2.3 FINANCIAL AND BANKING SECTOR REFORMS

The last two decades witnessed the maturity of India's financial markets. Since 1991, every government of India took major steps in reforming the financial sector of the country. The important achievements in the following fields, is discussed under separate heads

• Financial markets
• Regulators
• The banking system
• Non-banking finance companies
• The capital market
• Mutual funds
• Overall approach to reforms
• Deregulation of banking system
• Capital market developments
• Consolidation imperative

The details of the above segments have been explained separately as under.

FINANCIAL MARKETS

In the last decade, Private Sector Institutions played an important role. They grew rapidly in commercial banking and asset management business. With the openings in the insurance sector for these institutions, they started making debt in the market. Competition among financial intermediaries gradually helped the interest rates to decline. Deregulation added to it. The real interest rate was maintained. The borrowers did not
pay high price while depositors had incentives to save. It was something between the nominal rate of interest and the expected rate of inflation.

**REGULATORS**

The Finance Ministry continuously formulated major policies in the field of financial sector of the country. The Government accepted the important role of regulators. The Reserve Bank of India (RBI) has become more independent. Securities and Exchange Board of India (SEBI) and the Insurance Regulatory and Development Authority (IRDA) became important institutions. Opinions are also there that there should be a super-regulator for the financial services sector instead of multiplicity of regulators.

**THE BANKING SYSTEM**

Almost 80% of the businesses are still controlled by Public Sector Banks (PSBs). PSBs are still dominating the commercial banking system. Shares of the leading PSBs are already listed on the stock exchanges. The RBI has given licenses to new private sector banks as part of the liberalization process. The RBI has also been granting licenses to industrial houses. Many banks are successfully running in the retail and consumer segments but are yet to deliver services to industrial finance, retail trade, small business and agricultural finance. The PSBs will play an important role in the industry due to its number of branches and foreign banks facing the constraint of limited number of branches. Hence, in order to achieve an efficient banking system, the onus is on the Government to encourage the PSBs to be run on professional lines.
DEVELOPMENT OF FINANCIAL INSTITUTIONS

- FIs’s access to SLR funds reduced. Now they have to approach the capital market for debt and equity funds.
- Convertibility clause no longer obligatory for assistance to corporate sanctioned by term-lending institutions.
- Capital adequacy norms extended to financial institutions.
- DFIs such as IDBI and ICICI have entered other segments of financial services such as commercial banking, asset management and insurance through separate ventures. The move to universal banking has started.

NON-BANKING FINANCE COMPANIES

In the case of new NBFCs seeking registration with the RBI, the requirement of minimum net owned funds, has been raised to Rs.2 crores. Until recently, the money market in India was narrow and circumscribed by tight regulations over interest rates and participants. The secondary market was underdeveloped and lacked liquidity. Several measures have been initiated and include new money market instruments, strengthening of existing instruments and setting up of the Discount and Finance House of India (DFHI). The RBI conducts its sales of dated securities and treasury bills through its open market operations (OMO) window. Primary dealers bid for these securities and also trade in them. The DFHI is the principal agency for developing a secondary market for money market instruments and Government of India treasury bills. The RBI has introduced a liquidity adjustment facility (LAF) in which liquidity is injected through reverse repo auctions and liquidity is sucked out through repo auctions. On account of the substantial issue of government debt, the gilt- edged market occupies an important position in the
financial set-up. The Securities Trading Corporation of India (STCI), which started operations in June, 1994 has a mandate to develop the secondary market in government securities Long-term debt market. The development of a long-term debt market is crucial to the financing of infrastructure. After bringing some order to the equity market, the SEBI has now decided to concentrate on the development of the debt market. Stamp duty is being withdrawn at the time of dematerialization of debt instruments in order to encourage paperless trading.

2.4 THE CAPITAL MARKET

The number of shareholders in India is estimated at 25 million. However, only an estimated two lakh persons actively trade in stocks. There has been a dramatic improvement in the country's stock market trading infrastructure during the last few years. Expectations are that India will be an attractive emerging market with tremendous potential. Unfortunately, during recent times the stock markets have been constrained by some unsavory developments, which has led to retail investors deserting the stock markets.
Table 2.4 RETURNS OF BANK DEPOSITS AS WELL AS BSE SENSEX

<table>
<thead>
<tr>
<th>Year</th>
<th>Banks F.D. Returns*</th>
<th>BSE Sensex return*</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991-92</td>
<td>12</td>
<td>258.99</td>
</tr>
<tr>
<td>1992-93</td>
<td>11</td>
<td>-48.03</td>
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<tr>
<td>1993-94</td>
<td>10</td>
<td>63.49</td>
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<td>1994-95</td>
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<td>1995-96</td>
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<td>2002-03</td>
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<td>2003-04</td>
<td>4.625</td>
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<td>2004-05</td>
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<td>2005-06</td>
<td>6.25</td>
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<td>2006-07</td>
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<td>2009-10</td>
<td>6.5</td>
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<tr>
<td>2010-11</td>
<td>8.625</td>
<td>9.91</td>
</tr>
<tr>
<td>2011-12</td>
<td>9.5</td>
<td>21.77</td>
</tr>
<tr>
<td>Total Return</td>
<td>185.375</td>
<td>588.28</td>
</tr>
<tr>
<td>Avg. Return</td>
<td>8.827</td>
<td>28.013</td>
</tr>
</tbody>
</table>

Source RBI, BSE
* F.D. = Fixed deposit rates are for 1-3 years
* BSE Sensex figures are annual percentage returns, starting from 1st April to 31st March of each financial year since 1991-92.

Graph 2.1 Returns of Bank deposits as well as BSE Sensex
Normally our minds are tuned with the law of Physics. For every action there is an equal and opposite reaction. Hence, we are always under the impression that higher the return, higher the risks undertaken. Thus, we came to our own conclusion that equity investments are risky by their very in nature while fixed income instruments are safe investments. Equity investments are appear to be risky due to the volatility in their price, while fixed income securities appears to be safe as their prices do not fluctuate. In reality, the factor of inflation makes the fixed income securities much riskier. It can eat your fixed return. In contrast, Equities are proved to be good hedge against inflation. The following table shows the returns on equities as well as returns from a fixed income instrument (Bank fixed deposit) over a period of 21 years from 1991-92 to 2011-12.

By looking at the above table the average return of equities is 28.0137% over these years vehicle average return on bank fixed deposit have been just one 8.27%. In the economics where rising inflation is reality we all have to live with it, fixed income bearing securities which sores very poorly over the years. If one had bought the sensex in 1991-92 and stay invested, we would have immense wealth compared to bank fixed deposit return.

OVERALL APPROACH TO REFORMS

The last ten years have seen major improvements in the working of various financial market participants. The government and the regulatory authorities have followed a step-by-step approach, not a big bang one. The entry of foreign players has assisted in the introduction of international practices and systems. Technology developments have improved customer service. Some gaps however remain (for example lack of an inter-bank interest rate benchmark, an active corporate debt market and a
developed derivatives market). On the whole, the cumulative effect of the developments since 1991 has been quite encouraging. An indication of the strength of the reformed Indian financial system can be seen from the way India was not affected by the Southeast Asian crisis. However, financial liberalization alone will not ensure stable economic growth. Some tough decisions still need to be taken. Without fiscal control, financial stability cannot be ensured. The fate of the Fiscal Responsibility Bill remains unknown and high fiscal deficits continue. In the case of financial institutions, the political and legal structures have to ensure that borrowers repay on time the loans they have taken. The phenomenon of rich industrialists and bankrupt companies continues. Further, frauds cannot be totally prevented, even with the best of regulation. However, punishment has to follow crime, which is often not the case in India.

**DEREGULATION OF BANKING SYSTEM**

Prudential norms were introduced for income recognition, asset classification, provisioning for delinquent loans and for capital adequacy. In order to reach the stipulated capital adequacy norms, substantial capital were provided by the Government to PSBs. Government pre-emption of banks' resources through statutory liquidity ratio (SLR) and cash reserve ratio (CRR) brought down in steps. Interest rates on the deposits and lending sides almost entirely were deregulated. New private sector banks are allowed to promote and encourage competition. PSBs were encouraged to approach the public for raising resources. Recovery of debts due to banks and the Financial Institutions Act, 1993 was passed, and special recovery tribunals set up to facilitate quicker recovery of loan arrears. Bank lending norms liberalized and a loan system to ensure better control over credit introduced. Banks asked to set up asset liability management (ALM) systems. RBI
guidelines issued for risk management systems in banks encompassing credit, market and operational risks. A credit information bureau is being established to identify bad risks. Derivative products such as forward rate agreements (FRAs) and interest rate swaps (IRSs) introduced.

**CAPITAL MARKET DEVELOPMENTS**

The Capital Issues (Control) Act, 1947, repealed, Office of the Controller of Capital Issues were abolished and the initial share pricing were decontrolled. SEBI, the capital market regulator was established in 1992. Foreign institutional investors (FIIs) were allowed to invest in Indian capital markets after registration with the SEBI. Indian companies were permitted to access international capital markets through euro issues. The National Stock Exchange (NSE), with nationwide stock trading and electronic display, clearing and settlement facilities was established. Several local stock exchanges changed over from floor based trading to screen based trading.

**CONSOLIDATION IMPERATIVE**

Another aspect of the financial sector reforms in India is the consolidation of existing institutions which is especially applicable to the commercial banks. In India the banks are in huge quantity. First, there is no need for 27 PSBs with branches all over India. A number of them can be merged. The merger of Punjab National Bank and New Bank of India was a difficult one, but the situation is different now. No one expected so many employees to take voluntary retirement from PSBs, which at one time were much sought after jobs. Private sector banks will be self consolidated while co-operative and rural banks will be encouraged for consolidation, and anyway play only a niche role. In the case of insurance, the Life Insurance Corporation of India is a behemoth, while the
four public sector general insurance companies will probably move towards consolidation with a bit of nudging. The UTI is yet again a big institution, even though facing difficult times, and most other public sector players are already exiting the mutual fund business. There are a number of small mutual fund players in the private sector, but the business being comparatively new for the private players, it will take some time. We finally come to convergence in the financial sector, the new buzzword internationally. Hi-tech and the need to meet increasing consumer needs is encouraging convergence, even though it has not always been a success till date. In India organizations such as IDBI, ICICI, HDFC and SBI are already trying to offer various services to the customer under one umbrella. This phenomenon is expected to grow rapidly in the coming years. Where mergers may not be possible, alliances between organizations may be effective. Various forms of bank assurance are being introduced, with the RBI having already come out with detailed guidelines for entry of banks into insurance. The LIC has bought into Corporation Bank in order to spread its insurance distribution network. Both banks and insurance companies have started entering the asset management business, as there is a great deal of synergy among these businesses. The pensions market is expected to open up fresh opportunities for insurance companies and mutual funds. It is not possible to play the role of the Oracle of Delphi when a vast nation like India is involved. However, a few trends are evident, and the coming decade should be as interesting as the last one. Indian banking system has been subject to widespread structural reforms initiated since June 1991. This phase can be regarded as "second banking revolution". Reform measures such as introduction of new accounting and prudential norms, liberalization measures etc., are heading towards a truly competitive and well structured banking system resilient from an
international perspective. Continued financial profligacy of the Government coupled with close monitoring and control rendered the financial systems completely dependent and inefficient so much so that by the year 1991, the situation was ripe for drastic reforms. It was, however, precipitated by the unprecedented economic crisis which engulfed the economy in 1991. For the first time in its history, India faced the problem of defaulting on its international commitments. The access to external commercial credit markets was completely denied; International credit ratings had been downgraded and the international financial community’s confidence in India’s ability to manage its economy had been severally eroded. The economy suffered from serious inflationary pressures, emerging scarcities of essential commodities and breakdown of fiscal discipline. The Government took swift action to restore international confidence in the economy and redress the imbalances. Various macro-economic structural reformatory measures were undertaken in the field of foreign trade, tax system, industrial policy and financial and other sectors. The objective was to improve the underlying strength of the economy, attempt to ensure against future crises and further the fundamental developmental; objectives of growth with equity and self reliance.

2.5 COMMITTEE ON BANKING SECTOR

NARASIMHAM COMMITTEE – I (FIRST GENERATION REFORMS)

To restore the financial health of commercial banks and to make their functioning efficient and profitable, the Government of India appointed a committee called 'The Committee on Financed System' under the chairmanship of Sri M. Narasimham, ex-Governor of Reserve Bank of India which made recommendations in November 1991. The Committee laid down a blue print of financial sector reforms, recognized that a
vibrant and competitive financial system was central to the wide ranging structural reforms. In order to ensure that the financial system operates on the basis of operational flexibility and functional autonomy, with a view to enhance efficiency, productivity and profitability, the Committee recommended a series of measures aimed at changes according greater flexibility to bank operations, especially in pointing out statutory stipulations, directed credit program, improving asset quality, institution of prudential norm, greater disclosures, better housekeeping, in terms of accounting practices. In the words of Bimal Jalan, ex-Governor of RBI, "the central bank is a set of prudential norm that are aimed at imparting strength to the financial institutions, and inducing greater accountability and market discipline. The norms include not only capital adequacy, asset classifications and provisioning but also accounting standards, exposure and disclosure norms and guidelines for investment, risk management and asset liability management." These recommendations are a landmark in the evolution of banking system from a highly regulated to more market-oriented system. The reforms introduced since 1992-93 breathed a fresh air in the banking sector. Deregulation and liberalization encouraged banks to go in for innovative measures, develop business and earn profits. These reforms, the Narasimham Committee-I felt, will improve the solvency, health and efficiency of institutions. **The measures were aimed at**

1) Ensuring a degree of operational flexibility,

2) Internal 'autonomy for public sector banks in their decision-making process, and

3) Greater degree of professionalism in banking operations
The Reserve Bank of India grouped the first phase of reform measures into three main areas: Enabling measures, Strengthening measures, and Institutional measures. In other words, they can also be classified into five different groups:

(a) Liberalization measures,
(b) Prudential norms,
(c) Competition directed measures,
(d) Supportive measures, and
(e) Other measures.

(A) LIBERALIZATION MEASURES

Statutory Liquidity Ratio (SLR), Cash Reserve Ratio (CRR). The SLR and CRR measures were originally designed to give the RBI two additional measures of credit control, besides protecting the interests of depositors. Under the SLR, commercial banks are required to maintain with the RBI minimum 25 per cent of their total net demand and time liabilities in the form of cash, gold and unencumbered eligible securities (under the Banking Regulation Act, 1949). The RBI is capital adequacy which have all been implemented.

(B) PRUDENTIAL NORMS

In April 1992, the RBI issued detailed guidelines on a phased introduction of prudential norms to ensure safety and soundness of banks and impart greater transparency and accounting operations. The main objective of prudential norms is the strengthening financial stability of banks. Inadequacy of capital is a serious cause for concern. Hence, as per Basel Committee norms, the RBI introduced capital adequacy norms. It was prescribed that banks should achieve a minimum of 4 per cent capital adequacy ratio in
relation to risk weighted assets by March 1993, of which Tier I capital should not be less than 2 per cent. The BIS standard of 8 percent should be achieved over a period of three years, that is, by March 1996. For banks with international presence, it is necessary to reach the figure even earlier. Before arriving at the capital adequacy ratio of each bank, it is necessary that assets of banks should be evaluated on the basis of their realizable value. Those banks whose operations are profitable and which enjoy reputation in the markets are all over to approach capital market for enhancement of capital. In respect of others, the Government should meet the shortfall by direct subscription to capital by providing loan. As per the recommendations of the Narasimham Committee banks cannot recognize income (interest income on advances) on assets where income is not received within two quarters after it is past due. The committee recommended international norm of 90 days in phased manner by 2002. The assets are now classified on the basis, of their performance into 4 categories

(a) Standard,
(b) Sub-standard,
(c) Doubtful, and
(d) Loss assets.

Adequate provision is required to be made for bad and doubtful debts (substandard assets). Detailed instructions for provisioning have been laid down. In addition, a credit exposure norm of 15 per cent to a single party and 40 per cent to a group has been prescribed. Banks have been advised to make their balance sheets transparent with maximum 'disclosure' on the financial health of institutions. The Committee recommended provisioning norms for nonperforming assets. On outstanding
substandard assets 10 percent general provision should be made (1992). On loss assets the permission shall be 100 percent. On secured portion of doubtful assets, the provision should be 20 to 50 percent."

(C) COMPETITION DIRECTED MEASURES

Since 1969 none bank had allowed to be opened in India. That policy changed in January 1 1993 when the RBI announced guidelines for opening of private sector banks public limited companies. The criteria for setting up of new banks in private sector were (a) capital of Rs. 100 crore, (b) most modern technologic, and (c) head office at a non-metropolitan centre, In January' 2001, paid-up capital of these banks was increased to Rs. 200 crorewhich has to be raised to Rs. 300 crore within a period of 3 years after the commencement of business, The promoters share in a bank shall not be less than 40 per cent. After the issue of guidelines in 1993, 9 new banks have been set up in the private sector. Foreign banks have also been permitted to set-up subsidiaries, joint ventures or branches. Their number have increased from 24 in 1991 to 42 in 2000 and their branch network increased from 140 to 185 over the same period. Banks have also been permitted to rationalize their existing branches, spinning off business at other centers, opening of specialized branches, convert the existing non-urban rural branches into satellite offices. Banks have also been permitted to close down branches other than in rural areas. Banks attaining capital adequacy norms and prudential accounting standards can set-up new branches without the prior approval of RBI. Two recommendation of the Narasimham Committee was to abolish the system of branch licensing and allow foreign banks free entry.
(D) SUPPORTIVE MEASURES

Revised format for balance sheet and profit and loss account reflecting and actual health of scheduled banks were introduced from the accounting year 1991-92. There have also been changes in the institutional framework. The RBI evolved a risk-based supervision methodology with international best practices. New Board of Financial Supervision was set-up in the RBI to tighten up the supervision of banks. The system of external supervision has been revamped with the establishment in November 1994 of the Board of Financial Supervision with the operational support of the Department of Banking Supervision. In tune with international practices of supervision, a three-tier supervisory model comprising outside inspection, off-site monitoring and periodical external auditing based on CAMELS (Capital Adequacy, Asset quality, Management, Earnings, Liquidity and System controls) had been put in place. Special Recovery Tribunals are set-up to expedite loan recovery process.21 The recent Securitization and Reconstruction of Financial; Assets and Enforcement of Security Interests (SARFAAESI) Act, 2002 enables the regulation of securitization of and reconstruction of financial assets and enforcement of security interests by secured creditors. The Act will enable banks to dispose of securities of defaulting borrowers to recover debt.

(E) OTHER MEASURES

The Banking Companies (Acquisition and Transfer of Undertaking) Act was amended with effect from July 1994 permitting public sector banks to raise capital up to 49 per cent from the public. There are number of other recommendations of the Narasimham Committee such as reduction in priority sector landings, appointment of special tribunals for speeding up the process of loan recoveries, and reorganization of the
rural credit structure, all of which need detailed examination as these recommendations have far-reaching implications both in terms of the structure of the financial system and also the financing required to implement them. The Committee proposed structural reorganization of the banking sector which involves a substantial reduction of public sector banks through mergers and acquisitions. It proposed a pattern of

a) 3 or 4 large banks of international character,

b) 8 to 10 national banks engaged in "general or universal banking

c) local banks whose operation be confined to a specific areas, and

d) RRBs financing permanently agriculture I and allied activities. The Government had not taken any decision regarding this suggestion.

RECOMMENDATIONS OF NARASIMHAM COMMITTEE – I

The main recommendations of the Committee were-

- Reduction of Statutory Liquidity Ratio (SLR) to 25 percent over a period of five years

- Progressive reduction in

- Phasing out of directed credit programmes and redefinition of the priority sector

- Deregulation of interest rates so as to reflect emerging market conditions I

- Stipulation of minimum capital adequacy ratio of percent to risk weighted assets by March 1993, 8 percent by March 1996, and 8 percent by those banks having international operations by March 1994.

- Adoption of uniform accounting practices in regard to income recognition, asset classification and provisioning against bad and doubtful debts

- Imparting transparency to bank balance sheets and making more disclosures
- Setting up of special tribunals to speed up the process of recovery of loans
- Setting up of Asset Reconstruction Funds (ARFs) to take over from banks a portion of their bad and doubtful advances at a discount
- Restructuring of the banking system, so as to have 3 or 4 large banks, which could become international in character, 8 to 10 national banks and local banks confined to specific regions. Rural banks, including Regional Rural Banks (R.RBs), confined to rural areas.
- Setting up one or more rural banking subsidiaries by Public Sector Banks
- Permitting RRBs to engage in all types of banking business
- Abolition of branch licensing
- Liberalizing the policy with regard to allowing foreign banks to open offices in India.
- Rationalisation of foreign operations of Indian banks
- Giving freedom to individual banks to recruit officers
- Inspection by supervisory authorities based essentially on the internal audit and inspection reports.
- Ending duality of control over banking system by Banking Division and RBI
- A separate authority for supervision of banks and financial institutions which would be a semi-autonomous body under RBI
- Revised procedure for selection of Chief Executives and Directors of Boards of public sector banks
- Obtaining resources from the market on competitive terms by DFIs
- Speedy liberalization of capital market
Supervision of merchant banks, mutual funds leasing companies etc., by a separate agency to be set up by RBI and enactment of a separate legislation providing appropriate legal framework for mutual funds and laying down prudential norms for these institutions, etc. Several recommendations have been accepted and are being implemented in a phased manner. Among these are the reductions SLR,CRR, adoption of prudential norms for asset classification and provisions, introduction of capital adequacy norms, and deregulation of most of the interest rates, allowing entry to new entrants in private sector banking sector, etc.

**IMPACT OF FIRST GENERATION REFORMS**

The visible impact of first generation reforms may be summarized as follows:

- The banking system is well diversified with the establishment of new private banks and about 20 new foreign banks after 1993. The entry of modern, professional private sector banks and foreign banks has enhanced competition. With the deregulation of interest rates both for advances as well as deposits, competition between different bank groups and between banks in the same group has become intense. What is more important is that apart from growth of banks and commercial banking, various other financial intermediaries like mutual funds, equipment leasing and hire purchase companies, housing finance companies etc., which are sponsored by banks have cropped up.

- Finance regulation through statutory preemptions has been lowered while stepping up of the prudential regulations.

- Steps have been taken to strengthen PSBs through increasing their autonomy, recapitalization, etc. Based on specified criteria nationalized banks were given
autonomy in the matters of creation, abolition, upgradation of posts for their administrative officers up to the level of Deputy General Manager. Rs. 10,987.12 crore for capitalization funds were pumped into banks during 1993-95. This indicates the extent of capital erosion faced by the nationalized banks.

- A set of micro-prudential measures have been stipulated with regard to capital adequacy, asset classification, provisioning, accounting rules, valuation norms, etc. CRAR (Per cent to the risk weighted assets) of banks stood at 8 per cent. The percentage of Net NPAS to net advances of PSBs has declined from 14.4 per cent in 1993-94 to 8.5 per cent by 1997-98. The prudential norms have been significantly contributed towards improvement in pre-sanction appraisal and post-sanction appraisal and control, the impact of which is clearly seen in the decrease in fresh addition of performing accounts into the NPA category. As per RBI Report on Currency and Finance consequent upon prudential norms, the most visible structural change has been improvement in asset quality.

- Measures have been taken to broaden the ownership base of PSBs by allowing them to approach the capital market. The Government of India, in a major policy announcement, decided to reduce its stake in PSBs from 100 per cent to 51 per cent retaining, however, the policy parameters of PSBs. The Government proposes to reduce further its stake to 33 percent. Moreover, there is a provision for foreign investments to the extent of 20 per cent. The net result of the dilution in ownership of PSBs is that these banks are becoming slowly joint sector banks. A number of PSBs like State Bank of India, Andhra Bank, Bank of Baroda, Canara Bank, Punjab National Bank have gone up for public issue since 1994.
Mergers and acquisitions have been taking place in the banking sector. In the past, due to the existence of a large number of small non-viable banks, the RBI encouraged larger of small banks with big banks. Now, market driven mergers between private banks have been taking place.

As intense competition becomes a way of doing, banks have to pay attention to customer service. Product innovations and process engineering are the order of the day. Since interest income has fallen with lowering of interest rates on advances, banks have to look for enhancing fee-based income, to fill the gap in interest income. Banks have therefore been mooring towards providing value added services to customers. Under the impact of technological up-gradation and financial innovations, banks have now become super markets one stop shop of varied financial services. The set of measures, coupled with many others, did have a positive impact on the system. There has been considerable improvement in profitability of the banking system. There has been improvement in key financial indicators of all bank groups during the period 1992-98. For example, the net profits of the scheduled commercial banks as a percentage of the total assets has been turned around from a negative figure of 1.0 per cent on average during 1992-93 and 1993-94 to a positive of 0.5 per cent during 1994-95 to 1997-98. Simply, net profits as a percentage of working funds which was 0.39 per cent in 1991-92 and (-)1.08 per cent in 1992-93 turned positive in 1994-95 and reached 0.81 per cent by 1997-98. In case of most of the public sector banks business per employee and profit per employee have shown improvement in the recent period, For egg., in 1991-92 the average profit per employee of PSBs was Rs. 1.58 crore, it became
positive in 1996-97 at Rs. 0.35 crore. It further improved to Rs. 0.59 crore by 1999-2000 and Rs. 1.63 crore in 2002-03. By 1997, almost all public sector banks achieved the minimum capital adequacy norms of 8 per cent. The gross and net NPAs of the banking system as a percentage of advances have declined to 16 per cent and 8.2 per cent respectively by March 1998. In terms of percentage of total assets, gross and net non-performing assets have declined to 7.0 per cent and 3.3 per cent respectively by March 1998. As the second report of the Narasimham Committee has observed, "this improvement has arrested the deterioration in these parameters that had marked the functioning of the system earlier. There is still a considerable distance to traverse. The process of strengthening the banking system has to be viewed as a continuing process.

**NARASIMHAM COMMITTEE-II (1998)(SECOND GENERATION REFORMS)**

The recommendations of the Narasimham Committee-I (1991) provided blueprint for first generation reforms of the financial sector. The period 1992-97 witnessed laying of the foundations for reforms of the banking system. It also saw the implementation of prudential norms relating to capital adequacy, asset classification, income recognition and provisioning, exposure norms, etc. The difficult task of ushering in some of the structural changes accomplished during this period provided the bedrock for future reforms. In fact, India withstood the contagion of 1997 (South-East Asia crisis) indicates the stability of the banking system. Against such a backdrop, the Report of the Narasimham Committee-II in 1998 provided the road map for the second-generation reform process. Two points are worth noting at this juncture. First, the financial sector reforms were undertaken in the early reform cycle, and secondly, the reforms in the financial sector were initiated in well
structured, sequenced and phased manner with cautious and proper sequencing, mutually reinforcing measures; complementarily between reforms in the banking sector and changes in the fiscal, external and monetary policies, developing financial infrastructure; and developing financial markets. The Government appointed a second high-level Committee on Banking Sector Reforms under the chairmanship of Mr. Narasimham to "review the progress of banking sector reforms to date and chart a programme of financial sector reforms necessary to strengthen the Indian Financial System and make it internationally competitive. The Committee in its report (April 1998) made wide-ranging recommendations covering entire gamut of issues ranging from capital adequacy, asset quality, NPAs, prudential norms, asset-liability management, earnings and profits, mergers and acquisitions, reduction in government shareholdings to 33 per cent in public sector banks, the creation of global-sized banks, recasting banks boards to revamping banking legislation. The second generation reforms could be conveniently looked at in terms of three broad inter-related issues

- Measures that need to be taken to strengthen the foundations of the banking system,
- Related to this, streamlining procedures, upgrading" technology and human resource development, and
- Structural changes in the system. These would cover aspects of banking policy, institutional, supervisory and legislative dimensions.
The important recommendation of the Committee may be stated asunder

**A. MEASURES TO STRENGTHEN THE BANKING SYSTEM**

**Capital Adequacy**

The Committee set new an(t. Higher norms of capital adequacy. It recommended that the "minimum capital to risk assets ratio be increased to 10 per cent from its present level of 8 per cent in a phased manner -9 per cent to be achieved by the year 2000 and the ratio of 10 per cent by 2002. The RBI should have authority to rise further in respect of individual banks if in its judgment the situation warrants such increase.

**Asset Quality NPAs and Directed Credit**

The Committee recommended that an asset be classified as doubtful if it is in the substandard category for 18 months in the first instance and eventually 12 months and loss of it has been identified but not written off. Advances guaranteed by the government should also be treated as NPAs. Banks should avoid the practice of 'ever greening' by making fresh advance to the troubled parties with a view to settle interest dues and avoiding such loans treating as NPAs. The Committee believes that the objective should be to reduce the average level of net NPAs for all banks to below 5 per cent by the year 2000 and to .3 per cent by 2002. For banks with international presence, the minimum objective should be to reduce gross NPAs to 5 per cent and 3 per cent by 2000 and 2002 respectively and net NPA and to 3 per cent and 0 per cent by these dates. For banks with a high NPA portfolio, the Committee suggested the setting up of an Asset Reconstruction Company to take over bad debts.
Prudential Norms and Disclosure Requirements

It recommended moving to international practice for income recognition and recommended 90 days norm in a phased manner by the year 2002. In future income recognition, asset classification and provisioning must apply even to government guaranteed advances. Banks should pay greater attention to asset liability management to avoid mismatches.

B. SYSTEMS AND METHODS IN BANKS

The internal control systems which are internal inspection and audit, including concurrent audit submission of controls returns by banks and controlling offices to higher level offices, risk management system, etc. should be strengthened. There are recommendations for inducting an additional whole time director on the board of the banks, recruitment of skilled manpower, revising remuneration to persons at managerial level, etc.

C. STRUCTURAL ISSUES

Mergers

The Committee is of the view that the convergences of activities between bank and DFIs, the DFIs over a period of time convert themselves into banks. There will be only two forms of financial intermediary’s banks and non-bank financial companies. Mergers between banks and between banks and DFIs and NBFCs need to base on synergies and location and business specific complementarities of the concerned institutions. Merger of public sector banks should emanate from the management of banks, the government playing supportive role. Mergers should not be seen as bailing out weak banks. Mergers between strong banks would make for greater economic and
commercial sense and would be a case where the whole is greater than the sum of parts and have a 'force multiplied effect',

**Weak Banks**

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 recapitalization bonds is negative for three consecutive years. A case-by-case examination of weak banks should be undertaken to identify those that are potentially viable with a programme of financial and operational restructuring. Such banks should be nurtured into healthy units by eschewing high cost funds, confinement of expenditure recovery initiatives, etc. Mergers should be allowed only after they clean up their balance sheets.

**Narrow Banks**

Those banks, which have become weak because of high proportion of NPAs (20 per cent of the total assets in some cases), the Committee recommended the concept of 'Narrow banking'. Narrow banking implies that the weak banks place their funds in the short-term risk-free assets.

**New Banks**

The Committee also recommended the policy of permitting new private banks. It is also of the view that foreign banks may be allowed to set-up subsidiaries or joint ventures in India. They should be treated on par with private banks and subject to the same conditions in the regard to branches and directed credit as other banks.

**Need for Stronger Banks**

The Committee made out a strong case for stronger banking system in the country, especially in the context of capital account convertibility, which would involve large
inflows, and outflows of capital and consequent complications for exchange rate management and domestic stability. The Committee therefore recommended winding up of unhealthy banks and merger of strong and weak banks.

**Banking Structure**

The Committee has argued for the creation of 2 or 3 banks of international standard and 8 or 10 banks at the national level. It also suggested the setting up of small local banks, which would be confined to a limited area to serve local trade, small industry and agriculture at the same time these banks will have corresponding relationship with the large national and international banks.

**Local Area Banks**

In the 1996-97 budget, the Government of India announced the setting up of new Private Local Area Banks (LABs) with jurisdiction over three contiguous districts. This banker will help in mobilizing rural saving and in channeling them into investment in local areas. The RBI has issued guidelines for setting up such banks in 1996 and gave its approval 'in principle' to the setting up of seven LABs in the private sector. Of these, RBI had issued licenses to 5 LABs, located in Andhra Pradesh, Karnataka, Rajasthan, Punjab and Gujarat. These LABs have commenced business.

**Public Ownership and Autonomy**

The Committee argued that the government ownership and management of banks does not enhance autonomy and flexibility in the working of public sector banks. In this connection, the Committee recommended a review of functions of boards so that they remain responsible to the shareholders. The management boards are to be reorganized and they shall not be any government interference.
Review of Banking Laws

The Committee suggested the need to review and amend the provisions of RBI Act, SBI Act, Banking Regulation Act, and Banking Nationalization Act, etc. so as to bring them in line with the current needs of the industry. Other recommendations pertain to computerization process, permission to establish private sector banks, setting up of Board of Financial Regulation and Supervision and increasing the powers of debt recovery tribunals.

To summarize, the major recommendations were

- Capital adequacy requirements should take into account market risks also
- In the next three years, entire portfolio of Govt. securities should be marked to market
- Risk weight for a Govt. guaranteed account must be 100%
- CAR to be raised to 10% from the present 8%; 9% by 2000 and 10% by 2002
- An asset should be classified as doubtful if it is in the sub-standard category for 18 months instead of the present 24 months
- Banks should avoid evergreening of their advances
- There should be no further re-capitalization by the Govt.
- NPA level should be brought down to 5% by 2000 and 3% by 2002
- Banks having high NPA should transfer their doubtful and loss categories to Asset Reconstruction Company (ARC) which would issue Govt. bonds representing the realizable value of the assets.
- We should move towards international practice of income recognition by introduction of the 90 day norm instead of the present 180 days.
- A provision of 1% on standard assets is required.
- Govt. guaranteed accounts must also be categorized as NPAs under the usual norms.
- Banks should update their operational manuals which should form the basic document of internal control systems.
- There is need to institute an independent loan review mechanism especially for large borrower accounts to identify potential NPAs.
- Recruitment of skilled manpower directly from the market be given urgent consideration.
- To rationalize staff strengths, an appropriate VRS must be introduced.
- 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 recap bonds is negative for 3 consecutive years.

The Narsimham Committee seeks to consolidate the gains made in the Indian financial sectors while improving the quality of portfolio, providing greater operational flexibility, autonomy in the internal operations of the banks and FIs so to nurture in, a healthy competitive and vibrant financial sector.

**THE VERMA COMMITTEE (1999)**

Identified weak banks, strong banks and potential weak banks based on the study of seven financial performance parameters. These parameters include capital adequacy ratio, coverage ratio, return to assets, net interest margin, operating profits to average working funds, cost to income, and staff cost to net interest income plus other income. Accordingly, UCO Bank, United Bank of India and Indian Bank were identified as weak
banks in whose case none of the seven parameters were met. As against this, Oriented Bank of commerce and State Bank of Patiala were identified as strong banks because they satisfied all the parameters. But in respect of six banks, viz. Allahabad Bank, Central Bank of India, Indian Overseas Bank, Punjab and Sind Bank, Union Bank of India and Vijaya Bank, most of the parameters i.e. five or six of the total seven parameters were not fulfilled. Hence, they were described as potential weak banks.

The main weakness of financial ratio analysis adopted by Verma Committee (1999) is that the choice of a few or a single ratio does not provide enough information about the various dimensions of performance. As a result, a bank that is poorly managed on certain dimensions may appear to be performing well as long as it compensates in other dimensions. Furthermore, it is a short run analysis that may be inappropriate for describing the actual efficiency of the bank in the long run, since it fails to consider the value of management actions and investment decisions that will affect future performance. Another problem that may arise is the choice of a benchmark against which to compare a univariate or multivariate score from ratio analysis. Also, commonly used performance ratios fail to consider multiple outputs (services and, or transactions) provided with multiple inputs."

From the above the banking sector reforms, which were implemented as a part of overall economic reforms, witnessed the most effective and impressive changes, resulting in significant improvements within a short span. The distinctive features of the reform process may be stated thus

- The process of reforms has all along been pre-designed with a longterm vision.

The two Committees on financial sector reforms (Narasimham Committee-I and
II) have outlined a clear long-term vision for the banking segment particularly in terms of ownership of PSBs, level of competition.

- Reform measures have been all pervasive in terms of coverage of almost all problem areas. In fact, it can be said that, it is difficult to find an area of concern in the banking sector on which there has not been a Committee or a group.

- Most of the reform measures before finalization or implementation were passed through a process of extensive consultation and discussion with the concerned parties.

- Most of the reform measures have targeted and achieved international best practices and standards in a systematic and phased manner.

- All the reform measures and changes have been systematically recorded and are found in the annual reports as well as in the annual publications of RBI on "Trend and Progress of Banking in India".

The banking system, which was over-regulated and over administered, was freed from all restrictions and entered into an era of competition since 1992. The entry of modern private banks and foreign banks enhanced competition. Deregulation of interest rates had also intensified competition. Prudential norms relating to income recognition, asset classification, provisioning and capital adequacy have led to the improvement of financial health of banks. Consequent upon prudential norms the most visible structural change has been improvement in the quality of assets. Further, there has been considerable improvement in the profitability of banking system. The net profits of SCBs, which were negative in 1992-93, became positive in 1994-95 and stood at Rs. 17,077.07
Crore by March 2003. The profitability of the Indian Banking System was reasonably in line with International experience.

It may be pointed out that the banking sector reform is certainly not a one-time affair. It has evolutionary elements and follows a progression of being and becoming. From this point, Indian experience of restructuring banking sector has been reasonably a successful one. There was no major banking crisis and the reform measures were implemented successfully since 1992. Some expressed the fear that the reforms will sound a blow to social banking. The Government did not accept the Narasimham Committee-I recommendation that advances to priority sector should be brought down from 40 per cent to 10 per cent. The Banks continued to be directed to lend a minimum of 18 per cent of total banks credit to agriculture sector.

**Basel committee on banking sector:**

Basel III proposes many additional capital, leverage and liquidity standards to strengthen the regulation, supervision and risk management of the banking sector. The capital standards and additional capital buffers require banks to hold more capital, and higher quality of capital, than under the earlier Basel II rules. The leverage ratio introduces a non-risk based measure to supplement the risk-based measure to supplement the risk-based minimum capital requirements. The new liquidity ratios ensure that adequate funding is maintained in case of crisis.
Basel III strengthens the three Basel II pillars, especially pillar 1 with enhanced minimum capital and liquidity requirements.

The new regulations raise the quality, consistency and transparency of the capital base and strengthen the risk coverage of the capital framework. The major elements of the proposals are noted below.

<table>
<thead>
<tr>
<th>Regulatory Element</th>
<th>Proposed Requirement</th>
</tr>
</thead>
</table>
| Higher Minimum Tier 1 Capital Requirement | Tier 1 Capital Ratio: increases from 4% to 6%  
The ratio will be set at 4.5% from 1 January 2013, 5.5% from 1 January 2014 and 6% from 1 January 2015  
Predominance of common equity will now reach 82.3% of Tier 1 capital, inclusive of capital conservation buffer |
<p>| New Capital Conservation buffer     | Used to absorb losses during periods of financial and economic stress Banks will be required to hold a capital conservation buffer of 2.5% to withstand future periods of stress bringing the total common equity requirement to 7% (4.5% common equity requirement and the 2.5% capital conservation buffer) The capital conservation buffer must be met exclusively with common equity Banks that do not maintain the capital conservation buffer will face restrictions on payouts of dividends, share buybacks and bonuses |
| Countercyclical Capital buffer     | A countercyclical buffer within a range of 0% - 2.5% of common equity or other fully loss absorbing capital will be implemented according to national circumstances » When in effect, this is |</p>
<table>
<thead>
<tr>
<th>Regulatory Element</th>
<th>Proposed Requirement</th>
</tr>
</thead>
</table>
| Higher Minimum Tier 1 Common Equity Requirement | Tier 1 Common Equity Requirement: increase from 2% to 4.5%  
The ratio is set at 3.5% from 1 January 2013, 4% from 1 January 2014 and 4.5% from 1 January 2015 |
| Liquidity Standard                 | Liquidity Coverage Ratio (LCR): to ensure that sufficient high quality liquid resources are available for one month survival in case of a stress scenario. Phased introduction from 1 January 2015  
Net Stable Funding Ratio (NSFR): to promote resiliency over longer-term time horizons by creating additional incentives for banks to fund their activities with more stable sources of funding on an ongoing structural basis  
Additional liquidity monitoring metrics focused on maturity mismatch, concentration of funding and available unencumbered assets |
| Leverage Ratio                     | A supplemental 3% non-risk based leverage ratio which serves as a backstop to the measures outlined above  
Parallel run between 2013-2017; migration to Pillar 1 from 2018                                                                                      |
| Minimum Total Capital Ratio        | Remains at 8%  
The addition of the capital conservation buffer increases the total amount of capital a bank must hold to 10.5% of risk-weighted assets, of which 8.5% must be tier 1 capital  
Tier 2 capital instruments will be harmonized; tier 3 capital will be phased out                                                                                  |

Capital requirements are progressively and significantly increased and the cost of capital should be closely monitored. The diagram below demonstrates that increasing capital ratios Core Tier 1, Tier 1, Conservation buffer, Countercyclical buffer, stricter rules on eligible capital and higher capital requirements RWA increase for some asset classes are driving this change.

\[
\text{Capital Ratios} = \frac{\text{Eligible Capital}}{\text{Risk Weighed Assets}}
\]
Basel III introduces capital requirements to cover Credit Value Adjustment risk and higher capital requirements for securitization products. Derivatives and Repos cleared through Central Clearing Parties (CCPs) are no longer risk-free and have a 2% risk weight and clearing members shares in CCPs default funds shall be capitalized. Additionally, Basel III introduces a higher correlation factor (applicable to internal ratings based approaches) to risk weight large and unregulated financial institutions and changes concerning collateral eligibilities and haircuts rules. Regulatory liquidity risk reports will have to be produced at least monthly with the ability, when required by regulators, to be delivered weekly or even daily. This is challenging banks to put in place robust automated reporting solutions to meet this need. The first challenge banks will face is to consolidate clean exposures, liabilities, counterparties and market data in a centralized risk data platform. All portfolios’ contractual and behavioural cash flows should be made available and banks should have the ability to stress those and produce liquidity gap analysis according to various scenarios. LCR buffer eligibility and haircut rules rely on external ratings, Basel classification of counterparties and standardized credit risk weights. The LCR numerator run-off rates as well as NSFR, Available Stable Funding and Required Stable Funding factors also depend on such information, usually only available in risk specific systems.

The next challenge banks face is interfacing or merging their current risk and finance systems to meet the new Basel III Liquidity Risk ratio requirements. The funding concentration monitoring requirement will require banks to put in place a clean hierarchical referential of counterparties for consolidating their liabilities. Different LCR ratios will have to be produced per consolidation level and currencies. As it is already the
case for credit risk rules, international banks will have to cope with various national
discretions and local flavors for such new liquidity ratio rules and will have to generate
various kinds of liquidity risk regulatory reporting templates in different electronic
formats per jurisdiction.

The new Basel III regulations will affect all banks, however the severity of the
impact will differ according the type, scale and location of banks. Most banks will be
impacted by the increase in quantity and quality of capital, liquidity and leverage ratios,
as well as the enhanced requirements for pillar 2 and capital preservation. Most
sophisticated investment banks will be affected by the amended treatment of counterparty
credit risk, the more robust market risk framework and to some extent, the amended
treatment of securitizations. Global Systemically Important Banks (G-SIBs) are subject to
higher core tier capital requirements. (e.g. in Switzerland) or be subject to at least
additional supervision. Rules for SIFIs will be defined by the Basel Committee by mid-
year 2011. Yes. The US has stated on numerous occasions that it will move to Basel III.

New capital, leverage and liquidity regulations. In line with Basel Committee rules, are
part of the Dodd Frank Act Collins Amendment. It appears that all US banks will be
required to meet Basel III, but large bank holding companies with over $50 million US
dollar of assets should be subject to stricter rules than smaller institutions US specific
rules are to be clarified in 2012 and Basel III should take effect in early 2013. Many
institutions in several countries including the US are not Basel II compliant, but their
regulatory authorities have indicated that they will move to a Basel III framework in the
future. This creates as interesting situation because Basel II is the building block for
Basel III. If you will implement a Basel II solution before you go to Basel III then you
should ensure that the Basel II solution is flexible enough to smoothly move from a Basel II framework to a Basel III framework. The financial data that you implement should be able to easily accommodate a granular level of data and should support both assets and liabilities for calculation of your regulatory capital as well as your liquidity ratios. A vended solution also have a clear product roadmap that will allow you to migrate from your Basel II system to your Basel III system, and this migration should include regulatory capital calculation engines and regulatory reports. And because capital requirements are increasing the solution should be able to optimize regulatory capital calculations so that you are not required to hold excesses capital. If you can bypass Basel II and implement Basel III then you should start planning to update or replace your existing Basel II system as quickly as possible. From our vast experience implementing Basel I, II and III systems across the world, data is one of the most challenging and time consuming steps and should be considered early. Having granular level data has been identified as one of the biggest business benefits from Basel III. Implementing an advanced approach can be a costly endeavor and the cost,benefits should be examined. Using the advanced approach can result in lower capital requirements, which is beneficial from a return on capital perspective, but lower capital requirements are not guaranteed. We do anticipate that more institutions will leverage the advanced approach as a result of the higher capital requirements, which will likely make it more attractive from a capital reduction perspective. With increased capital requirements, allocating capital efficiently and maximizing returns becomes more important than ever. You should evaluate many of your risk and banking systems to determine if newer systems and processes can help you reduce operating costs, increase risk adjusted returns and allow you to allocate capital
more effectively. We are seeing more and more with our clients that open and flexible system architectures are growing in importance. The regulations will continue to evolve beyond Basel III and you want to ensure your systems are adaptable to meet these needs. National regulators may increase the quality and quantity of data included in their national regulatory reports especially around liquidity and leverage ratios. Existing capital adequacy reports will also be updated. Such additional information will also have to be reported to the market via enhancing the current bank Pillar 3 disclosures.

**REVIEW OF REFORMS**

In line with the recommendations of the second Narasimham Committee, the Mid-Term Review of the Monetary and Credit Policy of October 1999 announced a gamut of measures to strengthen the banking system. Important measures on strengthening the health of banks included (i) assigning of risk weight of 2.5 per cent to cover market risk in respect of investments in securities outside the SLR by March 31, 2001 (over and above the existing 100 per cent risk weight) in addition to a similar prescription for Government and other approved securities by March 31, 2000, and (ii) lowering of the exposure ceiling in respect of an individual borrower from 25 per cent of the bank’s capital fund to 20 per cent, effective April 1, 2000.

**CAPITAL ADEQUACY AND RECAPITALISATION OF BANKS**

Out of the 27 public sector banks (PSBs), 26 PSBs achieved the minimum capital to risk assets ratio (CRAR) of 9 per cent by March 2000. Of this, 22 PSBs had CRAR exceeding 10 per cent. To enable the PSBs to operate in a more competitive manner, the Government adopted a policy of providing autonomous status to these banks, subject to
certain benchmarks. As at end—March 1999, 17 PSBs became eligible for autonomous status.

**PRUDENTIAL ACCOUNTING NORMS FOR BANKS -**

The Reserve Bank persevered with the on—going process of strengthening prudential accounting norms with the objective of improving the financial soundness of banks and to bring them at par with international standards. The Reserve Bank advised PSBs to set up Settlement Advisory Committees (SACs) for timely and speedier settlement of NPAs in the small scale sector, viz., small scale industries, small business including trading and personal segment and the agricultural sector. The guidelines on SACs were aimed at reducing the stock of NPAs by encouraging the banks to go in for compromise settlements in a transparent manner. Since the progress in the recovery of NPAs has not been encouraging, a review of the scheme was undertaken and revised guidelines were issued to PSBs in July 2000 to provide a simplified, non-discriminatory and non-discretionary mechanism for the recovery of the stock of NPAs in all sectors. The guidelines will remain operative till March 2001. Recognising that the high level of NPAs in the PSBs can endanger financial system stability, the Union Budget 2000-01 announced the setting up of seven more Debt Recovery Tribunals (DRTs) for speedy recovery of bad loans. An amendment in the Recovery of Debts Due to Banks and Financial Institutions Act, 1993, was effected to expedite the recovery process.

**ASSET LIABILITY MANAGEMENT (ALM) SYSTEM -**

The Reserve Bank advised banks in February 1999 to put in place an ALM system, effective April 1, 1999 and set up internal asset liability management committees (ALCOs) at the top management level to oversee its implementation. Banks were
expected to cover at least 60 per cent of their liabilities and assets in the interim and 100 per cent of their business by April 1, 2000. The Reserve Bank also released ALM system guidelines in January 2000 for all-India term-lending and refinancing institutions, effective April 1, 2000. As per the guidelines, banks and such institutions were required to prepare statements on liquidity gaps and interest rate sensitivity at specified periodic intervals.

**RISK MANAGEMENT GUIDELINES**

The Reserve Bank issued detailed guidelines for risk management systems in banks in October 1999, encompassing credit, market and operational risks. Banks would put in place loan policies, approved by their boards of directors, covering the methodologies for measurement, monitoring and control of credit risk. The guidelines also require banks to evaluate their portfolios on an on-going basis, rather than at a time close to the balance sheet date. As regards off-balance sheet exposures, the current and potential credit exposures may be measured on a daily basis. Banks were also asked to fix a definite time-frame for moving over to the Value-at-Risk (VaR) and duration approaches for the measurement of interest rate risk. The banks were also advised to evolve detailed policy and operative framework for operational risk management. These guidelines together with ALM guidelines would serve as a benchmark for banks which are yet to establish an integrated risk management system.

**DISCLOSURE NORMS**

As a move towards greater transparency, banks were directed to disclose the following additional information in the ‘Notes to accounts’ in the balance sheets from the accounting year ended March 31, 2000 (i) maturity pattern of loans and advances,
investment securities, deposits and borrowings, (ii) foreign currency assets and liabilities, (iii) movements in NPAs and (iv) lending to sensitive sectors as defined by the Reserve Bank from time to time.

TECHNOLOGICAL DEVELOPMENTS IN BANKING -

India, banks as well as other financial entities have entered domain of information technology and computer networking. A satellite-based Wide Area Network (WAN) would provide a reliable communication framework for the financial sector. The Indian Financial Network (INFINET) was inaugurated in June 1999. It is based on satellite communication using VSAT technology and would enable faster connectivity within the financial sector. The INFINET would serve as the communication backbone of the proposed Integrated Payment and Settlement System (IPSS). The Reserve Bank constituted a National Payments Council (Chairman Shri S. P. Talwar) in 1999-2000 to focus on the policy parameters for developing an IPSS with a real time gross settlement (RTGS) system as the core.

REVIVAL OF WEAK BANKS -

The Reserve Bank had set up a Working Group (Chairman Shri S. Verma) to suggest measures for the revival of weak PSBs in February 1999. The Working Group, in its report submitted in October 1999, suggested that an analysis of the performance based on a combination of seven parameters covering three major areas of (i) solvency (capital adequacy ratio and coverage ratio), (ii) earnings capacity (return on assets and net interest margin) and (iii) profitability (operating profit to average working funds, cost to income and staff cost to net interest income plus all other income) could serve as the framework for identifying the weakness of banks. PSBs were, accordingly, classified into three
categories depending on whether none, all or some of the seven parameters were met. The Group primarily focused on restructuring of three banks, viz., Indian Bank, UCO Bank and United Bank of India, identified as weak as they did not satisfy any (or most) of the seven parameters. The Group also suggested a two-stage restructuring process, whereby focus would be on restoring competitive efficiency in stage one, with the options of privatization and/or merger assuming relevance only in stage two. Deposit Insurance Reforms. Reforming the deposit insurance system, as observed by the Narasimham Committee (1998), is a crucial component of the present phase of financial sector reforms in India. The Reserve Bank constituted a Working Group (Chairman Shri Jagdish W. Kapoor) to examine the issue of deposit insurance which submitted its report in October 1999. Some of the major recommendations of the Group are (i) fixing the capital of the Deposit Insurance and Credit Guarantee Corporation (DICGC) at Rs. 500 crore, contributed fully by the Reserve Bank, (ii) withdrawing the function of credit guarantee on loans from DICGC and (iii) risk-based pricing of the deposit insurance premium in lieu of the present, flat rate system. A new law, in supersession of the existing enactment, is required to be passed in order to implement the recommendations. The task of preparing the new draft law has been taken up. The relevant proposals in this respect would be forwarded to the Government for consideration.

2.6 AN INSIGHT INTO KGB

KGB was established on 01.12.1978. The bank has completed 33 years of its meaningful service to the people of Gulbarga, Bidar and Yadgir districts. Since inception the bank is striving hard to achieve its set objectives in its area of operation. The bank has now extended its coverage to all the urban and semi urban centers in both the districts.
The head office building has been well equipped with centralized air conditioning, computerized, functioning, solar lighting, modern gadgets and a sprawling well maintained garden. The head office premises is regarded as one of the BEST CORPORATE OFFICE not only in Gulbarga city but also in the entire Hyderabad Karnataka Area. The bank enjoys the popularity as the PEOPLE’S BANK in the area. During the year 2007-2008 the bank crossed a major milestone by surpassing Rs.1566 crores of business by registering a growth of 29.68% over the previous year. Further the bank has doubled its total business during the last 3 years from Rs.777 crores as on March 2005 to Rs.1566 crores as on March 2008. Systematic, proactive and sustained efforts are continued to accomplish all round excellence. The KGB is based on the traditional Indian value of services to the community, bank is reputed as one of the well run banks in the community of public sector banks in the country. The bank has been richly endowed with a relatively young, dynamic and efficient manpower, which is the key factor of the bank success. Excellence in performance and uniqueness in customer service form the central core of the banks organizational culture. The growing confidence of its clientele is well reflected in the banks performance in all critical areas of its operations all through the years.

The board of directors have pleasure in presently the annual report together with balance sheet and profit and loss account of the bank for the five years. The bank has put in place a well articulated frame work of 3 P’s (people, process, products) to identify and execute new initiatives to accelerate business growth on sound and sustainable lines. This frame work is also designed to improve customer engagement at all customer touch points. Innovation is actively encouraged people initiatives include new programmes for
leadership development, succession planning, appointment of executive coach, incentives for high performance, performance enhancement programmers through counselors etc. Process initiative include centralized of back office functions, separation of credit marketing and approved process and feed forward MIS to branches. New products like branchless inclusion strategies. The bank is actively chalking out strategies to take the bank to higher growth trajectory.

**Branch Network**

As at the end of the financial year, the bank is having a well spread out network of 139 branches, 67 in Gulbarga district and remaining 42 in Bidar district and 30 in Yadgir district. During the financial year 2011-2012, the bank has opened 20 new branches 7 in Gulbarga district, 8 in Bidar district and 5 in Yadgir districts. There are two relational offices of which one is Gulbarga district, situated at Gulbarga, Bidar and Yadgir, we have applied for licence to open another regional office at Yadgir.

**Share Capital**

The bank has an authorized share capital of Rs.50000,- and an issued and paid up capital of Rs.10000 thousands contributed by the three share holders viz,

<table>
<thead>
<tr>
<th>SHARE CAPITAL</th>
<th></th>
</tr>
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<tbody>
<tr>
<td>Govt. of India</td>
<td>50%</td>
</tr>
<tr>
<td>Sponsor Bank State of India</td>
<td>35%</td>
</tr>
<tr>
<td>Govt. of Karnataka</td>
<td>15%</td>
</tr>
</tbody>
</table>

Sources Audit report of KGB
Share Capital Deposit

During the year 1997-1998 the bank was taken up for restricting and a sum of Rs.251800 thousands was sanctioned to cleanse the ‘Balance Sheet’. According an aggregate sum of Rs.187577 thousands has been received from all the three share holders proportionately in two branches. The balance amount, in spite of our best efforts was not released till date. As on 31,03,2011 the position of share capital deposit was as under

Table-2.6
SHARE HOLDERS & AMOUNT RELEASED

<table>
<thead>
<tr>
<th>Sl. NO.</th>
<th>Name of the Share Holders</th>
<th>Amount Released</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Govt. of India (50%)</td>
<td>93788</td>
</tr>
<tr>
<td>2</td>
<td>Govt. of Karnataka (15%)</td>
<td>28137</td>
</tr>
<tr>
<td>3</td>
<td>State Bank of India (35%)</td>
<td>65652</td>
</tr>
<tr>
<td></td>
<td><strong>Total</strong></td>
<td><strong>187577</strong></td>
</tr>
</tbody>
</table>

Sources: Audit report of KGB

The bank has achieved a growth of Rs.1686786 thousands during the year. The break up of existing level of deposits is as under

TABLE-2.7
OVER ALL PERFORMANCE AT A GLANCE DURING THE STUDY PERIOD
(Amount in thousands)

<table>
<thead>
<tr>
<th>Particulars</th>
<th>No. of branches</th>
<th>Deposits</th>
<th>Advances</th>
<th>CD ratio</th>
<th>Per branch business</th>
<th>Staff production</th>
<th>P&amp;L</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008-09</td>
<td>112</td>
<td>95755</td>
<td>95819</td>
<td>100.07</td>
<td>1710</td>
<td>388</td>
<td>1150</td>
</tr>
<tr>
<td>2009-10</td>
<td>119</td>
<td>109423</td>
<td>114714</td>
<td>104.78</td>
<td>1883</td>
<td>407</td>
<td>1788</td>
</tr>
<tr>
<td>2010-11</td>
<td>139</td>
<td>128685</td>
<td>122475</td>
<td>95.17</td>
<td>2093</td>
<td>457</td>
<td>1946</td>
</tr>
<tr>
<td>2011-12</td>
<td>149</td>
<td>140119</td>
<td>129474</td>
<td>92.40</td>
<td>1809</td>
<td>499</td>
<td>1215</td>
</tr>
</tbody>
</table>

Sources: Audited annual report of KGB.
From table-2.7, over all performance at a glance during the study period it is clear that during the subsequent years 2007-08, 2008-09, 2009-10, 2010-11 and 2011-12 no. of branches were 109,112, 119,139 and 149 respectively at the same time total deposits was Rs. 75,331, Rs. 95,755, Rs. 1,14,714, Rs. 1,22475 and Rs. 1,29,474, respectively. By looking at total advances Rs. 81,305, Rs. 95,819, Rs. 1,14,714, Rs. 1,22,475 and Rs. 1,29,474, respectively. From the point of view of total business its Rs. 1,56,636, Rs. 1,91,574, Rs. 2,24,137, Rs. 2,51,162 and Rs. 2,69,593 respectively. By looking at C.D. ratio it is clear that 107.93, 100.07, 104.78, 95.17 and 92.40 percentage respectively during the study period, at the same time staff production is 406.25, 388, 407, 457 and 44 respectively. Over the years, also by looking at net result (P&L) it is Rs. 1954, Rs. 1150, Rs. 1,788, Rs. 1,946 and Rs. 1,215 consecutively over the 5 years over bank performance is stable and it is improving year after year.

- The growth in deposits during the year was a nifty 17.60%.
- The percentage of demand deposits has gone up marginally during the year on account of some of the state government departments preferring banks with core bank facility and shifted their accounts from KGB.
- Pre-branch deposits a raise from Rs.91952 thousands as on March 2011 to Rs.92580 thousands as on March 2012.
- Pre-employed deposits increased from Rs.20200 thousands as on March 2011 to Rs.23398 thousands as on March 2012.
Borrowings

Borrowings from NABARD and sponsor bank are the major sources of funds for our bank besides deposits. The detailed of limit sanctioned and refinance outstanding as on 31,03,2012 are as under. The bank continued to make prompt repayments to NABARD and the sponsor bank.

Table-2.8
DISBURSEMENT OF LOAN AND ADVANCES

<table>
<thead>
<tr>
<th>Sl. No</th>
<th>Particulars</th>
<th>From NABARD</th>
<th>From SBI</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Limit</td>
<td>Amt.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Sanction</td>
<td>Outstanding</td>
</tr>
<tr>
<td>1</td>
<td>Short term, seasonal agricultural operation</td>
<td>450500</td>
<td>450500</td>
</tr>
<tr>
<td>2</td>
<td>Short term, other than seasonal agricultural operation</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>3</td>
<td>Short term, development of tribal population</td>
<td>364300</td>
<td>364300</td>
</tr>
<tr>
<td>4</td>
<td>Short term, national oil seed development programme</td>
<td>274200</td>
<td>274200</td>
</tr>
<tr>
<td>5</td>
<td>Short term, marketing of crops</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>6</td>
<td>Medium term (schematic)</td>
<td>470560</td>
<td>470560</td>
</tr>
<tr>
<td>7</td>
<td>Medium term (conversion)</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td></td>
<td><strong>Total</strong></td>
<td><strong>1559560</strong></td>
<td><strong>1559560</strong></td>
</tr>
</tbody>
</table>

Sources Audit report of KGB

As on 31,03,2012 the total investment of the bank stood at Rs.2812780 thousands.
Loans and Advances Outstanding

The bank has recorded a growth of Rs.776100 thousands during 2011-2012 as against Rs.1889500 thousands achieved during the p.y 2009-2010. During the year the bank has disbursed Rs.5651440 thousands as against ACP target Rs.6242058 thousands.

Schemes of KGB

- **Krishna Krishi Card (KKC) Scheme**

  Kisan credit cards under KGB brand name Krishna Krishi card, the bank has disbursed an amount of Rs.3658140 thousands to formers. During the year the bank has issued new KKC card to 11986 formers with this the total number of KKC issued by the bank has shot up to 198987.

  All eligible borrowers have been issued with the credit cards and personal accident insurance cover has been provided to all eligible card holders (i.e. below the stipulated age of 70 years) under personal accident insurance scheme (PAIS). The share of premia borne by the bank is Rs.1890 thousands as against Rs.945 thousands contributed by borrowers.

- **Swarojgar Credit Cards (SCC)**

  The bank has sanctioned target of rupees aggregating 5189 SSCs credit limit of Rs. 623 lakhs during the year 2010-2011 as against a target of 5000 SCCs.
Table-2.9  
FINANCIAL PERFORMANCE

<table>
<thead>
<tr>
<th>Sl. No.</th>
<th>Particulars</th>
<th>2011-12</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Average working funds</td>
<td>17964417</td>
</tr>
<tr>
<td>1</td>
<td>Financial Return</td>
<td>11.09%</td>
</tr>
<tr>
<td>2</td>
<td>Financial Cost</td>
<td>5.29%</td>
</tr>
<tr>
<td>3</td>
<td>Financial Margin (I-II)</td>
<td>5.80%</td>
</tr>
<tr>
<td>4</td>
<td>Operating Margin</td>
<td>2.33%</td>
</tr>
<tr>
<td>5</td>
<td>Miscellaneous Income</td>
<td>0.42%</td>
</tr>
<tr>
<td>6</td>
<td>Operating Profit</td>
<td>3.89%</td>
</tr>
<tr>
<td>7</td>
<td>Risk Cost</td>
<td>0.17%</td>
</tr>
<tr>
<td>8</td>
<td>Net Margin</td>
<td>3.72%</td>
</tr>
</tbody>
</table>

Sources: Audit report of KGB

Graph -2.2 Financial Performance
The financial cost has decreased by 0.63% on account of aggressive mobilization of term deposits during the year and reduction of demand deposits shares in total deposits as some of the government departments preferred to bank, with bank having core banking facility for keeping their deposits. However, it is gratifying to note management substantially from 1.45% as on 31,03,2011 to 2.33% as on 31,03,2012 variation in all other ratio are marginal.

**Transfer Price Mechanism**

The bank has adopted a fair transfer price mechanism on funds lent to and borrowed from internally as under;

- Interest rate on funds that lent to head office on total monthly average deposits at 9.50% p.a.
- Interest rate on funds borrowed from head office on total monthly average advances at 8.00% p.a.

KGB is pioneer in promoting & extending financial assistance to self help group so far the Bank has Credit linked 8042 SHG’s out total 8841 SHGs who are having SB A,c with Bank. The aggregate quantum of micro finance to SHGs is Rs.40.69 Crores. The bank has bagged third prize from **NABARD** for best performances in SHG Bank linkage programme in Karnataka State. The Bank is one of the two RRBs in India selected by NABARD for implementation of smart credit pilot project were in processor card are used by SHG member to know balance in their SB A,c and to draw the money without bothering to Branch Manager ,Rural Development Officer.
Vision of the Bank

“To be the preferred banking institution of the people of our area, committed to improve the living standard of the mass so as to achieve inclusive growth with sustained viability”

Mission of the bank

- To Surpass Rs.2500 Crores of total Business by 31-03-2012
- To earn a minimum net profit of Rs. 35 Crores.
- Migration to core banking solution.
- To bring down gross NPV to 1%
- No. of branches 125.
- Reduced dependence on Government deposits.

Values of the bank

- Integrity
- Commitment
- Passion
- Seamlessness
- Speed

ACHIEVEMENT

- Award by NABARD Bangalore.
- Award by SBI Corporate Centre, Mumbai.
- State Level IIInd Prize for Best Farmers Club.
- Bank became member of Banking Codes and Standards Board of India.
- Bank has been awarded for best performer amongst RRBS Sponsored by State Bank of India.
- Business turnover crossed Rs.1566 crores surpassing the MoU signed with state bank of India. Growth over the previous year was to the extant of 24.68%
- 100% computerization of the bank has been completed. All the branches completed annual closing work successfully using computer.
- Adequate training was provided to staff of computerized branches.
- No loss making branch as on 31.03.2009.
- Ghorchincholi branch has been merged with Bhatambra branch.
- Four New branches were opened at Omnagar, Karuneshwar nagar, Kamalnagar & Naubad.

**ORGANIZATION STRUCTURE**

The Bank’s head officer is located at Kusnoor Road Gulbarga in It’s own Building with centralized air conditioning the Bank is headed by chairman a TEG Scale V officer on deputation from state Bank of India & is of the rank of asst general manager. The manager (Audit & vigilance) has responsibility of Audit & vigilance of all Branches , area officers and various Department Head office Manager are as under Head office.

- Personnel Department
- Credit Management Department
- Assets Management Department
- Fund Management Department
- General Banking Department
- Computer cell , Information Technology Department
The Branch network is spread into 3 categories

Table-2.10

<table>
<thead>
<tr>
<th>Sl. No.</th>
<th>Category of branches</th>
<th>Gulbarga District</th>
<th>Yadgir District</th>
<th>Bidar District</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Urban</td>
<td>11</td>
<td>02</td>
<td>05</td>
<td>18</td>
</tr>
<tr>
<td>2.</td>
<td>Semi-Urban</td>
<td>06</td>
<td>04</td>
<td>04</td>
<td>14</td>
</tr>
<tr>
<td>3.</td>
<td>Rural</td>
<td>50</td>
<td>24</td>
<td>33</td>
<td>107</td>
</tr>
<tr>
<td></td>
<td><strong>Total</strong></td>
<td><strong>67</strong></td>
<td><strong>30</strong></td>
<td><strong>42</strong></td>
<td><strong>139</strong></td>
</tr>
</tbody>
</table>

Sources: Audit report of KGB

Staff of the KGB

CLASSIFICATION OF STAFF

There are three groups of staff in KGB. They are as follows

- Group A
- Group B
- Group C

ORGANIZATIONAL STRUCTURE

The main reason to open this branch in Gulbarga was as this region was not represented by the banks and the town was very much potential for the banking service. Hence the branch was opened so as to improve this area with new things by providing services to the customers easily. Initially at the starting stage when this bank was opened it has started with the numbers of 100 customers. The main aim or the main motive is that for opening a branch in Gulbarga is to provide a value based banking service to the customers and the development of bank from strength to strength.
Following strategies are adopted by the bank

- Identifying the customers needs
- Lending the required loan to the customer.
- Giving the polite service.
- Systematic and up to date working of the bank etc.

The bank’s Head Office is located at Kusnoor road Gulbarga in the own building with centralized air-conditioning. The bank is headed by a chairman. T EG Scale-V officer on deputation from state bank of India the General Manager is an also on deputation from SBI and is of the rank of asset General Manager (audit and vigilance) has responsibility of audit vigilance of all branches, areas officers and various department at head office.

The bank may merge with Pragati Gramin Bank in coming days and its organization and structure will depend upon new policies and guidelines of the new management. Apart from the things discussed in this chapter exhaustively an attempt has been made in order to enhance further on some of the relevant issues specifically addressed in the next chapter “Banking Sector Reforms and KGB - An Overview”.
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