The US courts now made it clear that they were prepared to forcibly take apart companies that had a monopolistic hold on their industries, as the 1911 break-up of Standard Oil so clearly demonstrated. John D Rockefeller had created Standard Oil in 1868 in Pittsburgh, Pennsylvania and it then spread rapidly throughout the United States gaining more and more subsidiaries as it went. This one company represented all the power and wealth of the Rockefeller business empire and Standard Oil was well known for savage business practices that drove many of its competitors out of business. In 1911, however, the US Supreme Court decided to act and accused Standard Oil of discriminatory practices, abuse of power and excessive control of its market. All of these had been acceptable under the Sherman Act but the regulatory framework of the United States was changing and monopolistic behaviors were no longer acceptable. Standard Oil lost the ensuing court battle and was forced to dismantle thirty-three of its most important subsidiaries and distribute the shares to its existing shareholders. The company was also forbidden from creating a new trust to be the recipient of the shares effectively making it impossible for Rockefeller to maintain control of the subsidiaries. The break-up of Standard Oil represented the first step towards the new merger legislation that was to be introduced in 1914, the Clayton Act. This Act was put in place specifically to redress the weaknesses of the previous legislation and it actively encouraged companies to form oligopolies instead of monopolies.
APPENDIX – II

NARASIMHAM COMMITTEE II

Shri M. Narasimham Committee on banking sector reforms was appointed in 1998 to

- Measures to strengthen the banking system;
- Structural Issues;
- Systems and Methods in Banks.

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

2. In the next three years, the entire portfolio of Government securities should be marked to market and this schedule of adjustment should be announced at the earliest. It would be appropriate that there should be a 5% weight for market risk for Govt. and approved securities. (Chapter III para 3.11)

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

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

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

6. A ‘weak bank’ should be one whose accumulated losses and net NPAs exceed its net worth or one whose operating profits less its income on recapitalisation bonds is negative for three consecutive years. A case by case examination of the weak banks should be undertaken to identify those which are potentially revivable with a programme of financial and operational restructuring. Such banks could be nurtured into healthy units by slowing down on expansion, eschewing high cost funds/borrowings, judicious manpower deployment, recovery initiatives, containment of expenditure etc. The future set up of such banks should also be given due consideration. Merger could be a solution to the problem of weak banks but only after cleaning up their balance sheets. If there is no voluntary response to a take over of these banks, it may be desirable to think in terms of a Restructuring Commission for such public sector banks for considering other options including restructuring, merger
amalgamation or failing these closures. Such a Commission could have terms of reference which, inter alia, should include suggestion of measures to safeguard the interest of depositors and employees and to deal with possible negative externalities. Weak banks which on a careful examination are not capable of revival over a period of three years should be referred to the Commission. (Chapter V, para 5.16 – 5.18)

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

8. The Committee is of the view that foreign banks may be allowed to set up subsidiaries or joint ventures in India. Such subsidiaries or joint ventures should be treated on par with other private banks and subject to the same conditions with regard to branches and directed credit as these banks (Chapter V, para 5.21).
All NBFCs are statutorily required to have a minimum net worth of Rs.25 lakhs if they are to be registered. The Committee is of the view that this minimum figure should be progressively enhanced to Rs.2 crores which is permissible now under the statute and that in the first instance it should be raised to Rs.50 lakhs. (Chapter V, para 5.36)

9. Banks should bring out revised Operational Manuals and update them regularly, keeping in view the emerging needs and ensure adherence to the instructions so that these operations are conducted in the best interest of a bank and with a view to promoting good customer service.

These should form the basic objective of internal control systems, the major components of which are (1) Internal Inspection and Audit, including concurrent audit, (2) Submission of Control Returns by branches/controlling offices to higher level offices (3) Visits by controlling officials to the field level offices (4) Risk management systems (5) Simplification of documentation, procedure and of inter office communication channels. (Chapter IV, para 4.3)

10. An area requiring close scrutiny in the coming years would be computer audit, in view of large scale usage and reliance on information technology (Chapter IV, para 4.7) 26. The Committee feels that the present practice of RBI selection of statutory auditors for banks with Board of Directors having no role in the appointment process, is not conducive to sound corporate governance. We would recommend that the RBI may review the existing practice in this regard. It may also reassess the role and function of the Standing Advisory Committee on Bank Audit in the light of the setting up of
the Audit Committee under the aegis of the Board for Financial Supervision.(Chapter IV, para 4.19)
Khan Group

Shri S.H. Khan, the Chairman of IDBI, on review the role and structure of the Developmental Financial Institutions and the Commercial Banks in the emerging environment, and to recommend measures to achieve coordination and harmonization of Lending policies of financial institutions before they move towards Universal Banking was appointed in 1997.

The Group was to some of the recommendations of this Group are given below:

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

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

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

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

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

Basel Accords II on Banking Supervision Committee was appointed in 2004 to

- Ensuring that capital allocation is more risk sensitive;
- Separating operational risk from credit risk, and quantifying both;
- Attempting to align economic and regulatory capital more closely to reduce the scope for regulatory arbitrage.

The Committee suggests deals with maintenance of regulatory capital calculated for three major components of risk that a bank faces: credit risk, operational risk, and market risk. Other risks are not considered fully quantifiable at this stage.

The credit risk component can be calculated in three different ways of varying degree of sophistication, namely standardized approach, Foundation IRB and Advanced IRB. IRB stands for "Internal Rating-Based Approach".

For operational risk, there are three different approaches - basic indicator approach or BIA, standardized approach or TSA, and the internal measurement approach (an advanced form of which is the advanced measurement approach or AMA).

For market risk the preferred approach is VaR (value at risk).

As the Basel II recommendations are phased in by the banking industry it will move from standardized requirements to more refined and specific requirements that have been developed for each risk category by each individual bank. The upside for banks that do develop their own bespoke risk measurement systems is that they will be rewarded with potentially lower risk
capital requirements. In future there will be closer links between the concepts of economic profit and regulatory capital.

Credit Risk can be calculated by using one of three approaches:

1. Standardised Approach

2. Foundation IRB (Internal Ratings Based) Approach

3. Advanced IRB Approach

The standardized approach sets out specific risk weights for certain types of credit risk. The standard risk weight categories are used under Basel 1 and are 0% for short term government bonds, 20% for exposures to OECD Banks, 50% for residential mortgages and 100% weighting on unsecured commercial loans. A new 150% rating comes in for borrowers with poor credit ratings. The minimum capital requirement (the percentage of risk weighted assets to be held as capital) remains at 8%, with common equity at 2% and Tier 1 cap at x% (source: Proposed Basel 3 guidelines a credit positive for India)

For those Banks that decide to adopt the standardized ratings approach they will be forced to rely on the ratings generated by external agencies. Certain Banks are developing the IRB approach as a result.

The Committee suggests, deals with the regulatory response to the first pillar, giving regulators much improved 'tools' over those available to them under Basel I. It also provides a framework for dealing with all the other risks a bank may face, such as systemic risk, pension risk, concentration risk, strategic risk, reputation risk, liquidity risk and legal risk, which the accord combines under the title of residual risk. It gives banks a power to review their risk management system.
The Committee suggests, promoting greater stability in the financial system market discipline supplements regulation as sharing of information facilitates assessment of the bank by others including investors, analysts, customers, other banks and rating agencies. It leads to good corporate governance. The aim of pillar 3 is to allow market discipline to operate by requiring lenders to publicly provide details of their risk management activities, risk rating processes and risk distributions. It sets out the public disclosures that banks must make that lend greater insight into the adequacy of their capitalization. When marketplace participants have a sufficient understanding of a bank’s activities and the controls it has in place to manage its exposures, they are better able to distinguish between banking organizations so that they can reward those that manage their risks prudently and penalize those that do not.