim to reduce gross non-performing assets to 3 per cent and net NPAs to 0 per cent by 2002
- 90-day overdue norms to be applied for cash-based income recognition (down from 180 days)
- Government-guaranteed irregular accounts to be classified as NPAs and provided for
- Asset Reconstruction Company to take on NPAs of weak banks against issue of risk-free bonds

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• Directed credit obligation to be reduced from 40 per cent to 10 per cent
• Mandatory general provisions of 1 per cent of standard assets and specific provisions to be made tax-deductible

Systems and Methods

• Banks to start recruitment of skilled, specialized manpower from the market
• Overstaffing to be dealt with by redeployment and right-sizing via voluntary retirement scheme

Public sector banks to be given flexibility in remuneration/industry structure

• Only two categories of financial sector players to emerge: banks and non-bank financial companies, Development Financial Institutions to convert into banks or remain non-bank companies
• Mergers to be driven by market and business considerations, not imposed by regulators
• Weak banks to convert to 'narrow banks' (by focusing on retail deposit mobilization and reducing their credit intermediation role substantially) restructure, or close down if proven unviable
• Emergence of 3-4 international banks, 8-10 national banks, rest to play regional/local roles.
• Entry of new private sector banks and foreign banks to continue
• Banks to be given greater functional autonomy, and minimum government shareholding to be reduced to 33 per cent from 55 per cent for State Bank of India and 51 per cent for other Public Sector Banks on structure
• Rapid introduction of computerization and technology

Legal amendments

• Broad range of legal reforms to facilitate recovery of problem loans
• Introduction of laws governing electronic funds transfer
• Amendments in the Banking Regulation Act, Nationalisation Acts, and State Bank of India Act to allow greater autonomy, higher private sector shareholding, etc.
Implementation of measures suggested in second phase of reforms

Taking into account the importance of the management of asset-liability and the prescription thereof in accordance with the Basle Core Principles, the RBI issued draft guidelines in September 1998 for putting in place a comprehensive Asset-Liability Management (ALM) System in banks. The final guidelines were implemented effective April 1, 1999. Banks were advised to set up an internal Asset-Liability Management Committee headed by the Chief Executive Officer/Chairman and Managing Director. The Management or any specific Committee of the Board was required to oversee the implementation of the ALM system and review its functioning periodically.

Banks have set up the Risk Management Committee consisting of Top Management headed by Chairman and Managing Director. Committee meetings are held at least once in two months. Asset Liability Committee (ALCO) consisting of executives from various Divisions and headed by the CMD/Executive Director was formed and is meeting regularly. All banks have formed separate Divisions for Risk Management of the Banks on an ongoing basis. Risk management policies were formulated and implemented in banks.

NPA Management measures

In pursuance of the announcement in the Union budget for 1999-2000, guidelines were framed for the constitution of Settlement Advisory Committee (SAC) for compromise settlement of chronic NPAs of small sector. All PSBs were required to follow these guidelines uniformly, to maximize recovery of NPAs within the stipulated time. With a view to developing an institutional mechanism for sharing of information on borrowers/potential borrowers among banks and financial institutions, the Credit Information Bureau (India) Ltd. (CIBIL) was set up in August, 2000 for collecting, processing and sharing credit information on the borrowers and credit institutions.

One of the major developments in legal reforms was the promulgation of 'The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest ordinance, 2002'. The Ordinance empowered secured
creditors to enforce any security interest credited in their favour without any intervention of a court or tribunal. Banks have fully utilized the provisions of the Act and enforced the securities which are available to the bank as security. This helped the banks to improve the performance of recovery.

Prudential norms
With effect from April 1, 2000, the ceiling on a bank's exposure to an individual borrower was lowered to 20 per cent of the capital funds from the existing limit of 25 per cent with a view to move closer to the international standard of 15 percent in phases. Now, individual borrower limit further stands reduced to 15 percent of net owned funds as proposed by the Committee.

Categorisation and valuation of investments
Guidelines on categorization and valuation of banks' investment portfolio were issued requiring banks to classify their investment portfolio into 'held to maturity', 'available for sale' and 'held for trading'. Norms for valuation and providing for depreciation were also given.

The mark to market proportion of the approved securities was enhanced further from 60 per cent in 1997-98 to 70 per cent 1998-99. Now, the proportion stands enhanced to 100 per cent as per the recommendations of the Committee.

Consolidated supervision
The adoption of Basle core principles for effective banking supervision requires adherence to the principles of consolidated accounting and supervision of the affairs of the bank's subsidiaries. With a view to moving towards international best practices, banks were advised on May 3, 2000, to voluntarily build in the risk-weighted components of subsidiaries into their own balance sheet on notional basis, beginning with the year ending March, 2001. Banks implemented the said guidelines.
In the Monetary and Credit Policy of April 2000, the RBI announced its intention to move towards a risk-based approach to supervision of banks. The switch over to Risk-Based Supervision (RBS) from the then prevailing CAMELS based approach was intended to enhance supervisory standards and practices in alignment with the international best practices. The RBS approach was planned to be put in operation after the pilot run in the last quarter of the financial year 2002-03. Indications were that the approach will be implemented as soon as the banks and the regulator are ready for such very progressive leap.

With the passage of time, financial sector supervision is expected to become increasingly risk oriented and concerned more with validation of systems. The RBS process entails monitoring of banks by allocating supervisory resources and focusing supervisory attention according to the risk profile of each institution. Implementation of RBS requires complex prudential reporting system by banks. Banks are in the process of developing the MIS to meet such prudential reporting system.

Board for Financial Supervision

With various segments of the financial sector getting closely interlinked with liberalization, an integrated system of supervision over banks, financial institutions, and financial companies has been put in place by constituting the Board for Financial Supervision (BFS) on November 16, 1994. The BFS exercised its powers of supervision over commercial banks, the NBFCs and Financial Institutions.

Besides retaining the importance of the on-site inspection which had so far been the main plank of banking supervision, the new strategy encompasses. (a) setting up of off-site surveillance based on a new prudential reporting system, (b) restructuring the system of bank inspection in terms of focus, process, reporting and follow-up, (c) strengthening the statutory audit of banks and enlarging the role of auditors in the supervisory process including using them as agents and (d) strengthening the internal defense within the supervised institutions such as corporate governance, internal control and audit functions,
management information and risk control systems as an extension of the task of supervision.

Technology improvement
As part of the restructuring of the banking sector, special emphasis was accorded to improvements in payment and settlement systems. Prominent among the measures initiated in these areas included introduction of Electronic Funds Transfer (EFT), Real Time Gross Settlement System (RTGS), Centralized Funds Management System (CFMS), Negotiated Dealing System (NDS) and the Structured Financial Messaging Solution (SFMS). The SFMS would be the backbone for all message-based communication over the Indian Financial Network (INFINET).

To further upgrade the existing technology in the banking sector and also to suggest measures for implementation, the Reserve Bank appointed a 'Committee on Technology Upgradation in the banking sector'. The Committee in its Report, submitted in July 1999, recommended a new legislation on Electronic-Fund-Transfer System to facilitate multiple payments systems to be set up by banks and financial institutions. The Committee recommended
- Communication infrastructure and usage of INFINET
- Standardization and security
- Computerisation of Government transactions
- Data warehousing, data mining and management information system
- Legal framework for electronic banking
- Issues relating to human resource development

Status of action taken on the recommendations of Narasimham Committee II is given in the Appendix 2.2

Basel II and reforms
Basel is an international body which formulates guidelines relating to risk management in banks. G 10 countries implement and follow the guidelines. Rest of the world uses these guidelines as standard
In 1988, the Basel Committee on Banking Supervision drafted and published the Basel I Capital Accord, commonly referred as Basel I, to promote, banking stability and provide broad policy guidelines for setting minimum standards of capital adequacy. In 2001, Basel II was published after gathering comments from business and financial institutions. The implementation of the Accord is likely by the end of 2006. Major banks in India can operate within a regulatory environment in which their international competitors are subject to.

Basel II is a resolution in the form of a consultation paper of the Basel Committee on Banking Supervision. The present package, when finalized, will establish the basic capital frameworks for Committee member countries and Committee expects that it will also be adopted by supervisors across the world.

The new Basel Accord attempts to bridge the gap between regulatory capital and economic capital. The Accord seeks to make improvements in the measurement of risks within the banking system. The Accord further seeks to establish guidelines for the enhanced underlying of credits with bank equity in order to maintain credit stability, thus allowing effectively for the strengthening of the risk of default of credit. Basel II places more emphasis on banks' own internal control and management, the supervisory review process and market discipline. Its focus is predominantly on internationally active banks on varying levels. The new framework provides a spectrum of approaches from simple to advanced methodologies for the measurement of both credit risk and operational risk in determining capital levels. Adoption will help banking systems to migrate to a higher level of risk measurement and risk management with an accent on continued refinement.

The new accord consists of three, mutually reinforcing pillars, which together should contribute to safety and soundness in the financial system. The Accord has a three pillar structure:
The minimum capital requirement is maintained at 8 percent of risk weighted assets. New accord has introduced Tier III capital on the capital side and on the risk weight is given based on credit risk, market risk and operational risk. Supervisory review encourages banks to develop and use better risk management techniques in monitoring and managing risks. Market discipline imposes strong incentives to banks to conduct their business in a safe, sound and effective manner.

The new framework is to be made applicable from end of 2006. The more advanced approaches will be implemented by the end of 2007. More detailed framework of Basel II and its impact on Indian banks is discussed in Chapter III. The preparedness of commercial banks is also explained there. It is time to introduce the next phase of reforms after review of progress in banking sector reforms recommended in 1998.

To sum up
India decided to adopt reforms as a policy for achieving faster economic progress. Reforms were first initiated in financial sector. Narasimham Committee on Financial System charted the road map on reforms in 1991. This was mainly intended to clean up the financial system. Major initiatives suggested by the Committee included:

- Phased reduction of SLR and CRR of banks
- Liberalization of interest rate on deposits and advances
- Liberalised branch licensing
- Entry of new banks and allowing competition
- Setting up of banking Ombudsman and debt recovery tribunals
- Diversification of banking activities
- Introduction of prudential norms - Capital Adequacy, Income Recognition, Asset classification and provisioning

Above recommendations are already implemented.
The Committee on Banking Sector Reforms headed by M Narasimham suggested the measures to strengthen the banking system. The main recommendations include.

- Improvement of systems and procedures of banks
- Restructuring the banking system into banks and non banks only by conversion of development financial institutions into banks
- Reforms in regulation and supervision
- Introduction of risk management measures
- Further introduction of technology to improve banking convenience
- Achieving Basle II norms

Banks have started to implement the recommendations and likely to complete the process by end of 2006.

Indian banks have shown good progress in achieving the international best practices both in service delivery and risk management practices. This has strengthened the banking industry in general to face the challenges of competition and global risks.
Notes and references

1 As per the Banking Regulation Act, 1949, banks are required to maintain a prescribed percentage of their NDTL in the form of cash with Reserve Bank of India. This is a measure to create sufficient liquidity for the banks. This has been used for monetary control by the Reserve Bank of India many a times.

2 This is the rate of cash balance to be maintained by the banks with Reserve Bank of India for the purpose of liquidity.

3 NDTL is the net demand and term liabilities attracting SLR and CRR, which include the net demand and time liabilities, interbranch liability etc.

4 This is the rate at which the banks shall lend to its prime borrowers.

5 Punjab National Bank site www.pnbindia.com/contactus.htm

6 Banks classify the assets based on the quality of the asset, recognize income on the basis of asset classification and provide for losses based on the classification of assets. These norms cumulatively are referred as prudential norms.

7 In April 1992 it was decided to implement the Narasimham Committee’s recommendations, with certain modifications, in a phased manner over a three-year period commencing from the accounting year beginning April 1, 1992. Banks have been instructed to treat an amount in respect of term loans, overdrafts and cash credit accounts, bill purchased and discounted and other accounts, as “past due” when it has not been paid on the due date. A “non-performing asset” has been defined as a credit facility in respect of which interest has remained unpaid for a period of four quarters during the year ending March 31, 1993, three quarters during the year ending March 31, 1994 and two quarters during the year ending March 31, 1995 and onwards. Banks have been instructed that they should not charge and take to income account interest on all non-performing assets. As compared with the then prevailing eight health codes, banks were required to classify their advances into four broad groups (i) standard assets, (ii) sub-standard assets, (iii) doubtful assets, and (iv) loss assets. Broadly, classification of assets into these categories has to be done taking into account the degree of well-defined credit weaknesses and extent of dependence on collateral security for realization of dues. The health code system for classification of assets would, however, continue as a management information tool.

8 RBI site, www.rbi.org.in/sec7/10115