

**Committee on Banking Sector Reforms (Narasimham Committee II) - Action taken on the recommendations**

<u>Recommendation</u>	<u>Action Taken</u>
<b>Measures to strengthen the banking system: Capital Adequacy:</b>	
<p>1. <i>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)</i></p>	<p>Banks are now required to assign capital for market risk. A risk weight of 2.5% for market risk has been introduced on investments in Govt. and other approved securities with effect from the year ending 31<sup>st</sup> March, 2000. For investments in securities outside SLR, a risk weight of 2.5% for market risk has been introduced with effect from the year ending 31<sup>st</sup> March, 2001.</p> <p>(Circulars DBOD.No.BP.BC.103 /21.01.002 /98 dated 31.10.98 and 121/21.04.124/99-2000 dated 3.11.99).</p>
<p>2. <i>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)</i></p>	<p>The percentage of banks' portfolio of Govt. and approved securities which is required to be marked to market has progressively been increased. For the year ending 31<sup>st</sup> March, 2000, banks were required to mark to market 75% of their investments. In order to align the Indian accounting standards with the international best practices and taking into consideration the evolving international developments, the norms for classification and valuation of investments have been modified with effect from September 30, 2000. The entire investment portfolio of banks is required to be classified under three categories, viz., Held to Maturity, Available for Sale and Held for Trading. While the securities 'Held for Trading' and 'Available for Sale' should be marked to market periodically, the securities 'Held to Maturity', which should not exceed 25% of total investments are carried at acquisition cost unless it is more than the face value, in which case, the premium should be amortised over a period of time. (Circular DBOD. No BP.BC.32/21.04.048/2000-2001 dated 16.10.2000. )</p>
<p>3. <i>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</i></p>	<p>In cases of Govt. guaranteed advances, where the guarantee has been invoked and the concerned State Govt. has remained in default as on March 31, 2000, a risk weight of 20%</p>

*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. There is an additional capital requirement of 5% of the foreign exchange open position limit. Such risks should be integrated into the calculation of risk weighted assets. The Committee recommends that the foreign exchange open position limits should carry a 100% risk weight. (Chapter III para 3.13)

*5. The Committee believes that it would be appropriate to go beyond the earlier norms and set new and higher norms for capital adequacy. The Committee accordingly recommends that the minimum capital to risk assets ratio be increased to 10% from its present level of 8%. It would be appropriate to phase the increase as was done on the previous occasion. Accordingly, the Committee recommends that an intermediate minimum target of 9% be achieved by the year 2000 and the ratio of 10% by 2002. The RBI should also have the authority to raise this further in respect of individual banks if in its judgement the situation with respect to their risk profile warrants such an increase. The issue of individual banks' shortfalls in the CRAR needs to be addressed in much the same way that the discipline of reserve requirements is now applied, viz., of uniformity across weak and strong banks. (Chapter III, para 3.15 – 3.16)*

6. In respect of PSBs, the additional capital requirement will have to come from either the Govt. or the market. With the many demands on the budget and the continuing imperative need for fiscal consolidation, subscription to bank capital funds cannot be regarded as a priority claim on budgetary resources. Those banks which are in a position to access the capital market at home or abroad should, therefore, be encouraged to do so. (Chapter III, para 3.17)

on such advances, has been introduced. State Govts. who continue to be in default in respect of such invoked guarantees even after March 31, 2001, a risk weight of 100% is being assigned.

(Circular DBOD.NO.

BP.BC.103/21.01.002/98 dated 31.10.98)

Risk weight of 100% has been introduced for foreign exchange open position limits with effect from March 31, 1999. (Circular DBOD.No.BP. BC.103/21.01.002/98 dt.31.10.98)

The minimum capital to risk asset ratio (CRAR) for banks has been enhanced to 9% with effect from the year ending March 31,2000.

(Circular DBOD.No.BP.BC.103/21.01.002/98 dated 31.10.98).

Banks are permitted to access the capital market. Till today, 12 banks have already accessed capital market.

***Asset quality, NPAs and Directed Credit:***

*7. The Committee recommends that an asset be classified as doubtful if it is in the substandard category for 18 months in the first instance and eventually for 12 months and loss if it has been so identified but not written off. These norms, which should be regarded as the minimum, may be brought into force in a phased manner. (Chapter III, para 3.18)*

*Introduction of the norm of 90 days for income recognition in a phased manner.*

*8. The Committee has noted that NPA figures do not include advances covered by Government guarantees which have turned sticky and which in the absence of such guarantees would have been classified as NPAs. The Committee is of the view that for the purposes of evaluating the quality of asset portfolio such advances should be treated as NPAs. If, however, for reason of the sovereign guarantee argument such advances are excluded from computation, the Committee would recommend that Government guaranteed advances which otherwise would have been classified as NPAs should be separately shown as an aspect of fuller disclosure and greater transparency of operations. (Chapter III, para 3.21)*

*9. Banks and financial institutions should*

Banks have been advised that an asset will be classified as 'doubtful' if it has remained in the substandard category for 18 months instead of 24 months as at present, by March 31, 2001. Banks have been permitted to achieve these norms for additional provisioning in phases, as under :

As on 31.3.2001

Provisioning of not less than 50% on the assets which have become doubtful on account of the new norm.

As on 31.3.2002

Balance of the provisions not made during the previous year, in addition to the provisions needed as on 31.3.2002.

(Circular DBOD.No.BP.BC.103/21.01.002/98 dt.31.10.98)

In the Monetary and Credit Policy announced in April 2001, the banks have been advised to chalk out an appropriate transition path for smoothly moving over to 90 days norm. As a facilitating measure, banks should move over to charging of interest at monthly rests by April 1, 2002. Banks should commence making additional provisions for such loans, starting from the year ending March 31, 2002, which would strengthen their balance sheets and ensure smooth transition to the 90 days norm by March 31, 2004.

Prudential norms in respect of advances guaranteed by State Governments where guarantee has been invoked and has remained in default for more than two quarters has been introduced in respect of advances sanctioned against State Government guarantee with effect from April 1, 2000. Banks have been advised to make provisions for advances guaranteed by State Governments which stood invoked as on March 31, 2000, in phases, during the financial years ending March 31, 2000 to March 31, 2003 with a minimum of 25% each year.

(Circular DBOD. No. BP.BC.103/21.01.002/98 dt.31.10.98).

The RBI has reiterated that banks and

*avoid the practice of "evergreening" by making fresh advances to their troubled constituents only with a view to settling interest dues and avoiding classification of the loans in question as NPAs. The Committee notes that the regulatory and supervisory authorities are paying particular attention to such breaches in the adherence to the spirit of the NPA definitions and are taking appropriate corrective action. At the same time, it is necessary to resist the suggestions made from time to time for a relaxation of the definition of NPAs and the norms in this regard (Chapter III, para 3.22)*

*10. The Committee believes that the objective should be to reduce the average level of net NPAs for all banks to below 5% by the year 2000 and to 3% by 2002. For those banks with an international presence the minimum objective should be to reduce gross NPAs to 5% and 3% by the year 2000 and 2002, respectively, and net NPAs to 3% and 0% by these dates. These targets cannot be achieved in the absence of measures to tackle the problem of backlog of NPAs on a one time basis and the implementation of strict prudential norms and management efficiency to prevent the recurrence of this problem. (Chapter III, para 3.26)*

*11. The Committee is of the firm view that in any effort at financial restructuring in the form of hiving off the NPA portfolio from the books of the banks or measures to mitigate the impact of a high level of NPAs must go hand in hand with operational restructuring. Cleaning up the balance sheets of banks would thus make sense only if simultaneously steps were taken to prevent or limit the re-emergence of new NPAs which could only come about through a strict application of prudential norms and managerial improvement. (Chapter III, para 3.27)*

*12. For banks with a high NPA portfolio, the Committee suggests consideration of two alternative approaches to the problem as an alternative to the ARF proposal made by the*

financial institutions should adhere to the prudential norms on asset classification, provisioning, etc. and avoid the practice of "evergreening".  
(Cir.DBOD. No.BP. BC.103/21.01.002/98 dt.31.10.98)

This is the long-term objective which RBI wants to pursue. Towards this direction, a number of measures have been taken to arrest the growth of NPAs: banks have been advised to tone up their credit risk management systems; put in place a loan review mechanism to ensure that advances, particularly large advances are monitored on an on-going basis so that signals of weaknesses are detected and corrective action taken early ; enhance credit appraisal skills of their staff, etc. In order to ensure recovery of the stock of NPAs, guidelines for one-time settlement have been issued in July,2000.

Banks have been advised to take effective steps for reduction of NPAs and also put in place risk management systems and practices to prevent re-emergence of fresh NPAs. (Cir. DBOD. No. BP. BC. 103 /21.01.002/98 dated 31.10.1998)

The proposal to set up an Asset Reconstruction Company (ARC) on a pilot basis to take over the NPAs of the three weak public sector banks, has been announced in

*earlier CFS. In the first approach, all loan assets in the doubtful and loss categories - which in any case represent bulk of the hard core NPAs in most banks should be identified and their realisable value determined. These assets could be transferred to an Asset Reconstruction Company (ARC) which would issue to the banks NPA Swap Bonds representing the realisable value of the assets transferred, provided the stamp duties are not excessive. The ARC could be set up by one bank or a set of banks or even in the private sector. In case the banks themselves decide to set up an ARC, it would need to be ensured that the staff required by the ARC is made available to it by the banks concerned either on transfer or on deputation basis, so that staff with institutional memory on NPAs is available to ARC and there is also some rationalisation of staff in the banks whose assets are sought to be transferred to the ARC. Funding of such an ARC could be facilitated by treating it on par with venture capital for purpose of tax incentives. Some other banks may be willing to fund such assets in effect by securitising them. This approach would be worthwhile and workable if stamp duty rates are minimal and tax incentives are provided to the banks. (Chapter III, para 3.28)*

*13. An alternative approach could be to enable the banks in difficulty to issue bonds which could form part of Tier II capital. This will help the banks to bolster capital adequacy which has been eroded because of the provisioning requirements for NPAs. As the banks in difficulty may find it difficult to attract subscribers to bonds. Government will need to guarantee these instruments which would then make them eligible for SLR investments by banks and approve instruments by LIC, GIC and Provident Funds (Chapter III, para 3.29 )*

*14. Directed credit has a proportionately higher share in NPA portfolio of banks and has been one of the factors in erosion in the quality of bank assets. There is continuing need for banks to extend credit to agriculture*

the Union Budget for 1999 – 2000. The modalities for setting up the ARC are being examined.

Banks are permitted to issue bonds for augmenting their Tier II capital. Guarantee of the Govt. for these bonds is not considered necessary.

The loans to agricultural and SSI sectors are now generally being granted on commercial considerations and on the basis of creditworthiness of the borrower. Further, the concessionality on interest rates for advances

*and small scale sector which are important segments of the national economy, on commercial considerations and on the basis of creditworthiness. In this process, there is scope for correcting the distortions arising out of directed credit and its impact on banks' assets quality. (Chapter III, para 3.31)*

*15. The Committee has noted the reasons why the Government could not accept the recommendation for reducing the scope of directed credit under priority sector from 40% to 10%. The Committee recognises that the small and marginal farmers and the tiny sector of industry and small businesses have problems with regard to obtaining credit and some earmarking may be necessary for this sector. Under the present dispensation, within the priority sector 10% of net bank credit is earmarked for lending to weaker sections. A major portion of this lending is on account of Government sponsored poverty alleviation and employment generation schemes. The Committee recommends that given the special needs of this sector, the current practice may continue. The Branch Managers of banks should, however, be fully responsible for the identification of beneficiaries under the Government sponsored credit linked schemes. The Committee proposes that given the importance and needs of employment oriented sectors like food processing and related service activities in agriculture, fisheries, poultry and dairying, these sectors should also be covered under the scope of priority sector lending. The Committee recommends that the interest subsidy element in credit for the priority sector should be totally eliminated and even interest rates on loans under Rs.2 lakh should be deregulated for scheduled commercial banks as has been done in the case of Regional Rural Banks and co-operative credit institutions. The Committee believes that it is the timely and adequate availability of credit rather than its cost which is material for the intended beneficiaries. The reduction of the pre-empted portion of banks' resources through*

has been done away with, except for advances under the DRI Scheme. While advances upto Rs.2 lakh should carry interest rate not exceeding PLR, interest rates on advances of over Rs.2 lakh have been freed.

As per the present stipulation, banks are required to lend 10% of net bank credit (NBC) for weaker sections which includes all small and marginal farmers, all IRDP and DRI borrowers, borrowers under SUME etc. The Committee has recommended that the present stipulation may continue.

As recommended by the Committee, some activities like food processing, related service activities in agriculture, fisheries, poultry, dairying have been brought under priority sector. (circular RPCD. NO. Plan. BC. 60/04.09.01/ 98-99 dt.28-1-99).

Under the existing dispensation, Units in sectors like food processing, etc., satisfying either the definition of SSI [ the ceiling of investment in plant and machinery (original cost) for a unit being classified under this category has since been enhanced to Rs. 3 crore from Rs.60 lakhs / Rs.75 lacs for ancillaries and export oriented units] or small business are already covered under priority sector. No further changes are considered necessary, as larger units need not be given any advantage by enlarging the scope of definition of priority sector advances.

As a first step towards deregulation of interest rates on credit limits up to R.2 lakh and eliminating interest subsidy element in credit for priority sector, in the Monetary and Credit Policy announced in April, 1998, it has been stipulated that interest rates on loans up to Rs.2 lakh should not exceed PLR as against the earlier stipulation of 'not exceeding 13.5%', for credit limits of Rs.25,000--Rs.2 lakh and 12% for credit limit up to Rs.25,000. Banks are free to decide their PLR subject to their obtaining the prior approval of their Boards therefor. As the PLR differs from bank to bank, depending on their cost of funds and competitive

*the SLR and CRR would, in any case, enlarge the ability of banks to dispense credit to these sectors. (Chapter III, para 3.32)*

***Prudential Norms and Disclosure Requirements:***

*16. With regard to income recognition, in India, income stops accruing when interest or instalment of principal is not paid within 180 days. The Committee believes that we should move towards international practices in this regard and recommends the introduction of the norm of 90 days in a phased manner by the year 2002.(Chapter III, para 3.35)*

strategies, the measure is a step towards deregulation of interest rates. Thus the recommendation of the Committee has been implemented in spirit. It may be stated that except for loans under DRI there is no subsidisation of interest.

(Cir. MPD.BC.175/07.01.279/97-98 dated 29.4.98)

The recommendation of the Committee that we should move towards international practices in regard to income recognition is accepted in principle. However, tightening of the prudential norms should be made keeping in view the existing legal framework, production and payment cycles, business practices, the predominant share of agriculture in the country's economy, etc. The production and repayment cycles in the industry in the country generally involve a period of not less than from 4 to 6 months. A large number of SSIs also have difficulties in timely realization of their bills drawn on the suppliers. These have to be taken into account while contemplating any change in the norm.

Implementation of the recommendation would have serious implications on the asset portfolio of banks and even good quality borrowers and find it difficult to comply with the norms recommended. There have been representations from banks and financial institutions seeking relaxations in the above instructions by increasing the period to 3-4 quarters. Keeping in view the current industrial scenario, implementation of the recommendation would have serious implications even to healthy borrowers. Furthermore, interest on advances is calculated by banks at quarterly rests. Keeping in view the large number and volume of accounts, if we have to implement the recommendation, a few preconditions should be met :-

- [a] Banks should introduce calculation of interest at monthly rests;
- [b] There should be 100% computerization of banks' operations. Unless 100%

17. *At present, there is no requirement in India for a general provision on standard assets. In the Committee's view a general provision, say, of 1% would be appropriate and RBI should consider its introduction in a phased manner. (Chapter III, para 3.36)*

18. *The Committee believes that in the case of future loans, the income recognition and asset classification and provisioning norms should apply even to Government guaranteed advances in the same manner as for any other advance. For existing Government guaranteed advances, RBI, Government and banks may work out a mechanism for a phased rectification of the irregularities in these accounts. (Chapter III, para 3.37)*

19. *There is a need for disclosure, in a phased manner, of the maturity pattern of assets and liabilities, foreign currency assets and liabilities, movements in provision account and NPAs. The RBI should direct banks to publish, in addition to financial statements of independent entities, a consolidated balance sheet to reveal the strength of the group. Full disclosure would also be required of connected lending and lending to sensitive sectors. Furthermore, it should also ask banks to disclose loans given to related companies in the bank's balance sheets. Full disclosure of information should not be only a regulatory requirement. It would be necessary to enable a bank's creditors, investors and rating agencies to get a true picture of its functioning – an important requirement in a market driven*

computerization is made, it may not be feasible to implement the recommendation ; [c] It is also necessary to tone up the legal machinery for speedy disposal of the collateral taken as security for the advance. However, considering the need to bring our norms in line with the best international practices, the recommendations made by the Committee would be our long term objective. As the level of gross NPAs of banks come down because of better management practices, the recommendation to introduce the norm of 90 days will be examined.

To start with, a general provision on standard assets of a minimum of 0.25% from the year ended March 31, 2000 introduced.

(Cir.DBOD. No.BP.BC.103/21.01.002/98 dt.31.10.98)

Please see comments in respect of item No.8 above.

Banks have been advised to disclose the following information, in addition to the existing disclosures, in the 'Notes on Accounts' to the balance sheet from the accounting year ended March 31, 2000.

- i. Maturity pattern of loans and advances,
- ii. Maturity pattern of investment securities,
- iii. Foreign currency assets and liabilities
- iv. Movement in NPAs,
- v. Maturity pattern of deposits
- vi. Maturity pattern of borrowings
- vii. Lending to sensitive sectors as defined from time to time

(Cir.DBOD.No.BP.BC.9/21.04.018/99)

*financial sector. (Chapter III, para 3.38)*

dt.10.2.99)

20. *Banks should also pay greater attention to asset liability management to avoid mismatches and to cover, among others, liquidity and interest rate risks. (Chapter III, para 3.41).*

Detailed guidelines issued to banks on asset – liability management. Implementation of these guidelines would enable banks to avoid liquidity mismatches as also to cover, among others, liquidity and interest rate risks. (Circular. DBOD.No.BP.BC.8/21.04.098/99 dated 10<sup>th</sup> February, 1999).

21. *Banks should be encouraged to adopt statistical risk management techniques like Value-at-Risk in respect of balance sheet items which are susceptible to market price fluctuations, forex rate volatility and interest rate changes. While the Reserve Bank may initially, prescribe certain normative models for market risk management, the ultimate objective should be that of banks building up their own models and RBI backtesting them for their validity on a periodical basis.(Chapter III, para 3.41 – 3.42)*

Comprehensive guidelines have been issued to enable banks to put in place appropriate risk management systems. Banks have also been advised to adopt statistical risk management techniques like Value-at-Risk ( which is a statistical method of assessing the potential maximum loss from a credit or investment exposure, over a definite holding period at a given confidence level) or other models appropriate to their level of business operation. (Circular. DBOD. No. BP.BC 98/21.04.103/99 dated 7.10.99)

**Systems and Methods in Banks :**

22. *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)*

Banks have been advised to bring out revised Operative Manuals and update them regularly. Banks have confirmed having brought out revised Manuals. (Circular. DBOD. No.BP.BC.29/21.01.023/98-99 dt.16.4.99 )

23. *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)*

Banks have been advised to set up EDP Audit Cell, as part of their Inspection Department. ( circular DBS. No. CO PP.BC.55/11.01.005/ 98-99 dated 19.6.99).

24. *There is enough international experience*

RBI had in 1992 emphasised to banks the

*to show the dangers to an institution arising out of inadequate reporting to and checking by the back offices of trading transactions and positions taken. Banks should pay special attention to this aspect (Chapter IV, para 4.8).*

*25. There is need to institute an independent loan review mechanism especially for large borrowal accounts and systems to identify potential NPAs. It would be desirable that banks evolve a filtering mechanism by stipulating in-house prudential limits beyond which exposures on single/group borrowers are taken keeping in view their risk profile as revealed through credit rating and other relevant factors. Further, in-house limits could be thought of to limit the concentration of large exposures and industry/sector/geographical exposures within the Board approved exposure limits and proper overseeing of these by the senior management/ boards. (Chapter IV, para 4.12 – 4.16)*

*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)*

*27. The Committee notes that public sector banks and financial institutions have yet to introduce a system of recruiting skilled manpower from the open market. The Committee believes that this delay has had an impact on the competency levels of public sector banks in some areas and they have consequently lost some ground to foreign banks and the newly set up private sector banks. The Committee urges that this aspect*

importance of an effective management reporting system, segregation of the trading and back office functions, etc. The efficacy of the systems put in place by banks is being constantly reviewed by the RBI through periodical inspections.

( Circular DBOD. No. FSC. BC. 143A/ 24.48.001/91-92 dt.20.6.92)

Banks have been advised to put in place an independent Loan Review Mechanism, as recommended by the Committee. (Cir. DBOD.No.BP.BC.103/21.01.002/98 dated 31.10.98).

The recommendation was put up before the Audit Sub-Committee of the Board for Financial Supervision which was of the view that the existing practice should continue.

The public sector banks have been permitted to recruit from the open market or by way of campus recruitment, skilled personnel in areas like information technology, risk management, treasury operations, etc.

As regards the recommendation in regard to discontinuing the practice of recruitment of officers through Banking Services Recruitment Boards, Govt. may furnish

*be given urgent consideration and in case there are any extant policy driven impediments to introducing this system, appropriate steps be taken by the authorities towards the needed deregulation. Banks have to tone up their skills base by resorting, on an ongoing basis, to lateral induction of experienced and skilled personnel, particularly for quick entry into new activity/areas. The Committee notes that there has been considerable decline in the scale of merit-based recruitment even at the entry level in many banks. The concept of direct recruitment itself has been considerably diluted by many PSBs including the State Bank of India by counting internal promotions to the trainee officers' cadre as direct recruitment. The Committee would strongly urge the managements of public sector banks to take steps to reverse this trend. The CFS had recommended that there was no need for continuing with the Banking Service Recruitment Boards insofar as recruitment of officers was concerned. This Committee, upon examination of the issue, reaffirms that recommendation. As for recruitment in the clerical cadre, the Committee recommends that a beginning be made in this regard by permitting three or four large, well-performing banks, including State Bank of India, to set up their own recruitment machinery for recruiting clerical staff. If the experience under this new arrangement proves satisfactory, it could then pave the way for eventually doing away completely with the Banking Service Recruitment Boards. (Chapter IV, para 4.21 – 4.23)*

*28. It seems apparent that there are varying levels of overmanning in public sector banks. The managements of individual banks must initiate steps to measure what adjustments in the size of their work force is necessary for the banks to remain efficient, competitive and viable. Surplus staff, where identified, would need to be redeployed on new business and activities, where necessary after suitable retraining. It is possible that even after this some of the excess staff may not be suitable for redeployment on grounds of aptitude and*

comments.

While some of the public sector banks have introduced VRS after consultations with Employees' Unions, others are in the process of introducing such schemes.

*mobility. It will, therefore, be necessary to introduce an appropriate Voluntary Retirement Scheme with incentives. The managements of banks would need to initiate dialogue in this area with representatives of labour. (Chapter IV, para 4.5 & 4.24).*

*29. The Committee would urge the managements of Indian banks to review the changing training needs in individual banks keeping in mind their own business environment and to address these urgently. (Chapter IV, para 4.32)*

*30. Globally, banking and financial systems have undergone fundamental changes because of the ongoing revolution in information and communications technology. Information technology and electronic funds transfer systems have emerged as the twin pillars of modern banking development. This phenomenon has largely bypassed the Indian banking system although most technologies that could be considered suitable for India have been introduced in some diluted form. The Committee feels that requisite success in this area has not been achieved because of the following reasons:*

- ? *Inadequate bank automation.*
- ? *Not so strong commercially oriented inter-bank platform.*
- ? *Lack of a planned, standardised, electronic payment systems backbone.*
- ? *Inadequate telecom infrastructure.*
- ? *Inadequate marketing effort.*
- ? *Lack of clarity and certainty on legal issues and*
- ? *Lack of data warehousing network.*

*The Committee has tried to list out series of implementation steps for achieving rapid induction of information technology in the banking system. Further, information and control systems need to be developed in several areas like*

- ? *Better tracking of spreads, costs and NPAs for higher profitability.*
- ? *Accurate and timely information for strategic decisions to identify and*

Banks have been advised to review the training needs and give more focus to emerging areas like Credit Management, Treasury Management, Risk Management, Information Technology, etc. (Circular DBOD.No.BP.BC.103/21.01.002/98 dated 31.10.1998).

A Working Group was set up with representation from public sector banks, technology experts, to operationalise and implement the programme of computerisation for banks within a definite time frame. All the recommendations of Group have been accepted for implementation.

In pursuance of the recommendations of the Working Group, the Indian Financial Network (INFINET), a wide area Satellite based network using VSAT technology has been commissioned on 24<sup>th</sup> June, 1999 at IDRBT, Hyderabad which will connect bank branches and RBI Offices in a phased manner.

The development of the Payment System Generic Architecture Model for both domestic and cross-border payments has been undertaken.

A consultant has been appointed to assist in the implementation of the RTGS.

Progress is also being made towards developing standards for newer payment instruments such as Smart Cards.

Three standing Committees to review security policies, message formats, software, to examine legal issues on electronic banking and to monitor progress of computerization of branches of banks handling Govt. transactions have been formed. Public Sector Banks have been advised to report technology progress on 20 short-listed action points.

*promote profitable products and customers.*

- ? *Risk and Asset-Liability management; and*
  - ? *Efficient Treasury management.*
- (Chapter IV, para 4.66 & 4.70)*

### **Structural Issues :**

*31. 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) .*

Based on the recommendations of the Khan Working Group on Harmonisation of the Role and Operations of banks and DFIs, RBI had released a Discussion Paper in January, 1999 for wider public debate. The feedback on the discussion paper indicated that while universal banking is desirable from the point of view of efficiency of resource use, there is need for caution in moving towards such a system by banks and DFIs. Major areas requiring attention are the status of financial sector reforms, the state of preparedness of concerned institutions, the evolution of regulatory-regime and above all a viable transition path for institutions which are desirous of moving in the direction of universal banking. The Monetary and Credit Policy for the year 2000 –2001 proposed to adopt the following broad approach for considering proposals in this area :

- a. The principle of “Universal Banking” is a desirable goal and some progress has already been made by permitting banks to diversify into investments and long-term financing and the DFIs to lend for working capital, etc. However, banks have certain special characteristics and as such any dilution of RBI’s prudential and supervisory norms for conduct of banking business would be inadvisable. Further, any conglomerate, in which a bank is present, should be subject to a consolidated approach to supervision and regulation.
- b. Any DFI, which wishes to do so, should have the option to transform into bank (which it can exercise),

provided the prudential norms as applicable to banks are fully satisfied. To this end, a DFI would need to prepare a transition path in order to fully comply with the regulatory requirement of a bank. The DFI concerned may consult RBI for such transition arrangements. Reserve Bank will consider such requests on a case by case basis.

(Circular MPD.BC.196/07.01.279/99-2000 dt. 27.4.2000)

*32. Mergers between banks and between banks and DFIs and NBFCs need to be based on synergies and locational and business specific complementarities 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 co-operation 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*

The recommendation has been noted. A non-banking finance company has since been permitted to merge with a bank. Two banks in the private sector have also merged based on synergies and business specific complementarities.

*multiplier effect".(Chapter V, para 5.13 – 5.15)*

*33. 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 closure. 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)*

*34. 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*

In addition to the two definitions for identifying 'weak' banks recommended by the Committee, RBI monitors banks to identify 'potential weakness' on the basis of five more parameters (related to solvency, profitability and earnings) as recommended by the Working Group on Restructuring of Weak Public Sector Banks (Chairman : Shri M.S.Verma ).

In respect of weak banks, a bank-specific restructuring programme aimed at turning around the bank by reducing their cost of operation, and improving income levels, has been put in place.

The recommendation for setting up of a Restructuring Commission has not been considered. However, the Union Budget for 2000 – 2001 has proposed setting up of a Financial Restructuring Authority for a weak or potentially weak bank.

The policy of licensing new banks in the private sector has been reviewed by an in-house Working Group set up by RBI. Based on the recommendations of the Working Group, the licensing policy is being revised.

*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)*

*35. 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).*

*36. 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)*

*37. Deposit insurance for NBFCs could blur the distinction between banks, which are much more closely regulated, and the non banks as far as safety of deposit is concerned and consequently lead to a serious moral hazard problem and adverse portfolio selection. The Committee would advise against any insurance of deposits with NBFCs. (Chapter V, para 5.38)*

*38. RBI should undertake a review of the current entry norms for urban cooperative banks and prescribe revised prudent minimum capital norms for these banks. Though cooperation is a state subject, since UCBs are primarily credit institutions meant to be run on commercial lines, the Committee recommends that this duality in control*

The recommendation has been examined. It has been felt that branch presence by foreign banks would be better for the reason that the parent bank would stand ready to support the branch in times of distress. Since subsidiaries would be set up as a joint stock companies with limited liability, the parent bank's liability to its subsidiary would be limited to its shareholding. In the case of branches, the parent bank has responsibility both towards capital and management whereas in the case of subsidiaries, the parent bank's responsibility towards capital is limited. In respect of new NBFCs, which seek registration with the RBI and commence the business on or after April 20, 1999 the criteria in regard to minimum net worth has been increased to Rs.2 crore, vide the Monetary and Credit Policy for the year 1999-2000. (Circular MPD.BC.185/07.01.279/98-99 dated 20<sup>th</sup> April, 1999).

The recommendation on not providing insurance cover for deposits with NBFCs has been noted.

The norms with regard to minimum capital requirements for urban cooperative banks (UCBs) have been revised with effect from 1<sup>st</sup> April, 1998. Implementation of this recommendation on doing away with duality of control over UCBs would involve amendments to State Cooperative Societies Acts. The Government therefore, has to

*should be dispensed with. It should be primarily the task of the Board of Financial Supervision to set up regulatory standards for Urban Cooperative Banks and ensure compliance with these standards through the instrumentality of supervision. (Chapter V, para 5.39)*

*39. The Committee is of the view that there is need for a reform of the deposit insurance scheme. In India, deposits are insured upto Rs.1 lakh. There is no need to increase the amount further. There is, however, need to shift away from the 'flat' rate premiums to 'risk based' or 'variable rate' premiums. Under risk based premium system all banks would not be charged a uniform premium. While there can be a minimum flat rate which will have to be paid by all banks on all their customer deposits, institutions which have riskier portfolios or which have lower ratings should pay higher premium. There would thus be a graded premium. As the Reserve Bank is now awarding CAMELS ratings to banks, these ratings could form the basis for charging deposit insurance premium. (Chapter V, para 5.42)*

*40. The Committee is of the view that the inter-bank call and notice money market and inter-bank term money market should be strictly restricted to banks. The only exception should be the primary dealers who, in a sense, perform a key function of equilibrating the call money market and are formally treated as banks for the purpose of their inter-bank transactions. All the other present non-bank participants in the inter-bank call money market should not be provided access to the inter-bank call money market. These institutions could be provided access to the money market through different segments.(Chapter V, Annexure para A7)*

consider.

This has been accepted for implementation. The Working Group on Deposit Insurance appointed by RBI has recommended the modalities for switching over to 'risk based' premium for deposit insurance and the recommendations are under examination.

The phasing out of non-bank participants from inter-bank Call/Notice Money market will be synchronized with the development of repo market. Keeping in view this objective, RBI has widened the scope of repo market to include all entities having SGL Account and Current Account in Mumbai, thus increasing the number of eligible non-bank entities to 64. Further, the permission given to non-bank entities to lend in the call/notice money market by routing their operations through PDs has been extended upto June, 2001. RBI aims to move towards a pure inter-bank(including PDs) call/notice money market. With a view to further deepening the money market and enable banks, PDs and AIFIs to hedge interest rate risk, these entities are allowed to undertake FRA/IRSs as a product for their own balance sheet management and for market making purposes. Mutual Funds, in addition to corporates are also permitted to undertake FRAs/IRSs with

41. *There must be clearly defined prudent limits beyond which banks should not be allowed to rely on the call money market. This would reduce the problem of vulnerability of chronic borrowers. Access to the call market should be essentially for meeting unforeseen swings and not as a regular means of financing banks' lending operations (Chapter V, Annexure, para A8).*

42. *The RBI support to the market should be through a Liquidity Adjustment Facility under which the RBI would periodically, if necessary daily, reset its Repo and Reverse Repo rates which would in a sense provide a reasonable corridor for market play. While there is much merit in an inter-bank reference rate like a LIBOR, such a reference rate would emerge as banks implement sound liquidity management facilities and the other suggestions made above are implemented. Such a rate cannot be anointed, as it has to earn its position in the market by being a fairly stable rate which signals small discrete interest rate changes to the rest of the system.(Chapter V, Annexure para A8).*

these players. This measure is, inter alia, expected to help development of a term money market.

RBI has advised banks to put in place comprehensive ALM System with effect from 1.4.1999. ALM would effectively put a cap on reliance on call money market. Detailed Risk Management Guidelines have also been issued vide circular DBOD No. BP.BC.98/21.04.103/99 dated 7<sup>th</sup> Oct. 1999.

The ILAF (Interim Liquidity Adjustment Facility) introduced earlier has served its purpose as a transitional measure for providing reasonable access to liquid funds at set rates of interest. In view of the experience gained in operating the interim scheme last year, an Internal Group was set up by RBI to consider further steps to be taken. Following the recommendation of the Internal Group, it was announced in the Monetary and Credit Policy Measures in April, 2000 to proceed with the implementation of a full-fledged LAF. The new scheme will be introduced progressively in convenient stages in order to ensure smooth transition.

- ? In the first stage, with effect from June 5, 2000, the Additional CLF and level II support to PDs will be replaced by variable rate repo auctions with same day settlement.
- ? In the second stage, the effective date for which will be decided in consultation with banks and PDs, CLF and level I liquidity support will also be replaced by variable rate repo auctions. Some minimum liquidity support to PDs will be continued but at interest rate linked to variable rate in the daily repos auctions as determined by RBI from time to time.
- ? With full computerisation of Public Debt Office (PDO) and introduction of RTGS expected to be in place by the end of the current year, in the third stage, repo operations through electronic transfers will be introduced. In the final stage, it will be possible to

operate LAF at different timings of the same day.

(Cir. MPD.BC. 196/07.01.279/99-2000 dated 27.4.2000)

*43. The minimum period of FD be reduced to 15 days and all money market instruments should likewise have a similar reduced minimum duration.(Chapter V, Annexure para A9)*

The minimum maturity of CDs has been reduced to 15 days, vide circular DBOD.No. BP.BC. 169/21.01.002/2000 dated 3.5.2000.

*44. Foreign institutional investors should be given access to the Treasury Bill market. Broadening the market by increasing the participants would provide depth to the market (Chapter V, Annexure para A 10)*

FII's have been permitted to invest in Treasury Bills, vide Monetary and Credit Policy announced in April 1998. (Cir. MPD.BC. 175/07.01.279/97-98 dated 29.4.98).

*45. With the progressive expansion of the forward exchange market, there should be an endeavour to integrate the forward exchange market with the spot forex market by allowing all participants in the spot forex market to participate in the forward market upto their exposures. Furthermore, the forex market, the money market and the securities should be allowed to integrate and the forward premia should reflect the interest rate differential. As instruments move in tandem in these markets the desiderative of a seamless and vibrant financial market would hopefully emerge (Chapter V, Annexure para A 11).*

With effect from June 11, 1998 Foreign Institutional investors were permitted to take forward cover from Authorised Dealers to the extent of 15 per cent of their existing investment as on that date. Any incremental investment over the level prevailing on June 11, 1998 was also made eligible for forward cover. The Monetary and Credit Policy for 1999-2000 has further simplified the procedure by linking the above mentioned limits to FII's' outstanding investments as on March 31, 1999. In other words, 15 per cent of outstanding investment on March 31, 1999 as well as the entire amount – 100 per cent - of any additional investment made after this date will be eligible for forward cover. Further, any FII which has exhausted the limits mentioned above can apply to RBI for additional forward cover for a further 15 per cent of their outstanding investments in India at the end of March 1999.

#### **Rural and Small Industrial Credit :**

*46. The Committee also recommends that a distinction be made between NPAs arising out of client specific and institution specific reasons and general (agro-climatic and environmental issues) factors. While there should be no concession in treatment of NPAs arising from client specific reasons,*

In the event of adverse agro-climatic and environmental factors, covering all natural calamities, outstanding loans are converted/rescheduled/rephrased suitably. Agricultural advances so rescheduled are provided relief for NPA classification. The decision to declare a particular crop or

*any decision to declare a particular crop or product or a particular region to be distress hit should be taken purely on techno-economic consideration by a technical body like NABARD.(Chapter VI, para 6.6)*

*47. As a measure of improving the efficiency and imparting a measure of flexibility the committee recommends consideration of the debt securitisation concept within the priority sector. This could enable banks, which are not able to reach the priority sector target to purchase the debt from the institutions, which are able to lend beyond their mandated percentage.(Chapter VI, para 6.8)*

*48. Banking policy should facilitate the evolution and growth of micro credit institutions including LABs which focus on agriculture, tiny and small scale industries promoted by NGOs for meeting the banking needs of the poor. Third-tier banks should be promoted and strengthened to be autonomous, vibrant, effective and competitive in their operations.(Chapter VI, para 6.16)*

*49. Banks should devise appropriate criteria suited to the small industrial sector and be responsive to its genuine credit needs but this should not be by sacrificing cannons of*

product or a particular region as distress hit is at present vested in the concerned District Administration Authority and the desirability of consulting NABARD which is the technical body, before taking the decision, would be examined.

The recommendation of the Committee, which basically aims at ensuring that the target for priority sector lending is achieved by each of the banks, has been re-examined. As of March 2000, all public sector banks with the exception of UCO Bank have achieved the priority sector lending target individually and the public sector banks as a Group has exceeded the target at the macro-level. The UCO Bank is short of achievement only marginally.

Furthermore, every year the Govt. has been setting up a Rural Infrastructure Development Fund(RIDF) in which all banks which do not achieve the priority sector target contribute the amount of shortfall. Thus all banks, directly or indirectly are able to fulfill the priority sector lending targets. Though the concept of debt securitisation is a novel idea, it will not have any practical application since it will not help in augmenting the flow of credit to the priority sector nor will it help in addressing the question of regional imbalances.

It has, therefore, been decided that the recommendation need not be considered for the present.

In principle approval has been granted for setting up of 10 Local Area Banks (LABs). Out of these, on account of non-compliance with the terms and conditions, the 'in principle' approvals given to 4 banks were withdrawn. Of the remaining, 4 LABs have already started functioning after obtaining licences under Section 22 of Banking Regulation Act, 1949.

48 recommendations of the S.L. Kapur Committee conveyed to banks for implementation. As a further impetus to the flow of credit, banks have been advised that

*sound banking. Borrowers also need to accept credit discipline. There is also need to review the present institutional set up of state level financial/industrial development institutions.(Chapter VI, para 6.19).*

**Regulation and Supervision :**

*50. The Committee recommends that to improve the soundness and stability of the Indian banking system, the regulatory authorities should make it obligatory for banks to take into account risk weights for market risks. The movement towards greater market discipline in a sense would transform the relationship between banks and the regulator. By requiring greater internal controls, transparency and market discipline, the supervisory burden itself would be relatively lighter.(Chapter VII, para 7.13)*

*51. There is a need for all market participants to take note of the core principles and to formally announce full accession to these principles and their full and effective implementation.(Chapter VII, para 7.14)*

*52. Proprietorial concerns in the case of public sector banks impact on the regulatory function leading to a situation of 'regulatory capture' affecting the quality of regulation.(Chapter VII, para 7.16)*

the credit requirement of SSIs having credit limits upto Rs.5 crore, instead of Rs.4 crore, may be assessed on the basis of 20% of the projected annual turnover.

Banks are now required to assign capital for market risk. Please see comments against item 1 above.

As indicated against item 19 above, the disclosure requirements of banks have been strengthened.

We have endorsed the 'Core Principles for Effective Banking Supervision' and complied with almost all of them. Our compliance with the Core Principles has been rated as satisfactory by IMF Mission.

The prudential / regulatory norms stipulated by RBI are applicable to public sector banks, private sector banks and foreign banks uniformly.

53. *The Committee recommends that the regulatory and supervisory authorities should take note of the developments taking place elsewhere in the area of devising effective regulatory norms and to apply them in India taking into account the special characteristics but not in any way diluting the rigour of the norms so that the prescriptions match the best practices abroad. It is equally important to recognise that pleas for regulatory forbearance such as waiving adherence to the regulations to enable some (weak) banks more time to overcome their deficiencies could only compound their problems for the future and further emasculate their balance sheets.(Chapter VII, para 7.17)*

54. *An important aspect of regulatory concern should be ensuring transparency and credibility particularly as we move into a more market driven system where the market should be enabled to form its judgement about the soundness of an institution. There should be punitive penalties both for the inaccurate reporting to the supervisor or inaccurate disclosures to the public and transgressions in spirit of the regulations.(Chapter VII, para 7.19).*

55. *The Committee is of the view that banks should be required to publish half yearly disclosure requirements in two parts. The first should be a general disclosure, providing a summary of performance over a period of time, say 3 years, including the overall performance, capital adequacy, information on the bank's risk management systems, the credit rating and any action by the regulator/supervisor. The disclosure statement should be subject to full external audit and any falsification should invite criminal procedures. The second disclosure, which would be a brief summary aimed at*

The Regulatory / Supervisory norms have been formulated taking into account the best international practices. RBI has not waived adherence to the regulatory norms by any individual bank or category of banks.

We are moving towards greater transparency and Statutory Auditors of banks are now under the obligation to report on the deviations from adherence to the prudential norms prescribed by RBI in their 'Notes to Accounts'. These observations are followed up by the RBI with the concerned banks. In terms of the provisions of Section 47A of the B.R. Act, 1949, as amended in 1994, the RBI can impose a penalty not exceeding Rs. 5 lakh or twice the amount involved in such contravention or default where such amount is quantifiable whichever is more and where such contravention or default is a continuing one, a further penalty which may extent to Rs. 25,000 for every day after the first day when the contravention or default continues.

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*the ordinary depositor/ investor should provide brief information on matters such as capital adequacy ratio, non performing assets and profitability, vis-à-vis, the adherence to the stipulated norms and a comparison with the industry average. This summary should be in a language intelligible to the depositor and be approved by the supervisors before being made fully public when soliciting deposits. Such disclosure, the Committee believes, will help the strong banks to grow faster than the weaker banks and thus lead to systematic improvement.(Chapter VII, para 7.20)*

*56. The Committee recommends that an integrated system of regulation and supervision be put in place to regulate and supervise the activities of banks, financial institutions and non banking finance companies (NBFCs). The functions of regulation and supervision are organically linked and we propose that this agency be renamed as the Board for Financial Regulation and Supervision (BFRS) to make this combination of functions explicit. An independent regulatory supervisory system which provides for a closely coordinated monetary policy and banking supervision would be the ideal to work towards.(Chapter VII, para 7.24).*

*57. The Board for Financial Regulation and Supervision (BFRS) should be given statutory powers and be reconstituted in such a way as to be composed of professionals. At present, the professional inputs are largely available in an advisory board which acts as a distinct entity supporting the BFS. Statutory amendment which would give the necessary powers to the BFRS should develop its own autonomous professional character. The Committee, taking note of the formation of BFS, recommends that the process of separating it from the Reserve Bank qua central bank should begin and the Board should be invested with requisite autonomy and armed with necessary powers so as to allow it to develop experience and professional expertise and to function*

BFS needs to be strengthened before regulatory functions are vested with it. It was, therefore, felt that while the Committee's recommendations to set up an agency named Board for Financial Regulation and Supervision (BFRS) to provide an integrated system of regulation and supervision over banks, FIs and NBFCs could be a long term objective. For the time being, BFS may continue with its present mandate.

Please see comments against item 56 above.

*effectively. However, with a view to retain an organic linkage with RBI, the Governor, RBI should be head of the BFRS. The Committee has also set out specific measures to ensure an effective regulatory/supervisory system which are detailed in para 7.27 (Chapter VII, para 7.24)*

***Legal and Legislative Framework :***

*58. With the advent of computerisation there is need for clarity in the law regarding the evidentiary value of computer generated documents. The Shere Committee had made some recommendations in this regard and the Committee notes that the Government is having consultations with public sector banks in this matter. With electronic funds transfer several issues regarding authentication of payment instruments, etc. require to be clarified. The Committee recommends that a group be constituted by the Reserve Bank to work out the detailed proposals in this regard and implement them in a time bound manner. (Chapter VIII, para. 8.15 8.16)*

*59. Although there is a provision in our legislation effectively prohibiting loans by banks to companies in which their directors are interested as directors or employees of the latter with liberalisation and the emergence of more banks on the scene and with the induction of private capital through public issue in some of the nationalised banks there is a possibility that the phenomenon of connected lending might reappear even while adhering to the letter of law. It is necessary to have prudential norms which are addressed to this problem by stipulating concentration ratios in terms of which no bank can have more than a specified proportion of its net worth by way of lending to any single industrial concern and a higher percentage in respect of lending to an industrial group. At present, lending to any single concern is limited to 25% of a bank's capital and free reserves. This would seem to be appropriate along*

The Group set up by the RBI has submitted its Report and the recommendations are in various stages of implementation.

As the Committee has noted, Section 20 of the Banking Regulation Act, 1949 prohibits banks from entering into any commitment for granting of any loan or advance to or on behalf of any of its directors, any firm in which any of its directors is interested as partner, manager, employee or guarantor or any company of which any of the directors of the banking company is a director, managing agent, manager, employee, or guarantor or in which he holds substantial interest or, any individual in respect of whom any of its directors is a partner or guarantor.

The RBI has, as noted by the Committee, laid down prudential ceilings on exposures to single / group of borrowers.

Banks on their own, have also prescribed exposure ceilings on single borrower and group of borrowers.

*with the existing enhanced figure of 50% for group exposure except in the case of specified infrastructure projects. Similarly, concentration ratios would need to be indicated, even if not specifically prescribed, in respect of any bank's exposure to any particular industrial sector so that in the event of cyclical or other changes in the industrial situation, banks have an element of protection from over exposure in that sector. Prudential norms would also need to be set by way of prescription of exposure limits to sectors particularly sensitive to asset price fluctuations such as stock markets and real estate. As it happens, Indian banks do not have much exposure to the real estate sector in the form of lending for property development as distinct from making housing loans. The example of banks in East and South East Asia which had over extended themselves to these two sectors has only confirmed the need for circumspection in this regard. We would leave the precise stipulation of these limits and, if necessary, loan to collateral value ratios to the authorities concerned. The implementation of these exposure limits would need to be carefully monitored to see that they are effectively implemented and not circumvented, as has sometimes happened abroad, in a variety of ways. Another salutary prescription would be to require full disclosure of connected lending and lending to sensitive sectors. (Chapter III, para. 3.40)*

*60. The Committee recommends that to improve the soundness and stability of the Indian banking system, the regulatory authorities should make it obligatory for banks to take into account risk weights for market risks. The movement towards greater market discipline in a sense would transform the relationship between banks and the regulator. By requiring greater internal controls, transparency and market discipline, the supervisory burden itself would be relatively lighter.(Chapter VII, para. 7.13 )*

*61. The Committee recommends that the RBI should totally withdraw from the primary*

As regards the recommendation that prudential norms be set by way of prescription of exposure limits to sensitive sectors, i.e. those sectors where asset prices are subject to fluctuations, RBI has already put in place a cap on a bank's exposure to share market. The banks on their own have limited their exposure to real estate business. Banks are expected to set norms for lending to any particular industrial sector in their lending policy. Banks have been advised to disclose in 'Notes on Account' to their balance sheets, lending to sensitive sectors, (i.e., advances to sectors such as, capital market, real estate, etc.) and such other sectors to be defined as 'sensitive' by RBI from time to time with effect from the year ended March 31, 2000. (Cir. DBOD.No.BP.BC.9/21.04.018/99 dt.10 February, 1999).

Please see comments against item 1 above.

The withdrawal of RBI from the primary market in 91 day Treasury Bills is the long

*market in 91 days Treasury Bills; the RBI could, of course, have a presence in the secondary market for 91 days Treasury Bills. If the 91 days Treasury Bill rate reflects money market conditions, the money and securities market would develop an integral link. ....The Committee also recommends that foreign institutional investors should be given access to the Treasury Bill market. (Chapter V, Annexure, para. A-10 )*

term objective. The pace of implementation of the recommendation should depend upon the development and depth of the Govt. securities market. One of the objectives of evolving the system of Primary Dealers is to improve the underwriting and market making capabilities in Government securities market so that RBI could eventually withdraw from primary subscriptions. This will be possible only when Primary Dealers are capable of taking devolvement, if any, to the full extent.

**As regards giving access to FIIs to the Treasury Bill market it has been implemented. ((Cir. MPD.BC. 175/07.01.279/97-98 dated 29.4.98).**

**d) Recommendations on which a view has to be taken by Govt.**

*(i) So far, a sum of Rs.20,000 crore has been expended for recapitalisation and to the extent to which recapitalisation has enabled banks to write off losses, this is the cost which the Exchequer has had to bear for the bad debts of the banks. Recapitalisation is a costly and, in the long run, not a sustainable option. Recapitalisation involves budgetary commitments and could lead to a large measure of monetisation. The Committee urges that no further recapitalisation of banks be undertaken from the Government budget. As the authorities have already proceeded on the recapitalisation route it is perhaps not necessary to consider de novo the institution of an ARF of the type envisaged by the earlier CFS Report. The situation would perhaps have been different if the recapitalisation exercise had not been undertaken in the manner in which it has been.*

Govt. to reply

*(Chapter III, para. 3.24 – 3.25)*

*(ii) As an incentive to banks to make specific provisions, the Committee recommends that consideration be given to making such provisions tax deductible. (Chapter III, para. 3.39)*

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*(iii) It would be appropriate if the management committees are reconstituted to*

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*have only whole time functionaries in it, somewhat on the pattern of Central Office Credit Committee constituted in the State Bank of India. All decisions taken by these committees could be put up to the Board of Directors for information. (Chapter IV, para. 4.12 – 4.16)*

*(iv) It would be appropriate to induct an additional whole time director on the Board of the banks with an enabling provision for more whole time directors for bigger banks. (Chapter IV, para.4.17)*

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*(v) There are opportunities of outsourcing in other activities like building maintenance, cleaning, security, despatch of mail and more importantly, in computer related areas. The Committee has been informed that in some areas banks are unable to subcontract work because of a notification issued by the Labour Ministry under Contract Labour (Regulation and Abolition) Act, 1970. The Committee would urge that this be looked into by the authorities so that banks are enabled to effect efficiency and productivity improvements. The global trend in the banking and financial sector also reflects an increasing reliance on outsourced services. In an increasingly competitive environment, statutory provisions should not lead to banks having to carry on internally functions and tasks which can be performed more efficiently by outside service providers. (Chapter IV, para. 4.18).*

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*(vi) The Committee feels that the issue of remuneration structure at managerial levels prevailing in public sector banks and financial institutions needs to be addressed. There is an urgent need to ensure that public sector banks are given flexibility to determine managerial remuneration levels taking into account market trends. The Committee recommends that the necessary authority in this regard be given to the Boards of the banks initially in the case of profit making public sector banks which have gone public, for they would, in any case, be required to operate with an*

The recent wage settlement of bank staff with Unions has broadly kept this in view and leaving the decision on other perquisites to the potential of individual banks concerned.

Govt. to reply.

*accountability to the market. The forthcoming wage negotiations provide an opportunity to review the existing pattern of industry-wise negotiations and move over to bank-wise negotiations.(Chapter IV, para. 4.26 )*

*(vii) This Committee is of the view that in today's increasingly challenging business environment, a large institution can only be led effectively by a Chief Executive who has a reasonable length of tenure, which the Committee believes should not be less than five years. Since, however, moving over to this tenure may be difficult, we suggest that in the first instance, the minimum tenure should be three years. The Committee feels that there is now a need to delink the pay scales of the Chief Executives of public sector banks and financial institutions from the Civil Service pay scales and that this should be left to be decided by the individual banks, not excluding the possibility of performance based remuneration. The Committee would like to add that these observations and recommendations also apply to the whole time Directors on the Boards of banks and financial institutions appointed by the Government. (Chapter IV, para.4.29 – 4.30 )*

*(viii) There may be need to redefine the scope of external vigilance and investigative agencies with regard to banking business. External agencies should have the requisite skill and expertise to take into account the commercial environment in which decisions are taken. The vigilance manual now being used has been designed mainly for use by Government Departments and public sector undertakings. It may be necessary that a separate vigilance manual which captures the special features of banking should be prepared for exercising vigilance supervision over banks. The Committee feels that this is an extremely critical area and arrangements similar to the Advisory Board for Bank Frauds be made for various levels of staff of banks.(Chapter IV, para. 4.35 – 4.37)*

The recommendation pertaining to reasonable length of tenure for the Chief Executive has been implemented while appointing the new Chairmen of PSBs. As regards the recommendation regarding delinking of pay scales of Chief Executives of public sector banks from that of the Civil Service, this will have to be considered by the Government.

A separate chapter capturing special features of banking transactions has been incorporated in the Vigilance Manual.

*(ix) The Committee attaches the greatest importance to the issue of functional autonomy with accountability within the framework of purposive, rule bound, non-discretionary prudential regulation and supervision. Autonomy is a prerequisite for operational flexibility and for critical decision making whether in terms of strategy or day to day operations. There is also the question whether full autonomy with accountability is consistent and compatible with public ownership. Given the dynamic context in which the banks are operating and considering the situational experience further capital enhancement would be necessary for the larger Indian banks. Against the background of the need for fiscal consolidation and given the many demands on the budget for investment funds in areas like infrastructure and social services, it cannot be argued that subscription to the equity of public sector banks to meet their enhanced needs for capital should command priority. Public sector banks should be encouraged, therefore, to go to the market to raise capital to enhance their capital. At present, the laws stipulate that not less than 51% of the share capital of public sector banks should be vested with the Government and similarly not less than 55% of the share capital of the State Bank of India should be held by the Reserve Bank of India.*

*The current requirement of minimum Government of India/Reserve Bank of India shareholding is likely to become a constraint for raising additional capital from the market by some of the better placed banks unless Government also decides to provide necessary budgetary resources to proportionately subscribe to the additional equity, including the necessary premium on the share price, so as to retain its minimum stipulated shareholding. The Committee believes that these minimum stipulations should be reviewed. It suggests that the minimum shareholding by Government/RBI in the equity of nationalised banks and SBI should be brought down to 33%.*

Banks have been given further autonomy in matters relating to their business operations. These relate to greater autonomy to open branches, freedom to charge interest on advances as also on deposits, recruitment of specialist officers and other matters of corporate strategy.

Public sector banks are encouraged to go to the market raise capital to enhance their capital. Eleven public sector banks have since accessed the capital market for raising additional capital.

The recommendation has been accepted. The Bill to bring down the shareholding of the Govt. of India in nationalised banks has been introduced in Parliament.

The recommendation in regard to bringing down shareholding of the Govt. of India in nationalized banks to 33% has been accepted. A Bill has been introduced in the Parliament for the purpose.

*The Reserve Bank as a regulator of the monetary system should not be also the owner of a bank in view of the potential for possible conflict of interest. It would be necessary for the Government/RBI to divest their stake in these nationalised banks and in the State Bank of India. A reduction in their shares would come about through additional subscription by the market to their enhanced capital. A portion of upto 5 or 10% of the equity of the bank concerned may be reserved for employees of the bank with a provision of some later date for the introduction of stock options. The appointment by the Government of Boards and top executives of banks derives from its majority holding and if, as suggested above, the majority holding itself were to be given up, the appointment of Chairmen and Managing Directors should be left to the Boards of the banks and the Boards themselves left to be elected by shareholders.*

Govt. to reply.

*Needless to say, with a significant stock holding of not less than 33% Government would have a say in the election of Boards and indirectly of the chief executives without their being seen as administrative appointments. The reduction in the minimum holding of Government below 51% would in itself be a major and clear signal about the restoration to banks and financial institutions of autonomy in their functioning. The Committee makes this recommendation in the firm belief that this is essential for enhancing the effectiveness and efficiency of the system and not on any other consideration. (Chapter V, para 5.27 – 5.33)*

Govt. to reply.

*(x) To provide the much needed flexibility in its operations, IDBI should be corporatised and converted into a Joint Stock Company under the Companies Act on the lines of ICICI, IFCI and IDBI. For providing focussed attention to the work of State Financial Corporations, IDBI shareholding in them should be transferred to SIDBI which is currently providing refinance assistance to State Financial Corporations. To give it greater operational autonomy, SIDBI should*

Govt. to reply.

*also be delinked from IDBI (Chapter V, para 5.34).*

*(xi) Though cooperation is a state subject, since UCBs are primarily credit institutions meant to be run on commercial lines, the Committee recommends that this duality in control should be dispensed with. It should be primarily the task of the Board for Financial Supervision to set up regulatory standards for Urban Cooperative banks and ensure compliance with these standards through the instrumentality of supervision. (Chapter V, para 5.39)*

Govt. to reply

*(xii) The Committee is of the view that the banking system should be in a position to equip itself to identify the eligible clients based on prescribed norms in the Government sponsored programmes so that the full responsibility for all aspects of the credit decision remains with it. This should also help improve the client bank relationship instead of the present system of virtually imposed clientele and build a credit culture and discipline . (Chapter VI, para 6.3)*

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*(xiii) The Committee strongly urges that there should be no recourse to any scheme of debt waiver in view of its serious and deleterious impact on the culture of credit. (Chapter VI, para 6.7)*

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*(xiv) Evolution of a risk management system would provide the needed comfort to the banking system to finance agriculture. At present, under the Income Tax Act, provision for bad and doubtful debts not exceeding 5% of income and 10% of the aggregate average advances made by rural branches of a scheduled or a non scheduled bank are allowed as deduction in computing the income chargeable to tax. Consideration could be given to increasing this to 5% of income and 20% of average aggregate advances of rural branches to provide incentive to banks for lending to rural sectors.(Chapter VI, para 6.10)*

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*(xv) The Committee recommends that the RRBs and cooperative banks should reach a minimum of 8% capital to risk weighted assets over a period of five years. A review of the capital structure of RRBs should be undertaken with a view to enlarging public subscription and give the sponsor banks greater ownership and responsibility in the operation of RRBs. While considering the issue of salaries of employees of RRBs the Committee strongly urges that there should be no further dilution of the basic feature of RRBs as low cost credit delivery institutions. Cooperative credit institutions also need to enhance their capital through subscription by their members and not by Government. There should be a delayering of the cooperative credit institutions with a view to reducing the intermediation cost and thus providing the benefit of cheaper NABARD credit to the ultimate borrowers. (Chapter VI, para 6.12 )*

*(xvi) The supervisory function over rural financial institutions has been entrusted to NABARD. While this arrangement may continue for the present, over the longer term, the Committee would suggest that all regulatory and supervisory functions over rural credit institutions should vest with the Board for Financial Regulation and Supervision. ( Chapter VI para 6.13 )*

*(xvii) The present duality of control over the cooperative credit institutions by State Government and RBI/NABARD should be eliminated and all the cooperative banking institutions should come under the discipline of Banking Regulation Act, under the aegis of RBI/NABARD/BFS. Thus would require amendments to the Banking Regulation Act. The control of the Registrar of cooperative sector over cooperatives would then be somewhat on the lines of control that Registrar of Companies has over the Banking Institutions, registered under the Companies Act. (Chapter VI, para 6.14 )*

*(xviii) A legal framework that clearly defines the rights and liabilities of parties to*

This recommendation has been accepted in principle. Govt. of India is also contemplating suitable amendments to RRB Act, 1976 to facilitate further restructuring of RRBs involving changes in capital structure, ownership, etc. Pending amendments to RRB Act, sponsor banks have been entrusted with greater powers to guide and monitor the operations of RRBs. As regards the salary structure of employees of RRBs, the S.L. Mahalik Committee appointed by Reserve Bank of India has made certain recommendations on restructuring of the pay scales of RRB employees and these have been forwarded to the Govt. for consideration. As regards delayering of cooperative credit structure, the suggestion would be forwarded to NABARD for detailed examination. Govt. will have to consider amendment to the Cooperative Societies Act.

Govt. to reply since implementation of the recommendation would require amendments to relevant Acts.

Govt. to reply since implementation of the recommendation would require amendments to relevant Acts.

Govt. to reply.

*contracts and provides for speedy resolution of disputes is essential for financial intermediation. The evolution of the legal framework has not kept pace with the changing commercial practices and with the financial sector reforms. The Transfer of Property Act enacted in 1882 is a case in point.(Chapter VIII, para 8.1 )*

*(xix) Given the unsatisfactory state of the law of mortgage, the response has been to vest through special statute the power of sale in certain institutions like Land Development Banks and State Finance Corporations. This approach could be extended to other financial institutions and, if possible, to banks. The other approach is to set up special tribunals for recovery of dues to banks and financial institutions. These Tribunals need to have powers of attachment before judgement, for appointment of receivers and for ordering preservation of property. For this purpose, an amendment to the concerned legislation may be necessary. The Committee would like to emphasise the importance of having in place a dedicated and effective machinery for debt recovery for banks and financial institutions.(Chapter VIII, para 8.2 – 8.4 )*

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*(xx) Securitisation of mortgages is also critically dependent on the ease of enforcement and the costs associated with transfer of mortgages. The power of sale without judicial intervention is not available to any class of mortgages except where the mortgages is the Government or the mortgage agreement so provides and the mortgaged property is situated in Mumbai, Chennai and Calcutta and other towns so notified. Even if the power of sale without judicial intervention were available there would need to be measure to put the buyer in possession. (Chapter VIII, para 8.5 – 8.6 )*

Govt. to reply.

*(xxi) The question of stamp duties and registration fees also requires review. There is a case for reducing stamp duties and registration fees substantially.(Chapter VIII, para 8.7 )*

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(xxii) *In view of the recent amendments to Section 28 of Indian Contract Act, banks have expressed a fear that they can no longer limit their liabilities under bank guarantees to a specified period and that they would have to carry such guarantee commitments for long periods as outstanding obligations. Government departments do not generally return the original guarantee papers even after the purpose is served. This whole issue needs to be re-examined and bank guarantees exempted from the purview of the recent amendment to Section 28 of the Indian Contract Act. The issue of enforcing securities in the form of book debts also calls for review. The Committee also agrees with the proposal to amend the Sick Industrial Companies Act, seeking to trigger off the remedial mechanism on the sight of incipient sickness.*  
(Chapter VIII, para 8.9 – 8.14)

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(xxiii) *Certain legislative requirements would also be needed to implement some of the Committee's recommendations regarding the structure of the banking system and matters pertaining to regulation and supervision. The Banking Regulation Act is structured on the premise that bank supervision is essentially a Government function and that the Reserve Bank of India's position is somewhat on the lines of an agent. The Act also provides appellate powers to Government over the decisions of the RBI in this regard. It also provides original powers in certain instances. The Committee feels that these provisions should be reviewed.* (Chapter VIII, para 8.17)

Govt. to reply

(xxiv) *With respect to recommendations regarding constitution of a Board for Financial Regulation and Supervision, it would be necessary for amendments in the Banking Regulation Act and Reserve Bank of India Act. Amendments would also be needed in the Bank Nationalisation Acts to enable grant of greater managerial*

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*autonomy to public sector banks for lowering the minimum requirements of 51% Government ownership and as regards the constitution of Boards of Directors and of the Management Committees. The provisions relating to prior approval of Government for regulations framed under the Act would also need to be reviewed. In line with the above, amendments would also be needed in the State Bank of India Act with regard to shareholding of the RBI and constitution of its Central Board. (Chapter VIII, para 8.19 – 8.23 )*

*(xxv) These suggestions are not exhaustive and we would recommend that the legal implications with reference to each of these recommendations be examined and detailed legislative steps identified by the Ministry of Finance, Banking Division in consultation with the Ministry of Law. In view of the wide-ranging changes needed in the legal framework the Committee recommends setting up of an expert Committee comprising among others, representatives from the Ministry of Law, Banking Division, Ministry of Finance, RBI and some outside experts to formulate specific legislative proposals to give effect to the suggestions made above. (Chapter VII, para 8.22 – 8.23)*

An Expert Legal Group under the chairmanship of Shri. T. R. Andhyarujina, former Solicitor General, was set up . The Group's report is under examination of the Govt. of India.