The Indian Banking Sector

On the Road to Progress

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Overview of Banking and Financial Institutions

The Banking Sector

The banking system in India is significantly different from that of other Asian nations because of the country's unique geographic, social, and economic characteristics. India has a large population and land size, a diverse culture, and extreme disparities in income, which are marked among its regions. There are high levels of illiteracy among a large percentage of its population but, at the same time, the country has a large reservoir of managerial and technologically advanced talents. Between about 30 and 35 percent of the population resides in metro and urban cities and the rest is spread in several semi-urban and rural centers. The country's economic policy framework combines socialistic and capitalistic features with a heavy bias towards public sector investment. India has followed the path of growth-led exports rather than the "export-led growth" of other Asian economies, with emphasis on self-reliance through import substitution.

These features are reflected in the structure, size, and diversity of the country's banking and financial sector. The banking system has had to serve the goals of economic policies enunciated in successive five-year development plans, particularly concerning equitable income distribution, balanced regional economic growth, and the reduction and elimination of private sector monopolies in trade and industry. In order for the banking industry to serve as an instrument of state policy, it was subjected to various nationalization schemes in different phases (1955, 1969, and 1980). As a result, banking remained internationally isolated (few Indian banks had presence abroad in international financial centers) because of preoccupations with domestic priorities, especially massive branch expansion and attracting more people to the system. Moreover, the sector has been assigned the role of providing support to other economic sectors such as agriculture, small-scale industries, exports, and banking activities in the developed commercial centers (i.e., metro, urban, and a limited number of semi-urban centers).

The banking system's international isolation was also due to strict branch licensing controls on foreign banks already operating in the country as well as entry restrictions facing new foreign banks. A criterion of reciprocity is required for any Indian bank to open an office abroad.

These features have left the Indian banking sector with weaknesses and strengths. A big challenge facing Indian banks is how, under the current ownership structure, to attain operational efficiency suitable for modern financial intermediation. On the other hand, it has been relatively easy for the public sector banks to recapitalize, given the increases in nonperforming assets (NPAs), as their Government-dominated ownership structure has reduced the conflicts of interest that private banks would face.

Financial Structure

The Indian financial system comprises the following institutions:

1. Commercial banks
   a. Public sector
   b. Private sector
   c. Foreign banks
   d. Cooperative institutions
      (i) Urban cooperative banks
      (ii) State cooperative banks
      (iii) Central cooperative banks
2. Financial institutions
   a. All-India financial institutions (AIFIs)
   b. State financial corporations (SFCs)
   c. State industrial development corporations (SIDCs)
3. Nonbanking financial companies (NBFCs)
4. Capital market intermediaries

About 92 percent of the country's banking segment is under State control while the balance comprises private sector and foreign banks. The public sector commercial banks are divided into three categories.

Table 1: Public Equities by Public Sector Banks, 1993–1998 (Rs billion)

Name of Bank	Date of Issue	Equity Before Public Issue	Public Issue			Equity After Public Issue			Percent Share	
			Equity	Premium	Total	Government[a]	Others	Total	Government[a]	Others
State Bank of India	December 1993	2.00	2.74	19.38	22.12	3.14	1.60	4.74	66.34	33.66
State Bank of India (GDR)	October 1996	4.74	0.52	12.18	12.70	3.14	2.12	5.26	59.73	41.27
State Bank of Bikaner & Jaipur	November 1997	0.36	0.14	0.60	0.73	0.38	0.13	0.50	75.00	25.00
Oriental Bank of Commerce	October 1994	1.28	0.65	3.00	3.60	1.28	0.65	1.93	66.48	33.52
Dena Bank	December 1996	1.47	0.60	1.20	1.80	1.47	0.60	2.07	71.00	29.00
Bank of Baroda	December 1996	1.96	1.00	7.50	8.50	1.96	1.00	2.96	66.88	33.12
Bank of India	February 1997	4.89	1.50	5.25	6.75	4.89	1.50	6.39	77.00	23.00
Corporation Bank	October 1997	0.82	0.38	2.66	3.04	0.82	0.38	1.20	68.33	31.67
State Bank of Travancore	January 1998	0.35	0.15	0.75	0.90	0.38	0.12	0.50	76.00	24.00
Total			**7.68**	**52.52**	**60.15**					

GDR = global depository receipt.
[a] Reserve Bank of India/State Bank of India.
Source: Reserve Bank of India.

State bank group (eight banks): This consists of the State Bank of India (SBI) and Associate Banks of SBI. The Reserve Bank of India (RBI) owns the majority share of SBI and some Associate Banks of SBI.[1] SBI has 13 head offices governed each by a board of directors under the supervision of a central board. The boards of directors and their committees hold monthly meetings while the executive committee of each central board meets every week.

Nationalized banks (19 banks): In 1969, the Government arranged the nationalization of 14 scheduled commercial banks in order to expand the branch network, followed by six more in 1980. A merger reduced the number from 20 to 19. Nationalized banks are wholly owned by the Government, although some of them have made public issues. In contrast to the state bank group, nationalized banks are centrally governed, i.e., by their respective head offices. Thus, there is only one board for each nationalized bank and meetings are less frequent (generally, once a month).

The state bank group and nationalized banks are together referred to as the public sector banks (PSBs). Tables 1 and 2 provide details of public issues and post-issue shareholdings of these PSBs.

Table 2: Issue of Subordinated Debt Instruments for Inclusion in Tier-2 Capital During the Year Ended March 1998 (Rs billion)

Name of Bank	Amount Permitted	Amount Raised
Punjab & Sind Bank	1.0	1.0
Bank of India	7.0	nil
Syndicate Bank	0.8	0.6
Dena Bank	2.0	1.5

Source: Reserve Bank of India.

Regional Rural Banks (RRBs): In 1975, the state bank group and nationalized banks were required to sponsor and set up RRBs in partnership with individual states to provide low-cost financing and credit facilities to the rural masses.

Table 3 presents the relative scale of these public sector commercial banks in terms of total assets. The table clearly shows the importance of PSBs.

Table 3: Structure of the Banking Industry in Terms of Total Assets, March 1997

Bank	Number	Total Assets (Rs billion)
State Bank of India and associates	8	2,043.56
Nationalized banks	19	3,519.05
Old private sector banks	25	444.54
New private sector banks	9	161.13
Foreign banks	39	559.11
Regional rural banks	196	190.51[a]

[a]As of March 1996.
Source: Reserve Bank of India.

More than 40,000 NBFCs exist, 10,000 of which had deposits totaling Rs1,539 billion as of March 1996. After public frauds and failure of some NBFCs, RBI's supervisory power over these high-growth and high-risk companies was vastly strengthened in January 1997. RBI has imposed compulsory registration and maintenance of a specified percentage of liquid reserves on all NBFCs.

Reserve Bank of India and Banking and Financial Institutions

RBI is the banker to banks—whether commercial, cooperative, or rural. The relationship is established once the name of a bank is included in the Second Schedule to the Reserve Bank of India Act, 1934. Such bank, called a scheduled bank, is entitled to facilities of refinance from RBI, subject to fulfillment of the following conditions laid down in Section 42 (6) of the Act, as follows:

- it must have paid-up capital and reserves of an aggregate value of not less than an amount specified from time to time; and
- it must satisfy RBI that its affairs are not being conducted in a manner detrimental to the interests of its depositors.

The classification of commercial banks into scheduled and nonscheduled categories that was introduced at the time of establishment of RBI in 1935 has been extended during the last two or three decades to include state cooperative banks, primary urban cooperative banks, and RRBs. RBI is authorized to exclude the name of any bank from the Second Schedule if the bank, having been given suitable opportunity to increase the value of paid-up capital and improve deficiencies, goes into liquidation or ceases to carry on banking activities.

A system of local area banks announced by the Government in power until 1997 has not yet taken root. RBI has given in principle clearance to five applicants.

Specialized development financial institutions (DFIs) were established to resolve market failures in developing economies and shortage of long-term investments. The first DFI to be established was the Industrial Finance Corporation of India (IFCI) in 1948, and was followed by SFCs at state level set up under a special statute. In 1955, Industrial Credit and Investment Corporation of India (ICICI) was set up in the private sector with foreign equity participation. This was followed in 1964 by Industrial Development Bank of India (IDBI) set up as a subsidiary of RBI. The same year saw the founding of the first mutual fund in the country, the Unit Trust of India (UTI).

A wide variety of financial institutions (FIs) has been established. Examples include the National Bank for Agriculture and Rural Development (NABARD), Export Import Bank of India (Exim Bank), National Housing Bank (NHB), and Small Industries Development Bank of India (SIDBI), which serve as apex banks in their specified areas of responsibility and concern. The three institutions that dominate the term-lending market in providing financial assistance to the corporate sector are IDBI, IFCI, and ICICI. The Government owns insurance companies, including Life Insurance Corporation of India (LIC) and General Insurance Corporation (GIC). Subsidiaries of GIC also provide substantial equity and loan assistance to the industrial sector, while UTI, though a mutual fund, conducts similar operations. RBI also set up in April 1988 the Discount and Finance House of India Ltd.

(DFHI) in partnership with SBI and other banks to deal with money market instruments and to provide liquidity to money markets by creating a secondary market for each instrument. Major shares of DFHI are held by SBI.

Liberalization of economic policy since 1991 has highlighted the urgent need to improve infrastructure in order to provide services of international standards. Infrastructure is woefully inadequate for the efficient handling of the foreign trade sector, power generation, communication, etc. For meeting specialized financing needs, the Infrastructure Development Finance Company Ltd. (IDFC) was set up in 1997. To nurture growth of private capital flows, IDFC will seek to unbundle and mitigate the risks that investors face in infrastructure and to create an efficient financial structure at institutional and project levels. IDFC will work on commercial orientation, innovations in financial products, rationalizing the legal and regular framework, creation of a long-term debt market, and best global practices on governance and risk management in infrastructure projects.

NBFCs undertake a wide spectrum of activities ranging from hire purchase and leasing to pure investments. More than 10,000 reporting NBFCs (out of more than 40,000 NBFCs operating) had deposits of Rs1,539 billion in 1995/96. RBI initially limited their powers, aiming to moderate deposit mobilization in order to provide depositors with indirect protection. It regulated the NBFCs under the provisions of Chapter IIIB of the RBI Act of 1963, which were confined solely to deposit acceptance activities of NBFCs and did not cover their functional diversity and expanding intermediation. This rendered the regulatory framework inadequate to control NBFCs. The RBI Working Group on Financial Companies recommended vesting RBI with more powers for more effective regulation of NBFCs. A system of registration was introduced in April 1993 for NBFCs with net owned funds (NOF) of Rs5 million or above.

Magnitude and Complexity of the Banking Sector

The magnitude and complexity of the Indian banking sector can be understood better by looking at some basic banking data. Table 4 shows classification of banks based on working funds.

Table 4: Classification of Banks Based on Working Funds, as of 31 March 1997

Classification	Working Funds (Rs billion)
Small	Up to 50
Medium	50–100
Large	100–250
Very Large	250–500
Exceptionally Large	Above 500

Source: Reserve Bank of India.

In terms of growth, the number of commercial bank branches rose eightfold from 8,262 in June 1969 (at the time of nationalization of 14 banks) to 64,239 in June 1998. The average population per bank branch dropped from 64,000 in June 1969 to 15,000 in June 1997, although in many of the rural centers (such as in hill districts of the North), this ratio was only 6,000 people per branch. This was achieved through the establishment of 46,675 branches in rural and semi-urban areas, accounting for 73.5 percent of the network of branches. As of March 1998, deposits of the banking system stood at Rs6,013.48 billion and net bank credit at Rs3,218.13 billion.

The number of deposit accounts stood at 380 million and the number of borrowing accounts at 58.10 million. Tables 5, 6, and 7 reflect the diversification of branch network attained by commercial banks, the regional balance observed since nationalization, and stagnation in branch expansion in the post-reform period. There has been a net decline in the number of rural branches and a marginal rise in the number of semi-urban branches.

The outreach of cooperative banks and RSBs is shown in Table 8.

In an effort to increase the flow of funds through cooperative banks, the resources of the main

Table 5: Bank Group and Population Groupwise Distribution of Commercial Bank Branches in India

Bank Group	As of 30 June 1997					As of 30 June 1998				
	Rural	Semi-urban	Urban	Metropolitan	Total	Rural	Semi-urban	Urban	Metropolitan	Total
	Number of branches					Number of branches				
State Bank of India	4,127	2,412	1,346	936	8,821	4,120	2,414	1,358	947	8,839
Associate Banks of SBI	1,387	1,490	718	605	4,200	1,389	1,505	744	623	4,261
Nationalized banks	13,897	6,518	5,971	5,083	31,469	13,914	6,616	6,100	5,176	31,806
Indian private sector banks	1,136	1,567	1,049	783	4,535	1,145	1,609	1,102	860	4,716
Foreign banks in India	0	3	17	161	181	0	3	17	168	188
Nonscheduled banks	3	2	1	2	8	3	2	1	3	9
Regional rural banks	12,368	1,791	277	3	14,439	12,311	1,822	282	5	14,420
Total	**32,918**	**13,783**	**9,379**	**7,573**	**63,653**	**32,882**	**13,971**	**9,604**	**7,782**	**64,239**
	Percent distribution					Percent distribution				
State Bank of India	46.8	27.3	15.3	10.6	100.0	46.6	27.3	15.4	10.7	100.0
Associate Banks of SBI	33.0	35.5	17.1	14.4	100.0	32.6	35.3	17.5	14.6	100.0
Nationalized banks	44.2	20.6	19.0	16.2	100.0	43.7	20.8	19.2	16.3	100.0
Indian private sector banks	25.0	34.6	23.1	17.3	100.0	24.3	34.1	23.4	18.2	100.0
Foreign banks in India	0.0	1.7	9.4	88.9	100.0	0.0	1.6	9.0	89.4	100.0
Nonscheduled banks	37.5	25.0	12.5	25.0	100.0	33.3	22.3	11.1	33.3	100.0
Regional rural banks	85.7	12.4	1.9	0.0	100.0	85.4	12.6	2.0	0.0	100.0
Total	**51.7**	**21.7**	**14.7**	**11.9**	**100.0**	**51.2**	**21.7**	**15.0**	**12.1**	**100.0**

Sources: Indian Bank's Association, Reserve Bank of India.

refinancing agency, NABARD, were boosted substantially through deposits under the Rural Infrastructure Development Fund placed by commercial banks, as well as through the improvement of NABARD's capital base and increase in the general line of credit by RBI. The functioning of cooperative banking institutions did not show much improvement during 1996/97 and 1997/98. With deposits and credit indicating general deceleration, the overdue position of these institutions remained more or less stagnant. However, cooperative banks emulated the changing structure and practices of the commercial banking sector in revamping their internal systems, ensuring in the process timely completion of audit and upgrading of their financial architecture. In various regions, there is a differing pattern of cooperative banking, determined according to the strength of the cooperative movement. Some cooperatives such as those in the dairy and sugar sectors are as big as corporate entities. In fact, dairy cooperatives compete with multinational corporations such as Nestlé.

There is also a category in the cooperative sector called primary (urban) cooperative banks (PCBs). As of March 1998, there are 1,416 reporting PCBs catering primarily to the needs of lower- and middle-income groups. These are mainly commercial in character and located mostly in urban areas. Some have become a competitive force with notably big branch network and high growths recorded. As of 1998, PCBs have deposits of Rs384.72 billion and advances of Rs264.55 billion, as indicated in Table 9. Table 10 shows the gross NPA ratio of PCBs.

The advances of PCBs fall in the majority of categories of priority sectors prescribed for PSBs and their recovery performance is better than that of PSBs.

The cooperative banks also perform basic functions of banking but differ from commercial banks in the following respects:

- commercial banks are joint-stock companies under the Companies Act of 1956, or public sector banks under a separate Act of the Parliament.

Table 6: Credit-Deposit Ratio and Investment-and-Credit-Deposit Ratio of Scheduled Commercial Banks, By Region (percent)

	Credit-Deposit Ratio				Investment-and-Credit-Deposit Ratio	
Region	1995	1996	1997	1998	1995	1996
Northern Region	48.6	60.8	51.0	54.5	53.4	66.5
Northeastern Region	35.6	34.5	29.9	58.5	68.8	56.9
Eastern Region	47.1	47.7	39.8	63.2	62.7	63.4
Central Region	39.0	40.5	35.1	55.1	57.3	55.7
Western Region	63.2	69.4	65.5	68.0	67.2	73.9
Southern Region	69.4	76.6	72.3	80.5	80.9	87.1

Sources: Indian Bank's Association, Reserve Bank of India.

Table 7: Distribution of Commercial Bank Branches, By Region[a]

	Number of Branches			Average Population per Bank Branch (thousand)		
Region	1969	1997	1998	1969	1997	1998
Northern Region	1,253	10,003	10,159	46	12	12
Northeastern Region	90	1,898	1,898	203	19	20
Eastern Region	878	11,506	11,567	135	18	18
Central Region	1,090	13,143	13,225	115	18	18
Western Region	1,955	9,828	9,951	38	14	14
Southern Region	2,996	17,267	17,430	44	13	13

[a] Data are as of June 30 of each year.
Sources: Indian Bank's Association, Reserve Bank of India.

Table 8: Outreach of Cooperative Banks and Regional Rural Banks, as of March 1997

Name	Number of Banks	Number of Branches	Deposits (Rs billion)	Loans and Advances (Rs billion)
SCBs	28	779	1,764.92	289.46
DCCBs	364	11,791	288.12	299.57
RRBs	196	14,513	167.64	85.00
SCARDBs	19	854	1.63	21.51
PCARDBs	738	745	. 0.59	14.52

DCCB = district credit cooperative bank, PCARDB = primary cooperative agriculture and rural development bank, RRB = regional rural bank, SCB = scheduled commercial bank, SCARDB = state cooperative and agricultural rural development bank.
Sources: Reserve Bank of India, National Bank for Agriculture and Rural Development.

Table 9: Primary (Urban) Cooperative Bank Deposits and Other Funds (Rs billion)

Item	1996	1997	1998
Owned funds	38.48	46.95	56.59
Deposits	241.65	307.14	384.72
Borrowings	7.58	6.19	8.39
Loans outstanding	179.08	215.50	264.55
Number of reporting banks	1,327	1,363	1,416

Source: Reserve Bank of India.

Table 10: Gross Nonperforming Asset Ratio of Primary (Urban) Cooperative Banks

Period[a]	Number of Reporting PCBs	NPA/Total Advances (%)
1995	832	13.9
1996	1,161	12.9
1997	1,363	13.3
1998	179	11.0

NPA = nonperforming asset, PCB = primary (urban) cooperative bank.
[a] As of 31 March.
Source: Reserve Bank of India.

Cooperative banks were established under the Cooperative Societies Acts of different states;
- cooperative banks have a three-tier setup, with state cooperative bank at the apex, central/district cooperative banks at district level, and primary cooperative societies at rural level;
- only some of the sections of the Banking Regulation Act of 1949 (fully applicable to commercial banks), are applicable to cooperative banks, resulting in only partial control by RBI of cooperative banks; and
- cooperative banks function on the principle of cooperation and not entirely on commercial parameters.

Policy Issues in the Banking Sector

The Nonperforming Asset Problem

OPTIMISM WITH RESPECT TO THE NONPERFORMING ASSET PROBLEM

The NPAs of public sector banks were recorded at about Rs457 billion in 1998 (Table 11). By 1997/98 banks had managed to recover Rs250 billion and provisioned for Rs181.39 billion. But since new sets of loans go bad every year, the absolute figures could be increasing. About 70 percent of gross NPAs are locked up in "hard-core" doubtful, and loss assets, accumulated over years. Most of these are backed by securities, and, therefore, recoverable. But these are pending either in courts or with the Board for Industrial and Financial Reconstruction (BIFR).

Table 11: Nonperforming Asset Level and Ratios of Public Sector Banks

Year	Gross NPAs (Rs billion)	NPA/Gross Advances (percent)	NPA/ Total Assets (percent)
1993	392.53	23.2	11.8
1994	410.41	24.8	10.8
1995	383.85	19.5	8.7
1996	416.61	18.0	8.2
1997	435.77	17.8	7.8
1998	456.53	16.0	7.0

NPA = nonperforming assets.
Source: Reserve Bank of India.

NPAs in Indian banks as a percentage of total assets is quite low. The NPA problem of banking institutions in India is exaggerated by deriving NPA figures based on percentage against risk assets instead of total earning assets. The Indian banking system also makes full provisions and not net of collaterals as practiced in other countries.

Narasimham Committee (II) noted the danger of opaque balance sheets and inefficient auditing systems resulting in an underrating of NPAs. Nevertheless, there is a general feeling that the NPA problem is manageable. Considerable attention is being devoted to this problem by RBI, individual banks, and shareholders (Government and private).

With the increasing focus internationally on NPAs during the 1990s affecting the risk-taking behavior of banks, governments and central banks have typically reacted to the problem differently depending on the politico-economic system under which the banks operate. In some countries such as Japan, banks have been encouraged to write off bad loans with retained earnings or new capital or both. This ensures that the cost of resolving the NPA problem is borne by the banks themselves. However, this policy is not suitable for countries such as India where the banks neither have adequate reserves nor the ability to raise new capital. In some countries, the banks are State owned so the final responsibility of resolving the problem lies with the respective national government. In these cases, the governments concerned have been forced to securitize the debt through debt underwriting and recapitalization of the banks. For instance, in Hungary, guarantees were established for all or part of the bad loans with the banking system, while in Poland, loans have been consolidated with the help of long-term restructuring bonds.

Most of these countries have emphasized efforts to recover the bad loans from the borrowers, usually in conjunction with one or both the measures mentioned above. If direct sale of the assets of defaulting firms was deemed nonviable, banks were encouraged to coerce these firms to restructure. The former

Table 12: Outstanding Advances to Priority Sectors by Public Sector Banks

Type	June 1969	March 1994	March 1995	March 1996	March 1997	March 1998
			Amount (Rs billion)			
Agriculture	162.00	212.04	235.13	263.51	310.12	343.05
Small-scale industries	257.00	215.61	258.43	294.82	315.42	381.09
Others[a]	22.00	104.32	124.38	137.51	165.48	188.81
Total	**441.00**	**531.97**	**617.94**	**696.09**	**791.31**	**913.19**
			Percent of Net Bank Credit			
Agriculture	5.4	15.0	13.9	14.3	16.4	15.7
Small-scale industries	8.5	15.3	15.3	16.0	16.6	17.5
Others[a]	0.7	7.4	7.4	7.5	8.7	8.7
Total	**14.6**	**37.8**	**36.6**	**37.8**	**41.7**	**41.8**

[a] Include small transport operations, self-employed persons, rural artisans, etc.
Source: Reserve Bank of India, *Report on Trend and Progress of Banking in India 1997/98,* July 1997–June 1998.

Czechoslovakia and Poland, for example, consolidated all NPAs into one or more "hospital" banks, which were then vested with the responsibility to recover the bad loans. In Poland, this centralization of the recovery process was supplemented by regulations that authorized the loan recovery agency to force the defaulting industrial units to either restructure or face liquidation. Other countries such as Bulgaria created "hospital" banks and legalized swap of debt for equity that gave banks stakes in the defaulting firms, and hence provided them with the incentive and the power to restructure the enterprises.

In India, conversion of loans into equity is an option that should be seriously considered instead of attempting recovery solely through either or both legal means and an asset reconstruction company (ARC). Unlike NPAs, the substitute asset of equity will be an intangible investment ready for sale to potential buyers. The DFIs have a formal conversion clause for debt to be exchanged for equity that ought to be exercised not only if it is an NPA but also if the equity is appreciating. This clause has not been so far much exercised.

MAIN CAUSES OF NONPERFORMING ASSETS

One of the main causes of NPAs in the banking sector is the directed loans system under which commercial banks are required to supply a prescribed percentage of their credit (40 percent) to priority sectors. Table 12 shows that credit supply of PSBs to the priority sectors has increased gradually to a little more than 40 percent of total advances as of March 1998. Loans to weaker sections of society under state subsidy schemes have led borrowers to expect that like a nonrefundable state subsidy, bank loans need not be repaid.

Directed loans supplied to the "micro sector" are problematic of recoveries especially when some of its units become sick or weak. Table 13 shows PSB loans to sick/weak industrial units. Nearly 7 percent of PSB's net advances was directed to these units. Clearly, these units are one of the most significant sources of NPAs, rather than bank mismanagement on the scale that has been seen in Japan and some Southeast Asian countries. The weakness of the banking sector revealed by the accumulated NPAs stems more from the fact that Indian banks have to

Table 13: Public Sector Banks' Loans to Sick/Weak Industrial Units (Rs billion)

Item	SSI Sick Units		Non-SSI Sick Units		Non-SSI Weak Units		Total	
	1996	1997	1996	1997	1996	1997	1996	1997
Potentially viable units	6.36	4.79	33.66	31.07	5.12	5.57	45.14	41.43
Nonviable units	29.44	30.32	26.24	25.27	3.31	2.96	58.99	58.55
Viability not decided	1.42	0.98	28.33	29.60	3.61	7.11	33.36	37.89
Total	**37.22**	**36.09**	**88.23**	**86.14**	**12.04**	**15.64**	**137.49**	**137.87**

SSI = small-scale industry.
Source: Reserve Bank of India, *Report on Trend and Progress of Banking in India 1997/98,* November 1997.

serve social functions of supporting economically weak sectors with loans at subsidized rates.

The Narasimham Report (II) recommended that the directed credit component should be reduced from 40 to 10 percent. As the directed credit component of the priority sectors arises from loan schemes requiring Government approval of beneficiaries, banks' selection standards with regard to eligible borrowers are being interfered with. The nexus of subsidies should be eliminated from bank loan schemes. Targets or prescribed percentages of credit allocation toward the priority sectors should not be confused with directed credit.

Government subsidy schemes were intended originally to prompt bankers to lend to weaker sectors. But as the directed credit component became partly politicized and bureaucratized, the realization has grown that priority sector bank credit should operate with the required degree of risk management.

However, the dangers of the priority credit system to sound banking should not be exaggerated. The shackles of "directed lending" have been removed and replaced by tests of commercial viability. Economic activities classified under priority sector have undergone a metamorphosis and upgrade since 1969 when banks were first nationalized and assigned the role of financing the sector. The expansion of the definition of the priority sector, upgrade in the value limit to determine small-scale industry (SSI) status, and provision for indirect lending through placement of funds with NABARD and SIDBI have lightened the performance load of banks. Thus, priority sector financing is no longer a drag on banks. But in the long term, Indian banks should be freed from subsidized lending.

The scope in India for branch expansion in rural and semi-urban areas is vast and also necessary. Increasingly, NBFCs operating at such places are coming under regulatory pressure and are likely to abandon their intermediation role. Banks will have to move in to fill the void and these branches will find priority sector financing as the main business available especially in rural/semi-urban centers.

Operational restructuring of banks should ensure that NPAs in the priority sectors are reduced, but not priority sector lending. This will remain a priority for the survival of banks. Any decisions about insulating Indian banks from priority sector financing should not be reached until full-scale research is undertaken, taking into account several sources including records of credit guarantee schemes.

SMALL-SCALE INDUSTRIES: DECLINE IN SICK UNITS AND NONPERFORMING ASSETS

In 1996-1997, banks conducted a viability study across the country of 229,234 SSI units and identified 16,220 units as being potentially viable. In its report on *Currency and Finance*, RBI said that the number of sick units fell from 262,376 in March 1996 to 235,032 in March 1997. Of the viable units, 10,539 units had outstanding credit of Rs32.22 billion under a nursing program for turnaround or rehabilitation. The RBI has called for half-yearly reports from banks to monitor progress in industrial rehabilitation. In addition, it has also issued guidelines to banks on the need for proper coordination between them and term-lending institutions in the formulation and implementation of a rehabilitation program.

The main causes of industrial sickness in non-SSI units were internal factors such as deficiencies in project management (44.8 percent of the cases) and shortcomings in project appraisals (7.2 percent), as well as external factors such as nonavailability of raw materials, power shortages, transport and financial bottlenecks, increases in overheads, changes in Government policy, and demand shortfalls. The report notes that the number of sick/weak units, both SSIs and non-SSIs, decreased by 27,350 (10.3 percent) from 264,750 in March 1996 to 237,400 at end-March 1997. However, the amount of outstanding bank credit in this regard increased by Rs3.88 billion (3 percent) during 1996/97 to Rs137.87 billion.

The SSI sector accounted for about 99 percent of the total sick units, but the share in total bank credit outstanding to such units was only 26.2 percent. The

number of non-SSI sick units declined marginally from 2,374 in March 1996 to 2,368 in March 1997. Outstanding bank credit to these units also showed a decline of 2.4 percent from Rs88.23 billion at end-March 1996 to Rs86.14 billion in March 1997. The priority sector to which SSI belongs is not such a burden on banks. On the contrary, it offers a good spread of risks and business opportunities for all types of branches—metro, urban, semi-urban, and rural. On the other hand, in the case of non-SSI industrial units, banks are not the only source of institutional finance, a major part of which comes from AIFIs at the project formulation stage. There will be a need to separately study NPAs in which banks and AIFIs have common exposure.

COMPARISON WITH ASIAN COUNTRIES

NPA figures may be high in Indian banks, but certain factors need to be noted before comparing the country's system with that of other Asian nations. For instance, only 48 percent of banking institutions' assets are in corporate loans. The high level of preemption of bank funds by the Government in the form of cash reserve requirement (CRR) and statutory liquidity requirement (SLR) is one of the reasons for low profitability of banks and poor returns on assets. However, in times of stress, such as the recent economic crisis, these same assets provide balance sheet strength. India's contrast with the crisis-affected countries is clear from Table 14. Bank recapitalization needs in India are the lowest as a percentage of gross domestic product (GDP) while their contribution to developmental banking is high. This emphasizes the need for the Government to back the PSBs even in the weak category.

INCOME RECOGNITION

RBI guidelines stipulate that interest on all NPAs should not be charged and considered in the income account. The guidelines create some complications in the accounting system. For instance, if a loan has turned into an NPA shortly before the end of a financial year, the interest payments during the current and previous financial years are considered not yet earned and the corresponding book entries recognizing interest income should be reversed. The definition of income recognition has become a critical issue in presenting a clear picture on the profit/loss account of banks. A review and, if necessary, change in the guidelines and accounting system should immediately be undertaken.

CORPORATE ACCOUNTS—TRANSPARENCY

One of the important amendments introduced by the Companies (Amendment) Ordinance in 1998[2] requires that companies comply with accounting standards. As a step towards good corporate governance and better disclosure and presentation of accounts, it is a milestone. However, it was introduced and implemented in a halfhearted way. While the auditor was required to check on compliance with accounting standards, there was no statutory requirement for the company to make such compliance. Now the ordinance says that companies shall comply with accounting standards as defined.

The requirement covers all companies, public or private, listed or unlisted. That accounting standards are now compulsory is contradicted by the requirement that if the accounting standards are not complied with, the fact of such noncompliance, and the reasons and the financial effect of such

Table 14: Banks' Recapitalization Needs in Asia

Country	GDP 1997 ($ billion)	Recapitalization Needs ($ billion)	Recapitalization/GDP (percent)	Loans/Assets (percent)
India	381	6.5	1.7	42
Indonesia	205	25.0	12.2	70
Korea	442	63.0	14.3	52
Malaysia	95	9.0	9.5	69
Thailand	153	48.0	31.4	78

GDP = gross domestic product.

noncompliance shall be disclosed. It is possible that a company can get away with noncompliance merely by making the required disclosures.

The "going concern" is a fundamental accounting concept that allows financial statements to be prepared on the assumption that the enterprises will continue in operational existence in the foreseeable future. The Institute of Chartered Accounts of India in 1998 issued a Statement on Standard Auditing Practices (SAP 16) that aims to establish auditors' responsibilities regarding the appropriateness of the going concern assumption as a basis for preparing financial statements. It also elaborates the need for planning and conducting audits, gathering sufficient evidence, and exercising judgment whether the going concern assumption made by directors is appropriate. The practice was to be followed for accounting periods commencing on or after April 1999. The conclusion that a financial statement has been prepared for a going concern depends on a few fundamental uncertainties.

Prominent among these is availability of future funding, which may affect future results as well as investments needed and changes in capital structure. In addition, auditors will have to look at cash generated from operations and other cash inflows, capital funding and Treasury policies, inherent strengths and resources of the business, and availability of liquidity at the end of the period. All these extend the scope of the audit. Even if one accepts that auditors are capable of providing information about business risks that is useful to investors and other parties, it is questionable whether the benefits of expanding the auditors' role in this direction are likely to outweigh costs. Auditors are also required under the new statement to add a paragraph in their audit report that highlights the going concern problem by drawing attention to the relevant note in the financial statement. They must qualify their report, however, if the management does not make adequate disclosure in the financial statements.

Clients are unlikely to welcome the going concern qualification and their apprehension may well be reinforced if it restricts their freedom of action, by forcing covenants in loan agreements to be activated or by restricting the freedom to pay dividends. Moreover, because of the lack of any form of quantification, qualified reports are likely to be fuzzy and may differ significantly depending on the interpretation of each audit firm. Following well-settled international practice, it should be made mandatory for directors to confirm that the financial statements have been prepared on the basis of the going concern assumption. Auditors should then examine appropriate financial and other information and, if they are not satisfied, comment appropriately in their audit report.

PROBLEM OF THE REAL SECTOR VS. BANKING SECTOR REFORMS

Changes in M3 and its select components—net bank credit to Government (NBCG) and net bank credit to commercial sector (NBCCS)—show that credit offtake has slowed down and even declined in 1998/99 for NBCCS (see Tables 15 and 16). Government funding from banks has been rising in the last three years. An increase in new bank credit to

Table 15: Annual Changes in M3, 1990/91–1997/98 (Rs billion)

Year	M3	Variation	NBCG	Variation in NBCG	NBCCS	Variation in NBCCS
1990/91	2,658.28	na	1,401.93	na	1,717.96	na
1992/93	3,668.25	1,009.97	1,762.38	360.45	2,201.35	483.39
1993/94	4,344.07	675.82	2,039.18	276.80	2,337.74	136.39
1994/95	5,314.26	970.19	2,224.19	185.01	2,927.23	589.49
1995/96	6,040.07	725.81	2,557.78	333.59	3,446.48	519.25
1996/97	7,018.48	978.41	2,886.20	328.42	3,763.07	316.59
1997/98	8,253.89	1,235.41	3,306.19	419.99	4,321.90	558.83

na = not available.
NBCG = net bank credit to Government, NBCCS = net bank credit to commercial sector.
Source: Reserve Bank of India.

Table 16: **Monthly Changes in M3, March–July 1998/99 (Rs billion)**

Month	M3	Variation	NBCG	Variation in NBCG	NBCCS	Variation in NBCCS
March	8,253.89	na	3,306.19	na	4,321.90	na
April	8,376.64	122.75	3,360.85	64.76	4,316.36	(5.54)
May	8,460.14	83.50	3,497.40	136.55	4,298.30	(18.06)
June	8,554.03	93.89	3,601.38	203.98	4,286.27	(12.03)
July	8,616.23	62.20	3,666.97	65.59	4,329.23	42.96

na = not available, ( ) = negative values are enclosed in parentheses.
NBCG = net bank credit to Government, NBCCS = net bank credit to commercial sector.
Source: Reserve Bank of India.

the commercial sector in 1997/98 is partly due to liquidation of high cost external commercial borrowings. The real differences are more evident in 1998/99 (Table 16).

There is a close connection between the relatively small flow of finance to enterprises, the downward trend in the real sector, and the depressed stock market. The economy's downward trend has persisted despite several initiatives taken by the monetary authorities.

There has been a large-scale extension of bank credit to the Government at the expense of the commercial sectors. This suggests that the principal reason for the poor growth of bank loans is "inadequate" demand, which can be traced to developments in the real sector. The troubles faced by the real sector also seem to originate from a fall in market demand for goods. In many industries, output expansion has been nil to modest, often with inventory pileups. Adverse market conditions facing consumer goods industries strongly support the hypothesis concerning demand failure in the real sector.

A cut in the bank rate by itself will have a limited impact on the economy for the following reasons. First, even if producers expect to make profits on their investment and banks are willing to lend, investment may not materialize because of the difficulty of securing complementary finance from a depressed stock market. Second, banks may be too wary of lending or, more likely, may not have developed an efficient credit delivery system to the major part of the economy. Third, and most important, the large majority of producers would take a dim view of future profitability of investment in the context of infrastructural bottlenecks. The three problems are interrelated and suggest the need for short- and long-term measures.

The basic maladies affecting the financial sector in India are as follows:

- structural weakness of the real sector and lack of competitiveness in international markets, and
- underdeveloped credit delivery systems that fail to respond to fast changing situations.

Strengthening the viability of the real sector has much relevance to the future strength of the Indian financial system. The Committee on Capital Account Convertibility has not dwelt on the impact of expected inflows of capital in relation to efficiency and absorptive capacity of the real sector on the one hand, while emphasizing the needed strength of the financial sector on the other.

It is mainly the second malady that has to be overcome by banks and financial institutions. Future reforms will have to focus on how the real and the banking sectors can strengthen each other.

INDIAN CORPORATE SECTOR

The private sector's (gross) investment in plant and machinery rose from Rs120 billion per year (3 percent of GDP) in 1986-1990 to Rs730 billion per year (7 percent of GDP) in 1995-1997. A sixfold increase in investment in such a short span is a structural change brought about by strong macroeconomic fundamentals and corporate management. There were, however, deficiencies in the management of structural reforms.

The sequencing of the 1991 reforms seemed inappropriate. Securing quick gains in the form of foreign institutional investor (FII) inflows into the capital

market (instead of foreign direct investment [FDI]) failed to improve the real sector and fueled stock price rises (the Government also did not take advantage of disinvestment in public sector holdings). Capital market liberalization and opening up avenues of foreign funds raised through global depository receipt (GDR) issues, and other sources were not matched by a full upgrade and modernization of the industries to increase their competitiveness.

A persistent trade deficit is indicative of an incorrect sequencing of reforms (in contrast with the People's Republic of China [PRC], which from 1990 onwards boosted foreign reserves through trade surpluses from manufactured goods exports). Not many Indian listed companies have foreign trading exposure in the form of exports or imports. The concern for Indian banks and FIs naturally is the risk of underperformance of the real sector and lack of adequate cushion. Many companies have faced difficulties in coping with adverse foreign exchange fluctuation because of declines in the value of the rupee.

NPAs of banks with respect to corporate sector lending have been caused by the following:

- mindless diversification;
- neglect of core competencies;
- diversion of new equity raised into nontradable assets;
- inattention to cost controls;
- lack of coordination between banks and FIs; and
- rapid growth after liberalization of merchant banks, which hastily vetted projects and initial public offerings (IPOs) in the rush to beat competition, neglected to develop a debt market, and gave extraordinary support to raising of equity issues by the companies.

The depressed stock market has caused companies to turn back to banks for finance. The loss of investor confidence happened even after several reforms in the capital markets (some under the United States Agency for International Development's [USAID's] Financial Institutions Reform Expansion [FIRE]) program.

CORPORATE SECTOR CONTROL OF NONPERFORMING ASSETS

Banks, FIs, and the market by themselves cannot exercise control over companies. The reaction of investors to falls in bond and stock prices ensures that any damage is limited once there is a perception that something is wrong. Bank financing provides a shield to companies from such short-term market whims if the bank is satisfied the unit will pull through. In India, the process of disintermediation is of recent origin and DFIs have, in fact, a lot of hold on companies through their equity stakes and loan stakes in the units financed. Even as the role of the stock market expands, banks and DFIs still have a significant role as finance providers and some complementarity of controls (in terms of rigors of financial discipline) can be evolved to ensure corporate efficiency.

Banks are highly deficient on the stock market side (a position well established by the dismal record of mutual funds and merchant banking subsidiaries floated by most of the public sector banks). Their portfolios of investments in bonds and equities (which are 100 percent risk assets) need to be screened using credit risk assessment standards and not by market prices alone. Banks also must adopt methods of converting debt into equities in NPA accounts whenever possible to either ensure turnaround in corporate performance, or else sell equities to limit future losses. Currently, they do not have an exit route. The case for corporate control is presented in Table 17, which highlights the extent of cost consciousness in the corporate sector.

Despite competition and falling profits, there has been no significant improvement in cost structure. Also, the slowdown has not made cost consciousness a top concern. This is exactly what banks and FIs have to be worried about. Equity holders, banks, and FIs can position themselves as drivers of shareholder value. Credit risk analysis needs to be complemented by cost structure analysis and output efficiency with reference to the companies' capital and stock of borrowed funds. This is one reason why

Table 17: Cost Curve—Composition and Structure (as percent of sales)

Item	1989/90	1993/94	1994/95	1997/98
Raw materials, stores	49.2	48.5	49.0	49.4
Raw materials	38.3	36.2	37.0	37.4
Stores and spares	3.6	3.4	3.1	3.2
Packaging expenses	0.5	1.2	1.2	1.1
Purchase of finished goods	6.9	7.7	7.7	7.7
Wages and salaries	8.5	7.5	7.1	7.2
Energy (power and fuel)	5.9	6.1	5.8	5.9
Other manufacturing expenses	2.3	2.6	2.7	2.5
Direct taxes	13.5	12.5	12.9	11.6
Repair and maintenance	1.7	1.6	1.5	1.5
Selling and distribution expenses	4.6	5.1	5.1	5.8
Advertising	0.6	0.8	0.9	1.1
Marketing	1.4	1.6	1.5	1.6
Distribution	2.5	2.6	2.6	2.9
Amortization	0.0	0.1	0.1	0.1
Miscellaneous expenses	3.8	3.6	3.6	3.9
Nonrecurring expenses	0.5	0.3	0.2	0.3
Less: Expenses capitalized	0.3	0.4	0.2	0.4
Interest capitalized	0.0	0.2	0.3	0.3
Profit before depreciation, interest, and tax	14.0	15.7	17.2	16.1
Interest	4.9	5.2	4.5	5.2

Source: National Council for Applied Economic Research.

banks and FIs should maintain credit files on equity or other tradable instruments of each issuer. In the US, the Federal Reserve and Federal Deposit Insurance Corporation (FDIC) guidelines emphasize this type of credit control. While analyzing credit offtake volumes, RBI equates such portfolio holdings of banks to loans and advances. Qualitatively, the risk-control mechanism for the two categories of assets has to be on absolute par level.

Table 17 also reflects how interest from borrowing from banks and FIs remains high among total business costs of borrowers, while banks and FIs have high liquidity. This problem can be combated by macroeconomic intervention to reduce interest rates to enable the economy to expand and the banks to outgrow their problems, and by banks and FIs ensuring efficient use of capital by borrowers to improve allocative efficiency of resources.

The culture of just in time (JIT) inventories and quick response (QR) to maintain an efficient supply chain is still not evident in Indian business management. The credit delivery system is anchored around requirements of average/peak inventory holdings and outstanding receivables, although the earlier RBI stipulations of industry-wise norms have been abolished. Banks are now free to decide but buildup of current assets in borrowing units pushes up interest costs of borrowing for existing borrowers and results in nonavailability of resources to new borrowers. Surplus liquidity in banks today is not an indicator of efficient allocation of credit resources.

Other issues concerning corporate control emerge from closer analysis of how cash credits extended by banks became NPAs of defaulting borrowers while they floated new industries with the help of DFIs, as well as how BIFR cases have dragged on. There are 60 public sector units under BIFR review. Banks and FIs need to study how favored projects of the past became sick units later. Lack of transparency in the accounts of corporates helped them to disguise cash flow projections for sourcing credit from banks and FIs.

DEBT RECOVERY TRIBUNAL REVAMP

The final report of the working committee on Debt Recovery Tribunals (DRTs)[3] has recommended the revamp of the tribunals to ensure that they are not burdened with more than a specified number of cases. It has also called for the exclusion of cases under the Sick Industrial Companies Act (SICA) if these cases are filed with DRTs. In short, this will mean that DRTs could be given powers to override those of BIFR, and this is the greatest stumbling block to the recovery of bad debts.

According to the working group, not only should there be a tribunal in every state but there should also be more than one DRT in the same state if it is justified by the workload of the tribunals. The DRTs' prosecuting officers should not face more than 30 cases on any given date and there should not be more than 800 cases in the pipeline at any given point. If the number of cases exceeds 800, the Government should consider appointing more tribunals to deal with such cases.[4] While the working committee has

suggested that more recovery officers should be appointed to ensure speedy recovery of bank dues, it has also stated that recovery officers may be given the assistance of police and professional debt recovery agencies.

INADEQUACIES OF THE BOARD FOR INDUSTRIAL AND FINANCIAL RECONSTRUCTION

A total of 320 cases were registered with BIFR in 1998. This exceeded the 230 cases registered in 1997 and was a far cry from the 97 cases recorded in 1996. According to Board officials, a more than threefold rise in the number of cases registered since 1996 could be due to the competition that companies are facing because of economic liberalization.

On the other hand, the board seems to be unable to cope with the deluge of cases. It is working with only one bench and eight members. SICA provides that the board shall consist of a chairman and a minimum of two and maximum of 14 members. From January to November 1998, the board disposed only 127 cases compared to 220 cases in 1997. With the disposal of another five to ten cases in 1998, this adds up to a dismal record of about 135 cases—only almost half of the number of cases disposed in 1997.

PUBLIC SECTOR BANKS' BAD DEBTS: PARLIAMENTARY REVIEW

Government ownership in banks attracts parliamentary review. The Estimates Committee of Parliament takes a serious view of adverse comments made against top managements of PSBs and NPAs on account of transgression of powers. The committee called for a total revamp of the training system for bank officers. The committee also noted that public sector undertaking (PSU) banks have to be able to contain NPAs at a par with international standards where the tolerable levels of NPAs are "around 3 to 4 percent."

NONPERFORMING ASSETS OF ALL-INDIA FINANCIAL INSTITUTIONS

The net NPAs-total loans ratio at IDBI stood at 10.1 percent, ICICI at 7.7 percent, and IFCI at 13.6 percent as of 31 March 1998. However, loans from other AIFIs such as LIC, GIC, UTI, and their subsidiaries, Risk Capital and Technology Corporation (RCTC), Technology Development and Information Company of India (TDICI), and Tourism Finance Corporation of India (TFCI), to the industrial sector have been substantial, but the data on their NPAs are not readily available. For state-level institutions such as SFCs and SIDCs, which lend to medium-size industry and SSI sectors, the NPA data are also not readily available. State-level institutions benefit from a special recovery procedure allowed under their separate enactment. With the exception of IDBI, ICICI, and IFCI, the other AIFIs are not under RBI's regulatory discipline. There is a need to study features of their loan operations, credit control, and NPAs.

Disclosure, Accounting Framework, and Supervision

Greater transparency in banks' balance sheets and penal action by RBI, including against bank auditors, require highly focused action. Internal audits in banks, now supervised by audit committees of respective boards, have been more a formality than reflecting management's reporting responsibility to the stockholders of the banks. High standards of preventive and detective (internal) controls are required. Risk management with respect to "off-balance sheet items" requires considerable attention as evidenced by instances of losses on letters of credits and guarantees business. This applies also to auditing off-balance sheet items. At the macro level, the size of NPAs as a percentage of GDP provides a good measure to assess the soundness of the system.

The issue needs to be tackled in terms of market segments from which NPAs have emerged: not putting them simply under the umbrella of "priority sector," or "nonpriority sector" but individually, in much

wider market segments (for example, agriculture as a market segment has itself many subsegments).

PRUDENTIAL NORMS

RBI is considering changes in asset classification, income recognition, and provisioning norms in line with recommendations of the Basle Committee on Banking Supervision that were made public in October 1998. It remains to be seen if RBI will give banks and FIs discretion in the classifications of assets, partially replacing the prevailing rigid norms and redefining provisioning norms taking into account collateral. According to current practice, banks and FIs are required to make 10 percent provisioning on substandard assets and 20 percent on doubtful assets, even if the assets are backed by collateral.

The Basle Committee on Banking Supervision circulated a consultative paper entitled "Sound Practices for Loan Accounting, Credit Risk Disclosure, and Related Matters," complementing the Basle core principles in the fields of accounting, and disclosure for banks' lending business and related credit risk. RBI has already taken steps to implement the Basle core principles, which broadly deal with risk management, prudential regulations relating to capital adequacy, and various internal control requirements.

Banks and FIs have been insisting that existing asset classification rules are rigid leaving no scope for discretion, while the Basle Committee has said that recognition and measurement of impairment of a loan cannot be based only on specific rules. The committee has also indicated that banks should identify and recognize impairment in a loan when the chances of recovery are dim. It also stated that the focus of assessment of each loan asset should be based on the ability of the borrower to repay the loan. The value of any underlying collateral factors also plays a major role in this assessment.

Another major difference between the Basle Committee recommendations and the existing asset classification norms in India relates to "restructured" loans. According to the Basle Committee norms, a restructured troubled loan would not automatically be classified as an impaired loan. In India, however, any restructuring automatically classifies the assets as impaired. Banks and institutions are required to classify the restructured loans as substandard for two years and are prohibited from booking interest during this period. The "relaxation" in asset classification norms will mean little in the Indian context.

In developed financial systems, it is beneficial to have flexibility in determining weights for NPAs. However, liberal measures should be introduced only when all local players employ greater transparency in the asset classification process. It is necessary to first ensure that companies and borrowers follow norms of disclosure and transparency. Much needs to be done in this respect by the Institute of Chartered Accountants of India.

The condition of Indian banks under the present norms has improved, contributing to a better culture of recovery. The borrowers must respond with better performance.

SEPARATING SUPERVISION

The Narasimham Committee (II), while recommending separation of supervision, admits that conflicting international experience has left no overwhelming case for either separation or combining of the central bank's supervisory powers. The likely conflict between monetary policy and supervisory concerns justifies the need to combine the two functions. Separate authority structures for the two functions have more likelihood of coming into conflict with each other.

Economic downturns tend to highlight supervisory concerns, and can put the banking system at risk and subject the monetary authority to face the counterpressure of reflecting economic circumstances. The choice then becomes one of fine balance. Combining supervisory functions with monetary policy can provide a synergy that will get lost by separation. In fact, central banks take on the supervisory function in more than 60 percent of IMF member countries. In the case of African and Asian countries alone, the figure is

more than 80 percent. In other countries, supervision involves varying degrees of central bank involvement.

The regulatory and supervisory systems have to take into account peculiarities of the banking and financial structures as well as historical and cultural factors. For example, in India, the rural banking sector is large and the cooperative movement strong but the banks in this sector have remained generally financially weak. No amount of sophisticated monetary policy management is likely to provide props to this sector. What it needs is financial strengthening, management upgrades, and different norms of financial supervision with reference to culture and the economic activity of the clients. Rural and semi-urban populaces need dependable banks and rarely get alternatives in the form of banking competition.

The importance of rural banking sector has been overlooked in the various deliberations of banking and financial reforms in India. Several issues need to be raised in this regard. For instance, the separation of supervisory functions and monetary policy formulation would only harm the interests of the rural banking sector, which RBI and NABARD look after. Then, there is also the question of the large number of urban cooperative banks, which serve communities in different cities and adjoining areas. How can a separate supervisory body develop methods and resources to supervise these banks? Separation of the functions may not necessarily strengthen either supervision or monetary policy management, or both.

As NBFCs come increasing under the regulatory gaze, there will be vacuum in places where there is no bank and the NBFC is required to fold. Regulators have to ensure that banking expansion is promoted in these places.

RATING OF BANKS

RBI has subjected banks to ratings under capital adequacy, asset quality, compliance, and system (CACS); and capital adequacy, asset quality, management, earnings, liquidity, and systems (CAMELS) models for differentiating supervisory priorities. When reforms were first introduced under recommendation of the Narasimham committee (I), the 27 (then 28) PSBs were placed under A, B, and C categories; i.e., sound banks, banks with potential weakness, and sick banks, respectively. Accordingly, recapitalization and restructuring were carried out for B and C categories.

For individual ratings by international rating agencies, a bank is assessed as if it were entirely independent and could not rely on external support. The ratings are designed to assess a bank's exposure to risks, appetite for risks, and management of risks. Any adverse or inferior rating is an indication that it may run into difficulties such that it would require support. Such credit rating announcements ignore the public sensitivity to which the banking system is constantly exposed. The individual and support ratings are further explained in Table 18.

The public expects banks to try to anticipate changes, recognize opportunities, deal with and manage risks to limit losses, and create wealth through lending. While the best banks may always play a super-safe role by confining operations to choice centers and business segments, banks in India are expected to operate on a high-risk plane. As such, the Government should support banks even during stages when they are nudged to offer equity to the public.

Regulatory Issues

INDIAN BANKS' ASSOCIATION

The Indian Banks' Association (IBA) should evolve into a self-regulatory organization (SRO) that would work toward strengthening India's fairly weak banking sector and the sector's moral regulator. Its broad agenda should be to encourage the continued implementation of prudential business practices. IBA is completing an organizational restructuring after which it will examine its role as an SRO. It is now an advisory organization of banks in India and its members include most of the PSBs, private banks, and foreign banks. Its main activities involve generation and ex-

Table 18: Ratings of Banks

Individual Rating	Support Rating
Very Strong. Characteristics may include outstanding profitability and balance sheet integrity, franchise, management, operating environment, or prospects.	A bank for which there is a clear legal guarantee on the part of the state, or a bank of such importance both internationally and domestically that support from the state would be forthcoming, if necessary. The state in question must clearly be prepared and able to support its principal banks.
Strong. Characteristics may include strong profitablity and balance sheet integrity, franchise, management, operating environment or prospects.	A bank for which state support would be forthcoming, even in the absence of a legal guarantee. This could be, for example, because of the bank's importance to the economy or its historic relationship with the authorities.
Adequate. Possesses one or more troublesome aspects on profitability and balance sheet integrity, franchise, and management, operating environment or prospects.	A bank or bank holding company that has institutional owners of sufficient reputation and possessing such resources that support would be forthcoming, if necessary.
Weak. Weaknesses of internal and/or external origin. There are concerns regarding profitability and balance sheet integrity, franchise, management, operating environment or prospects.	A bank for which support is likely but not certain.
Problematic. Has serious problems that either require or are likely to require external support.	A bank or bank holding company, for which support, although possible, cannot be relied upon.

Source: Fitch IBCA.

change of ideas on banking issues, policies; and practices; collection and analysis of sectoral data; personnel administration; and wage negotiations between labor unions and bank managements. But in its new role, it would reportedly expand its functions to supplement RBI's role as a legal regulator with a focus on strengthening the sector.

While the sector's risk profile improved considerably after prudential norms were introduced in 1994, by international standards, India's banking sector is perceived as fairly weak with poor asset quality by leading agencies such as Standard & Poor's. The SRO would examine and recommend the implementation of more stringent prudential norms as laid out in the recommendations of the Narasimham Committee (II). It would encourage practices to strengthen the sector. Its expanded role could incorporate vigilance, improvement in accounting standards and balance sheet practices, encouraging provisioning, and tackling the problem of weakness and deteriorating asset quality in the banking sector.

IBA as an SRO would have to ensure that banks follow at least a certain minimum level of prudential practices. This can, however, be all very well in theory but difficult to practice because an SRO is more of a culture than an institution. It takes a long time to breed a culture of self-regulation. The respect for a supervisor has to be earned and does not happen overnight.

IBA has to transform itself into a "real" industry body once the IBA management committee acts on the blueprint for change proposed by a consulting firm. The proposal is to overhaul the structure of the organization to increase efficiency. The new focus is on networking as IBA was, for a long time, working in isolation. Now the objective is to emerge as a representative body for the banking industry. IBA has already started interacting with different industries and looking into various aspects of financing software companies, the film industry, construction companies, and the shipping industry.

IMPROVING REGULATORY FRAMEWORKS TO DECREASE SYSTEMIC RISK

Deregulation has helped promote competition and efficiency in the banking system in India and will

have a positive impact on systemic risk in the long run. Initially, however, deregulation has affected the stability of the banking sector. Substantial progress has been made toward stronger regulatory frameworks. Changes in banks' reporting requirements, improvement in the quality of on-site supervision, and the establishment of credit information and loan-grading and provisioning requirements have all helped. More important, a focus on evaluating bank solvency, more than enforcing a set of detailed regulations, has resulted in lower systemic risk across the board. But there are still many instances in which neither investors nor bank supervisors are able to properly monitor an institution's creditworthiness.

Asset quality is still the main source of risk for a financial institution and must be carefully assessed. There are loan classification systems in which bad loans can be converted into good ones through restructuring and are never reported as bad by rolling over the debt ("evergreening"). In some instances the main factor for loan classification is performance of payment instead of the financial position of borrower, which also creates difficulties in assessing credit risk. Previously, DFIs in India supported new industries through equity and loan participation, and they usually insisted on payment of dues on existing loans. But these payments may be diverted from working capital sourced from cash credit facilities from banks for their existing ventures. In this way, defaulters could promote new industries. What is important, therefore, is not merely payment record but actual surplus generation by the borrowers to qualify for investment in new ventures. Consolidated supervision of banks and their subsidiaries is another important area that needs to be addressed in future regulatory framework improvements.

REGULATION OF FINANCIAL CONGLOMERATES

In 1993, the Bank for International Settlements (BIS) set up a Tripartite Group of banking, securities, and insurance regulators to consider ways of improving the supervision of financial conglomerates. The Tripartite Group agreed that the term "financial conglomerate" would be used to refer to "any group of companies under common control whose exclusive or predominant activities consist of providing significant services in at least two different financial sectors (banking, securities, insurance)." Many of the problems encountered in the supervision of financial conglomerates would also arise in the case of mixed conglomerates offering not only financial services, but also nonfinancial services and products. Coordination between RBI, Insurance Regulatory Authority, and Securities and Exchange Board of India (SEBI) is becoming increasingly urgent.

Asset Liability Management

MATURITY MISMATCH

Interest rates have changed several times over the past seven years causing maturity transformations in assets and liabilities and their frequent repricing. A clear and continuous statement of rate sensitive assets and rate sensitive liabilities has to form the basis of interest rate risk management. RBI is expected to issue guidelines that show that management-driven asset liability management (ALM) initiatives in banks are absent. This is also the reason why India's money market has remained mostly as a call money market that is meant for clearing day to day temporary surpluses and deficits among banks. Traditionally, many banks, including the foreign banks, have used "call" money as a regular funding source.

PSBs are notably absent players in the market for term funds since they lack data on maturity gaps and interest rate gaps to be complied under ALM discipline. The common complaints about difficulties in collection of data from hundreds of rural and semi-urban branches will not be combated unless there is computerization in these branches to facilitate data compilation progressively.

According to RBI and many PSBs, about 80 percent of deposits are term deposits (one to three years). Long-term lending (three to five years) comprises about 30 percent of total loans and thus, matu-

rity mismatch is not a serious issue. However, this claim may not be valid as maturity of deposits and term loans are not disclosed. Moreover, banks have invested a large portion of funds in Government securities and debentures (long-term assets). RBI should highlight and address the real maturity mismatch issue. Call money market is an age-old terminology that RBI itself has to stop referring to in its publication. The "call" segment of the market is different from the "term" segment in all sophisticated market centers in the world.

ASSET LIABILITY MANAGEMENT SOPHISTICATION

The importance of more sophisticated ALM has increased for Indian banks in view of liberalization of interest rates and business activities, limits to the expansion of lending volume, introduction of derivatives, prevailing international discussions concerning risk management, innovation of computer technology, and globalization. In ALM, risks in the banking account (which comprises the traditional banking products including deposits and loans and the trading account, which mainly comprises short-term trading products such as foreign exchange and investments) are managed separately. The primary focus is on how to hedge the passively arising interest rate risk in the banking account.

However, given the changes in the business environment, Indian banks and financial institutions have to move forward to maximize profits through comprehensive measurement and management of market risks, particularly interest rate risk, by

- upgrading the risk management measures for banking and trading accounts, thus integrating the risk measurement for the institution as a whole;
- shifting the focus of ALM in the banking account from simply hedging risks to actively taking and controlling risks; and
- reviewing organizational structure to make risk management more sophisticated and provide for more flexible ALM operations.

An example of such organizational structure review is strengthening the authority of a financial institution's ALM committee, or by establishing an ALM expert section or a middle office. Risk management can shift from the worst method of controlling the market risks related to assets and liabilities to an integrated risk management measure incorporating the credit risks in the banking and trading accounts. This shift would enable objective assessments of profitability and, based on these assessments, a strategic allocation of resources could be carried out.

In general, the development of ALM operations has to be in the direction of an objective and comprehensive measurement of various risks, a pursuit of returns commensurate with the size of the risk, and a strategic allocation of capital and human resources based on the risk. This can be said to be the key to successful ALM in an era of financial liberalization. Unless Indian banks and FIs adopt these principles, there can be little progress in the following critical ALM operations:

- upgrading of trading techniques;
- implementation of flexible ALM operations in the banking account, such as strategic risk-taking operations that use interest rate swaps and investment securities and strategic pricing of medium- to long-term deposits, as well as the concentration of interest rate risk at the head office through a review of the interoffice rate; and
- with regard to customer business, the provision of various financial services based on improved market risk management ability—for example, the development of new types of deposit and loan products involving the use of derivatives and the provision of ALM services—and the search for new clients among small- and medium-size firms through sophisticated credit risk management techniques.

The evolution in financial management in terms of sophistication in ALM operations has to be an autonomous response and not driven by regulators.

SINGLE CUSTOMER LIMIT

Single customer limits are set at less than 25 percent of net worth of the bank for a single customer, and less than 50 percent of net worth of the bank for a group. By definition, a loan includes debentures issued by the customer. As loans of PSBs are limited, they would be able to comply with these ceilings. However, small private banks may exceed these ceilings if proper supervisory measures are not undertaken.

RISK ASSESSMENT OF INVESTMENT

Banks are required to comply with the SLR by investing in approved securities, e.g., central Government bonds, Treasury bills (T-bills), and state government bonds. Moreover, banks invest in PSU bonds, corporate debentures, and equities (limit is 5 percent of the increase in the previous year's deposits). Investments are assessed at market prices. As for approved securities, only 60 percent of outstanding are assessed at mark-to-market. It is difficult to identify the actual asset position of banks if approved securities are not assessed at market price. For this reason, RBI is planning to require banks to assess 100 percent of the approved securities at mark-to-market in a few years.

These regulations are based on the Government's objective of bringing down fiscal deficit. It recognizes the fact that it is simply not feasible for banks and FIs to increase the share of Government securities in their portfolio without affecting their own viability and indeed the viability of the productive sectors of the economy.

Despite the progressive reduction in the SLR over the past five years in the wake of implementation of Narasimham Committee (I) recommendations, banks voluntarily directed high deposits growth into risk-free assets of Government securities. This trend coincided with companies raising external commercial borrowings and issuing GDRs in international markets in preference to borrowings from banks. Backtracking during previous changes in government on efforts to curb the fiscal deficit caused monetary policy to be tight and interest rates to remain high. Now that an industrial slowdown has set in, RBI has concluded that nothing should be done to dampen the emerging signs of incipient recovery and focus should be largely on strengthening balance sheets of banks and financial institutions.

Excess investments made by banks in Government securities point to the fact that investable surpluses have not been adequately deployed to finance industry and trade. Clearly, banks have been unable to predict interest rate changes, the root cause being that ALM has been neglected. Through 1993/94 to 1997/98, PSBs invested in Government securities in excess of SLR requirements by an average of 6 to 7 percent. The trend continued even through periods of high growth in the economy when the overall GDP grew at more than 7 percent. The growth in SLR securities with the banks in excess of the requirement has been high. PSBs had excess Government securities to the tune of Rs160.68 billion in March 1994. This grew to Rs227.15 billion by March 1995, Rs316.77 billion by March 1997, and Rs408.74 billion by March 1998.

Investments in Government securities are totally risk free over a certain period. Banks can end up making large provisions if interest rates rise consistently over several years. This would depreciate the heavy portfolio acquired, as was demonstrated in 1995 and 1996 when Government securities depreciated as interest rates perked up. Based on their experience, RBI has begun to assign some risk weight to Government securities to discourage banks from buying heavily into them.

Assigning risk weight to Government securities, however, contradicts the statutory requirement of maintaining minimum liquidity in Government securities investments. Also, balance sheets would not be strengthened significantly nor would the attraction of investing excess funds in Government securities be removed. Instead, banks should have strong ALM practices and risk management system in the com-

mercial lending area. RBI and Government should improve bank balance sheets by removing contamination effect of NPAs in the form of Government-guaranteed loans; i.e., by issuance of special Government bonds in favor of banks for converting such NPAs into Government debt.

The conflicting considerations—the need to reduce monetary expansion while at the same time nurturing real growth—starkly illustrate the monetary policy dilemma that RBI faces. It has not proposed to change the CRR or interest rates, and will continue to manage liquidity through open market operations and repo operations. RBI will not hesitate to resort to further monetary tightening if inflationary pressures increase or if external developments warrant. Going a step beyond the recommendations of the Narasimham Committee (II) on introduction of market risk to Government and approved securities, an additional risk weight of 20 percent on investments in Government-guaranteed securities of Government undertaking that do not form part of a market borrowing program is also being introduced.

TRADING RISK MANAGEMENT

Banks in India need a new attitude toward the scope and extent of different types of risks. These risks are made up of the dynamics between many conflicting parameters—for example, balancing the needs of market constraints, industries, and geographic concentrations with the individual requirements of counterparties and corporate customers. Information to support such understanding has not historically been defined nor kept within banks' systems. Trading portfolios of banks in India are becoming diverse with the range of bonds, equities, and derivative instruments, and allowance made by RBI permitting investments in overseas markets. Debt swaps and interest rate swaps as well as currency swaps are entered into with foreign banks and such exposures need special monitoring. There is an eagerness to introduce a variety of derivative instruments but the regulatory and risk management apparatus is not fully ready.

DEPOSIT INSURANCE PREMIUMS

The banking crisis that plagued the US during the 1980s was instrumental in drawing the attention of policy makers to the fact that the system of deposit insurance has to be reformed. In the absence of deposit insurance, banks are vulnerable to a run that will precipitate a liquidity crisis in the financial system. As a consequence, most Governments implicitly or directly guarantee the deposits in their respective banking systems. However, deposit insurance can lead to problems in the form of an increase in the proportion of credit disbursed to risky borrowers.

This realization led to a reform of the deposit insurance regime in the US with the enactment of the Federal Deposit Insurance Corporation Improvement Act, which imparts greater autonomy on the banks. The Act provides that "as long as it appears that a bank will be playing with its own money (capital), almost any activity that can be adequately monitored by the insurer could be permitted. But if the structured early resolution fails, early resolution is required through recapitalization by current shareholders, sale, merger or liquidation before the institution's capital turns negative." Clearly, the Act aims to eliminate agency problems by ensuring that the losses are restricted to the shareholders, and do not spill over to affect the depositors or the Government's budget.

In India, however, the Narasimham Committee (II) has recommended differentiated premium rates, which would amount to broadcasting to the public the status of banks. An alternative would be for the deposit insurance system to extend rebates to banks showing improvements and deduct the rebate amount from the next year's premium. Rebates would be on the basis of annual performance whereas penal premium rates would operate only after deterioration is detected.

Function of Bank Capital

CAPITAL ADEQUACY

Capital adequacy is a self-regulatory discipline and cannot save banks that are distressed. As such, the time required for meeting bank capital adequacy must be shortened to a minimum. The CAMEL rating system clearly recognizes the strength of bank capital as just one requirement and also an end product of other processes, mostly management driven. It is essential to amplify the quality of earnings as it is the first thing that catches shareholders' attention. History shows that banking problems germinate during years of economic boom. When the earnings component becomes volatile and susceptible to sharp growth that is not sustainable, the quality of loan/risk assets can become suspect.

PSBs are owned by the Government, therefore, they have implicit guarantees from the Government, resulting in the lack of capital adequacy ratio (CAR) norm. Given the recommendation of the Narasimham Committee (I) in 1991 on the BIS standard of capital adequacy, a CAR of 8 percent was to be achieved by March 1996. Twenty-six out of 27 PSBs had complied with this requirement as of March 1998.

Narasimham Committee (II) recommended CAR targets of 9 percent by 2000 and 10 percent by 2002. As many PSBs have already high CARs (some indicated an average CAR of about 9.6 percent as of March 1998), such targets could be attained. Moreover, as 35 percent of deposits are allocated to CRR and SLR, coupled with investment in Government guaranteed bonds, risk assets are not preferred. However, RBI has introduced a calculation method that 60 percent of approved securities should be mark-to-market, and the ratio will be raised to 100 percent in a few years. Despite the higher mark-to-market ratio, many banks increased investments in approved securities to comply with CAR.

The banks will have difficulties raising more capital in the near future, with capital markets sluggish, investor confidence low, and bank issues unpopular with investors. The need for general provisioning on standard assets increases the pressure on profitability of banks as Government-guaranteed securities are prone to default.

RBI has decided to implement certain recommendations of Narasimham Committee (II).

- Banks are to achieve a minimum of 9 percent CAR by 31 March 2000. Decisions on further enhancement will be made thereafter.
- An asset will be treated as doubtful if it has remained substandard for 18 months instead of 24 months. Banks may make provisions in two phases. On 31 March 2001 provisioning will be at not less than 50 percent on the assets that have become doubtful on account of the new norms.
- On 31 March 2002, a balance of 50 percent of the provisions should be made in addition to the provisions needed by 31 March 2001. A proposal to introduce a norm of 12 months will be announced later.
- Government-guaranteed advances that have turned sticky are to be classified as NPAs as per the existing prudential norms effective 1 April 2000. Provisions on these advances should be made over a period of four years such that existing/old Government-guaranteed advances that would become NPAs on account of new asset classification norms should be fully provided for during the next four years from the year ending March 1999 to March 2002 with a minimum of 25 percent each year. To start with, banks should make a general provision of a minimum of 0.25 percent for the year ending 31 March 2000. The decision to raise further the provisioning requirement on standard assets shall be announced in the process.
- Banks and financial institutions should adhere to the prudential norms on asset classification, provisioning, etc., and avoid the practice of evergreening.

- Banks are advised to take effective steps for reduction of NPAs and also put in place risk management systems and practices to prevent reemergence of fresh NPAs.
- PSBs shall be encouraged to raise their tier-2 capital, but Government guarantee to bond issues for such purpose is deemed inappropriate.
- Banks are advised to establish a formal ALM system beginning 1 April 1999. Instructions on further disclosures such as maturity pattern of assets and liabilities, foreign currency assets and liabilities, movements in provision account, and NPAs, will be issued in due course.
- Arrangements should be put in place for regular updating of instruction manuals. Compliance has to be reported to RBI by 30 April 1999.
- Banks are to ensure a loan review mechanism for large advances soon after their sanction and continuously monitor the weaknesses developing in the accounts in order to initiate corrective measures in time.
- A 2.5 percent risk weight is to be assigned to Government/approved securities by March 2000.
- Risk weights to be assigned for Government-guaranteed advances sanctioned effective 1 April 1999 are as follows:
  - central Government: 0 percent;
  - state government: 0 percent;
  - governments that remained defaulters as of 31 March 2000: 20 percent; and
  - governments that continue to be defaulters after 31 March 2001: 100 percent.

The latest figures (as of 1997/98) for banks' and selected financial institutions' capital adequacy are shown in Tables 19 and 20. Table 19 indicates that most PSBs have comfortable CARs but once the accounts are recast in conformity with the forthcoming provisioning norms, banks will have to start planning for capital issues. The size of bank issues, sequencing, and readiness of the capital market to absorb all public offerings will pose tremendous challenges to bank management. The time frame allowed for adjustments seem to be insufficient since profitability cannot be raised rapidly enough to accommodate additional provisioning and still be considered attractive by investors. This raises a question on how far banks will actively support growth through new financing initiatives. Clearly, additional returns to inject better profitability in the short run have to come from (already shrunk) avenues of short-term financing and not from new industrial and infrastructure projects, which entail long gestation periods.

TIER-2 CAPITAL FOR BANKS

To meet CAR requirements, seven banks—Canara Bank, Punjab National Bank, Central Bank of India, Indian Overseas Bank, United Bank of India, Federal Bank (private sector), and Vijaya Bank—are finalizing plans to raise about Rs20 billion worth of subordinated debt, which qualifies as tier-2 capital. The funds will be raised in the form of bonds from the domestic private placement markets in 1998/99. With this, the total amount of tier-2 borrowing (primarily debentures and bonds as against equity shares, which are considered tier-1 capital) planned in November 1998 to February 1999 might have exceeded Rs150 billion.

While RBI regulations have capped the coupon rate on bank offerings to 200 basis points (bp) above the coupon rate on similar Government securities, none of these banks can hope to find market interest at such fine rates. A five- to six-year bank borrowing will have to be capped at about 14 percent as similar Government borrowing was effected at a coupon of 11.78-11.98 percent in 1998-1999. However, with the top of the line FIs raising five-year funds at 14 percent, these banks will have to offer more incentives to investors. Public issue timing and pricing is a new challenge for PSBs. There are reports that some banks have invested in tier-2 capital issues of other banks and it remains to be seen how it will affect their CAR.

Table 19: Capital Adequacy Ratio of Public Sector Banks, 1995/96–1997/98 (percent)

Name of Bank	1995/96	1996/97	1997/98
State Bank of India	11.60	12.17	14.58
State Bank of Bikaner & Jaipur	9.33	8.82	10.65
State Bank of Hyderabad	9.90	10.84	10.83
State Bank of Indore	8.80	9.31	9.83
State Bank of Mysore	8.81	10.80	11.61
State Bank of Patiala	9.51	11.25	13.24
State Bank of Saurashtra	12.38	12.14	18.14
State Bank of Travancore	9.40	8.17	11.48
Allahabad Bank	9.68	11.00	11.64
Andhra Bank	5.07	12.05	12.37
Bank of Baroda	11.19	11.80	12.05
Bank of India	8.44	10.26	9.11
Bank of Maharashtra	8.49	9.07	10.90
Canara Bank	10.38	10.17	9.54
Central Bank of India	2.63	9.41	10.40
Corporation Bank	11.30	11.30	16.90
Dena Bank	8.27	10.81	11.88
Indian Bank	neg.	neg.	1.41
Indian Overseas Bank	5.95	10.07	9.34
Oriental Bank of Commerce	16.99	17.53	15.28
Punjab & Sind Bank	3.31	9.23	11.39
Punjab National Bank	8.23	9.15	8.81
Syndicate Bank	8.42	8.80	10.50
United Commercial Bank	7.83	3.16	9.07
Union Bank of India	9.50	10.53	10.86
United Bank of India	3.50	8.23	8.41
Vijaya Bank	neg.	11.53	10.30

neg. = negative.
Source: Reserve Bank of India.

Table 20: Capital Adequacy Ratio[a] of Selected Financial Institutions, 1997 and 1998 (%)

Institution	As of 31 March 1997	As of 31 March 1998
IDBI	14.7	13.7
ICICI	13.3	13.0
IFCI	10.0	11.6
SIDBI	25.7	30.3
IIBI	10.6	12.8
Exim Bank	31.5	30.5
NABARD	40.4	52.5

ICICI = Industrial Credit and Investment Corporation of India, IDBI = Industrial Development Bank of India, IFCI = Industrial Finance Corporation of India, IIBI = Industrial Investment Bank of India, NABARD = National Bank for Agriculture and Rural Development, SIDBI = Small Industries Development Bank of India.
[a] As percent of risk weighted assets.
Source: Reserve Bank of India.

Mergers and Recapitalization

CONSOLIDATION OF THE BANKING INDUSTRY

Global trends in the banking industry in recent years have focused on cost management, which drove banks to venture into nontraditional functions, standardize products, centralize activities, and form mergers and alliances to gain capital strength and access to broader customer bases. Such global trends are found in India, with the exception of consolidation.

The Indian banking system is still in the growth phase. The impulses of consolidation are not yet seen in private banks and much less so in PSBs whose policies originate from the Government. Even the merger of one PSB with another that took place five years ago in the early period of banking sector reforms benefited neither bank.

The increasing forays of banks into new areas and convergence of business operations of banks, DFIs, and NBFCs raise the issue of merging banks, based on specific business complementarities. Mergers would be determined by the size of the balance sheet, or by efficiency, competitiveness and strategic repositioning to reduce intermediation costs, expand delivery platforms, and to operate on econo-

mies of scale. The Government is disinclined to urge mergers whereas RBI wants market forces to decide.

In the corporate world, 50 percent of mergers fail due to cultural incompatibility of the two organizations coming together. The Government in 1996/97 favored merging banks to create megabanks of international size and competitiveness. The only merger that materialized was five years ago between ICICI (a DFI) and the financially ailing Imperial Tobacco Company (an NBFC of the multinational: ITC). ICICI had the incentive of a tax shield advantage in addition to expansion into retail business and a network advantage. But the resulting merger was widely regarded as unsuccessful for both parties.

Mergers of international banks are being evolved to develop synergy and worldwide international competitiveness. Indian banks have a long way to go in this regard. The country has a lot of small banks not interested in the global market, for they lack the required expertise. They need to remain focused on doing what they do best—understanding their local market base. The danger is that of becoming too specialized, because when business drops, the difficulties start. Banks need to diversify. In the right place and with the right focus, there is room for big multinationals and small private banks operating within a country. A smooth merger may be possible among the eight state banks because of their 50 years of staffing and management homogeneity, while small private banks may be forced to merge to remove diseconomies of scale.

Consolidation will remain a matter of theoretical discussion at least until after the merger of New Bank of India with Punjab National Bank has been studied. The problem of weak PSBs is a separate one. Banks that were nationalized in 1969 had a regional branch network and influence before nationalization. Instead of mergers, they should be given freedom to expand their branch network in regions of their choice to facilitate relocation of staff that were rendered surplus due to computerization. SBI has allowed its associate banks to expand in their respective regions. Such a policy may accelerate improvement in the population per branch ratio and also productivity.

RECAPITALIZATION

The Government owns the core of the Indian banking sector, a factor that has contributed to its quick recovery from capital shortage. It did not need to adopt the complicated procedures observed in the rehabilitation processes of Japan and Korea to inject public funds into major banks. The Government even helped the nationalized banks increase their CARs (Table 21).

Table 21: Capital Contributions by Government to Nationalized Banks[a] (Rs billion)

Item	Amount
Up to March 1992	33.00[b]
1992/93	7.00[c]
1993/94	57.00[c]
1994/95	52.87[b]
1995/96	8.50[c]
1996/97	15.09[c]
1997–February 1998	27.00
Total	200.46
Capital Returned to Government	6.43
Net Contribution	194.03

[a] Including New Bank of India
[b] Capital contribution.
[c] Capital allocation.
Source: Reserve Bank of India.

Recapitalization has been going on since 1991 in line with the implementation of the recommendations of Narasimham Committee (I). The total amount of net contribution of the Government to the nationalized banks up to February 1998 was Rs194.03 billion, which was 5.5 percent of total assets as of March 1997. Needless to say, this recapitalization of the nationalized banks has been supported by India's taxpayers.

Additionally, some PSBs issued equity or subordinated debt to increase CARs. Three nationalized banks (Dena Bank, Bank of Baroda, and Bank of India) raised capital of Rs17.05 billion through public issues. In contrast, four PSBs obtained capital by

issuing subordinated debt. However, the precise figure of the amount of capital derived from the subordinated debt is not available.

This process of bank recapitalization was guided by the Indian authorities because the Government and RBI are major holders of PSBs. Thus, in theory, there should exist no conflict between shareholders and the regulatory authorities that monitor the process on behalf of depositors and other debt holders. This conflict sometimes complicates and hinders the process of disposing of distressed banks in a fully privatized banking industry, such as that in countries like Japan.

The public issues by PSBs suggest that the Indian Government believes that bailout of such banks through capital injection is costly. However, according to the recapitalization figures of nationalized banks, the Government has not yet abandoned the policy of restricting interface of PSBs with the capital market. It will take a long time for the capital market to play a pivotal role in monitoring and disciplining bank managements in India.

Meanwhile, the shortage of capital seems to be getting worse in the cooperative bank sector although the expert committee organized by NABARD recommends that the stringent capital adequacy norm should be extended to cooperative banks and RRBs. The committee recommends that the Government rescue program should be quickly implemented to assist cooperative banks to achieve 4 percent capital adequacy level by the end of March 1999.

Restructuring Commission for Weak Banks

BANK RESTRUCTURING

The Narasimham Committee (II) recommended a restructuring commission as an independent agency to run weak banks to restore them to operational health over a period of three to five years. Also, such banks should operate as "narrow banks," i.e., deploy only deposits for investment in Government securities. The recommendations ignore that the weak (public sector) banks are old banks and they should be dealt with according to causes of deterioration such as mismanagement, lack of supervision, and political interference.

The Government and RBI instituted restructuring exercises for weak banks detected based on the implementation of recommendations of the Narasimham Committee (I) in 1992/93. There are only three PSBs (India Bank, United Commercial Bank, and United Bank of India) that still require treatment. What has gone wrong with these banks is well known and remedial measures should lie with individual banks according to the nature of their respective sickness. Since investment in Government securities now carries risk weight, narrow banking may not be the correct solution.

The weak banks must improve the bottom line of each branch by adding earning assets. In the absence of these, they may end up with "one-legged managers," i.e., who know only how to raise deposits (liabilities) but are averse to risk management (of assets). These banks are too big and rationalization or closure of branches is not going to mitigate their major weaknesses. A long-term solution will lie only in financial strengthening and efficiency. Since mergers with the strong banks have been ruled out, the Government as the owner must stand by these banks while firmly rooting out bad managers and deficiencies. Restructuring does not have fixed rules and has to be bank specific, depending on several factors, as follows:

- importance of the banking system to the economy,
- methods for developing institutional arrangements,
- maturity of society, and
- political system.

Redimensioning (i.e., downsizing) by closure of branches will go against India's development objective of reducing the population-branch ratio. The much neglected cooperative banking sector cannot fill the increasing service delivery gap for a population that is rapidly rising.

ASSET RECONSTRUCTION FUND

Developmental banking remains the need of the country and the Government should concretely demonstrate the will to back the risk-taking ventures of banks. The ability of public sector banks to raise equity from the markets will depend upon how Government chooses to back the banks. An asset reconstruction fund (ARF) is a solution that will favor bad banks while penalizing good ones.

The current thinking is that an ARF would be formed for weak banks with equity contribution from PSBs. This would amount to withdrawing equity from such banks in times when they have to meet stringent CAR deadlines. It is the weak banks and their borrowers who must struggle to reform the balance sheet. Debt recovery processes in India are tortuously lengthy and ARF will not deliver goods better than the banks and their particular branches out of which funds have been lent.

Unlike the banking crises in Asia, Latin America, or the savings and loans problem in the US (in 1989), Indian banks' NPA problem was not caused by excessive risk concentrations. The real sector (which has been buoyant in Asia) has not undergone structural changes to be internationally competitive and Indian banks have remained at the receiving end. PSBs should seek conversion of nonpayable debt obligations of the defaulting borrowers into equity and line up cases for sale/mergers. What banks can do in this respect, ARF will not be able to do. Instead, a lot of time will be wasted in finding equity for ARF and assembling NPA assets from banks for transfer to ARF. The need is to reform the real sector and also to develop preventive controls in banks.

The weak PSBs owned by the Government are of the "too big to fail type" and have been in existence for nearly a century. The critical policy initiative should be to reform and recapitalize them instead of relieving them of bad debts through an ARF vehicle.

ASSET RESTRUCTURING COMPANY

The Union Finance Ministry is considering asking the strong PSBs to set up an ARC for the weak banks who have problems in recovering their bad loans.

It is proposed that the debt funding of ARC be through the issuance of Government-guaranteed bonds. Although the Finance Ministry has not yet taken a final decision on the modalities of an ARC, an internal study on establishing an ARC is being worked out.

Operational Efficiency

The most important problem facing Indian banks is how to improve their operational efficiency.

Overall efficiency of the banking sector may be measured by an index of financial deepening defined by the ratio of total bank deposits to GDP. This index increased substantially between the 1970s and the mid-1980s (see Table 22). The improvement can be partly explained by the expansion of the branch network in India.

Table 22: Financial Deepening

Year	Deposits/GDP (percent)
1970	13.4
1975	18.0
1980	27.8
1985	33.6
1990	35.7
1991	36.9
1992	38.4
1993	39.1
1994	39.6
1995	36.2
1996	38.3

GDP = gross domestic product.
Source: IMF, *International Financial Statistics*, various issues.

However, in spite of the branch network expansion, financial deepening still remains at a low level (less than 40 percent) by global standards. The Indian financial deepening index is slightly higher than those of the PRC and Viet Nam at the beginning of

their respective market reforms. This suggests that there is plenty of room for the Indian banking sector to increase its presence in the financial system.

Commercial banks in India will also have to service the demands of the different economic segments. They must not ignore nor prefer to serve only one of these at the expense of the others. Banking services have to be designed and delivered in response to the wide disparity in standards and ways of living of rural, semi-urban, urban, and metropolitan populaces. For example, the banking needs of a vast majority of the Indian population residing in the rural and semi-urban areas are relatively simple. In these markets, availability of services, timely credit, and low cost of their delivery are needed.

Autonomy and Governance

The issue of autonomy concerns mainly PSBs and DFIs. Autonomy as a concept can be summarized as follows:

- it calls for separation of ownership and management;
- it requires distinction between bureaucracy and business management. In terms of accountability, this means distinguishing between performance accountability and accountability for misfeasance;
- it necessitates change in the mindset of bankers as well as regulators;.
- banks have to ready themselves to exercise autonomy. This requires creation of knowledgeable workers who can bring to bear upon the functioning of the bank at all its establishments the collective wisdom of the management;
- autonomy is an inevitable fallout of deregulation;
- government or regulatory scrutiny does not amount to "back seat driving" and does not deprive a good management of its autonomy; and
- where Government/RBI directives concern procedural aspects in place of performance scrutiny through results, then banks may suffer the phenomenon of "back seat driving."

Increasing public ownership of banks will require management to prudently handle shareholder constituencies since takeovers by speculators wanting to make easy money or ensure financing for their own businesses are among the potential risks. This task lies squarely in the domain of the regulator and corporate offices of banks. Banks as business organizations have to match up to both social expectations and stakeholder aspirations. The board of a bank bears a principal responsibility for fashioning a governance code appropriate to its structure. It is also to be charged with the responsibility of subjecting the code to a periodic review to make it contemporary in a multibusiness banking organization.

The fundamental factor that has brought boards of directors into the spotlight is a lack of confidence in their system of accountability. The second factor that has focused attention on corporate governance is the emergence of the global market. In the search for attractive investment opportunities, the major institutional investors have moved beyond their domestic markets and are looking to spread their risks geographically. As they do so, they demand high and consistent standards in terms of both financial reporting and the treatment of shareholders' interest, making boardroom accountability and standards of corporate governance a global issue.

There are, however, no uniform global standards of corporate governance. Nevertheless, these standards are moving forward and this is gradually leading to a greater degree of convergence between markets. No company can afford to ignore these developments, which are underpinned by advances in information technology (IT) that make information about companies more widely and immediately accessible, thus contributing to the unification of financial markets. This also very much applies to the players in banking and other financial sectors.

Bank Computerization

Entry of new private sector banks, PCBs, and foreign banks offering most modern technology bank-

ing has forced PSBs to address computerization problems more seriously in recent years. The pace of computerization has remained slow even though opposition from staff unions has softened. The Central Vigilance Commission wants 100 percent computerization in Indian banks to check frauds, delays, etc. The general perception is that in recent years, the prime focus of bank computerization has been less on the number of branches computerized but more on better connectivity, say, between the head office and regional offices of a bank with select branches. These are usually banks that handle large corporate borrowing accounts on one side, and those that are in high deposit zones, on the other.

While the private sector banks have been upgrading technology simultaneously with branch expansion, many of the top PSBs have completed automating their branches in the urban areas. The next step to total branch automation is networking these branches. PSBs need to frame a strategy to choose the branches that have to be included in their networking scheme. Since it would be a daunting task for them to connect all the 64,000 branches spread across the country, as a first step, they are following the 80-20 thumb rule. It assumes that 80 percent of bank's business is carried out by only 20 percent of its branches. It is the branches with substantial business, most of which lie in the urban areas, that are initially targeted for interconnection.

A major problem PSBs have to face once IT implementation reaches its optimum level is staff retention. While the private sector banks have been recruiting trained and experienced IT professionals, it may not be possible for PSBs to do likewise. They will have to train their existing staff to function effectively in the new environment. And once the requisite skills are acquired by employees, they may have trouble retaining staff. PSBs can only allocate limited capital resources to computerization. They will have to choose between high cost of computerization at metro and urban centers and low cost computerization at rural, semi-urban branches. Also, they will have to factor in returns on IT assets, and growth and productivity improvements.

Newly opened private sector banks, foreign banks, and a few other Indian banks have started Electronic Money activities, which open up business opportunities but carry risks that need to be recognized and managed prudently. The Basle Committee on Banking Supervision has raised issues of critical importance to banking authorities in this regard. There is no evidence that these aspects are being looked into in India, yet there is a need for auditing firms to be aware of this issue.

Despite recapitalization, the overall performance of PSBs continues to lag behind those of private sector and foreign banks. Questions of ownership, management, and governance are central to this issue. Under public ownership, it is almost impossible to draw a distinction between ownership responsibility and managerial duty. For this reason, Government-owned banks cannot insulate themselves from interference. Inevitably, some PSBs are overregulated and overadministered.

A central concern is that banking operation flexibility, which is essential for responding to changing conditions, is difficult to implement. Under public control, the efficiency objective in terms of cost, profitability, and market share is subordinated to the vaguely defined public interest objective.

Moreover, it is not only difficult to inject competition between PSBs since they have a common ownership, but Government-imposed constraints have also meant that they have not been able to effectively compete with private sector banks. India still has to find a middle path of balancing divergent expectations of socioeconomic benefits while promoting competitive capitalism.

Political sensitivities can make privatization difficult but the Government aims to bring down its holdings to 51 percent. When that happens, a great stride will have been completed. In 1998, announcements have been made on corporatization of IDBI and reduced Government holdings in Bank of Baroda, Bank

of India, Corporation Bank, Dena Bank, IDBI, Oriental Bank of Commerce, and SBI.

Importance of Branches

BRAND IDENTITY

PSBs and the rural banking system have to build up the transaction and advisory services of their branches. In a competitive marketplace, a retail branch environment that can project and deliver the brand promise has become increasingly important.

As retail banks undertake strategic reengineering of distribution and delivery strategies, product and service enhancement and network downsizing, they ignore the role of the branch and the power of a brand at their peril, since the branch is a retail bank's shop window and platform for differentiating its products and services.

With the growth of automated transactions, the role of the branch is changing and must reflect new marketing and brand communication strategies. Is the branch to be a retail opportunity drawing customers for financial services advice, or is it an outpost of technology and remote transaction efficiency? Can the branch network provide both? The answers lie in the strength, depth, and clarity of an organization's brand identity, which is the foundation upon which a retail bank can communicate its unique product or service.

INTERDEPARTMENTAL COORDINATION

Branch investment and reengineering is often the responsibility of operations or premises departments with little regard for coordination with marketing departments. In order to maximize the benefits of branch investment or reengineering, astute management teams should integrate all aspects of their brand and its customer interface under identity management to harness the power of the bank

REGIONAL SPREAD OF BANKING

RBI currently uses only demographic data for issuing branch licenses. The "population served per branch" criterion is the yardstick that is routinely used to measure the adequacy or otherwise of banking facilities in regions that have been demographically demarcated as follows: rural (population below 10,000), semi-urban (population between 10,000 and 100,000), urban (population between 100,000 and 1 million), and metropolitan (population above one million).

Dividing the total population by the number of bank branches, the population per branch has fallen from 64,000 in 1969 to 15,000 as of June 1997. This does not take into account, however, staff redundancies likely from computer-based banking including the spread of automated teller machine (ATM) outlets. Even in the most advanced branch banking and computerized banking environments such as Canada, the ratio of population to branch is only 3,000 and if ATM banking is included as branch-type retail outlet, the ratio is still lower. In India, foreign banks are fast experiencing staff redundancy and aging problems but not allowed to branch out freely into places requiring competition, especially in foreign trade financing.

The Government needs to expand the branch network to ensure a reduction in the population per branch ratio further to 10,000 (phase I), 5,000 (phase II), and 3,000 (phase III) by including, if necessary, ATMs and similar outlets as branches at metro and urban centers.

SPREAD OF CREDIT CARD CULTURE

It would be worthwhile for RBI to reward banks through a special subsidy for spreading a credit card culture on the basis of the number of credit cards and annual transition volumes. The largest bank, SBI, did not even have a credit card until the formation of its joint venture with GE Capital in 1998/99.

NARROW BANKING

Weaker banks have been under pressure to cease lending and concentrate on investments in Government securities, which are subject to depreciation risks. Narrow banking is therefore not a solution for

weak banks. Enhancing the branch network can improve the bottom line and should be explored. Such banks require all-round restructuring.

Credit Delivery System

Table 23 shows the Indian banks' low coverage of bills and receivables financing, and low level of exposure of bank clientele to the foreign trade segment. Partly these should be ascribed to a lack of banking services or expertise of centers where demand for the services exists but is met by distantly placed branches. Inadequate bills and direct receivables financing results in underutilization of network branches through which collections can take place.

Human Resources Issues in Banking

LABOR UNION AND HUMAN RESOURCES

The number of bank management staff and employees in India is vast (223,000 in SBI; 81,252 in SBI Associates; 581,000 in nationalized banks; 57,241 in old private sector banks; 1,620 in new private sector banks, and 13,510 in foreign banks operating in the country). The total is 957,623, with the number of staff employed in cooperative and rural banks equally large. Potentially, the gap between availability of required skills and actual requirements is increasing as more complex product mixes are introduced and traditional banking products are replaced. Another reason is the skewed age profile of employees, some of whom were taken on 30-35 years back when the branch expansion programs started.

Indian banks are highly unionized and productivity benchmarks are not clearly established. To create a more constructive work attitude, the disinvestment or privatization programs of PSBs should include share offerings to staff, an idea successfully carried out by SBI, Bank of Baroda, and Bank of India, among others. The spread of computerization (so far inhibited by staff union pressures on quotas and wage hikes) must be evaluated in terms of return on information technology assets of the banks and revised productivity benchmarks.

Another issue requiring attention is regular recruitment in various grades every year, since experienced employees in banking are built up over several years. An embargo on recruitment since 1985 has skewed the age profile of the workforce in PSBs. Such imbalances are difficult to rectify. There are those who argue for productivity-linked wages, which is a dangerous recipe in the context of a unionized workforce.

Table 23: Distribution of Outstanding Credit of Scheduled Commercial Banks According to Type of Account, March 1996 (percent)

Type of Account	No. of Accounts	Credit Limit	Amount Outstanding
Cash credit	16.1	35.7	35.7
Overdrafts	6.8	7.7	7.4
Demand loans	7.2	7.9	8.0
Medium-term loans	24.8	9.4	10.3
Long-term loans	42.9	18.9	19.8
Packing credit	0.5	7.3	7.0
Export trade bills purchased	0.3	3.2	2.6
Export trade bills discounted	0.1	2.1	1.8
Export trade bills advanced	0.1	1.1	0.9
Advances against export cash incentives and duty drawback claim	0.0	0.1	0.1
Inland (Trade) bills purchased	0.4	1.3	1.2
Inland (Trade) bills discounted	0.3	2.4	2.2
Inland (Others) bills—purchased	0.2	0.9	0.9
Inland (Others) bills—discounted	0.1	0.8	0.7
Advances against important bills	0.1	0.8	0.8
Foreign currency checks/TCs/DDs/TTs/ MTs purchased	0.2	0.4	0.4
Total	**100.0**	**100.0**	**100.0**
Amount (Rs billion)	**4,767,771.0**	**2,684.4**	**2,184.4**

DD = demand draft, MT = mail transfer, TC = travelers check, TT = telegraphic transfer.
Source: Reserve Bank of India.

What is needed is fair competition, merit-based career progression policies, strong management of staff, and transparent performance evaluation systems (experience of international banks paying proprietary rewards and packages for specialist traders, etc., have not exactly been happy since such staff have landed some banks with losses).

The merger of banks as recommended by Narasimham Committee (II) to create strong banks that can compete internationally can result only in the creation of formidable union power and amplify inefficiencies.

Policies are also needed to prevent significant turnover of banking staff in cities, urban as well as semi-urban and rural branches. Incentives must be given to staff in rural and semi-urban branches to increase motivation and minimize fast personnel turnover.

WAGE HIKES

For the first time, the Government, RBI, and IBA have ruled out a uniform wage increase formula that is not linked to banks' productivity and performance. Across-the-board pay hikes blur the distinction between good and bad performers while operating costs continue to mount. About 80 percent of the operating expenses of PSBs are accounted for by wages and salaries. RBI data on bank intermediation cost (BIC) ratios show that PSBs in the period 1991-1998 recorded an average rise in the BIC ratio, in contrast with Indian private sector banks, which managed to hold the ratio down. The only way forward now is for banks to be left free to genuinely compete.

The Chief Vigilance Commission in 1999 has clarified that banks should be 100 percent computerized by the year 2000 and that bank unions will have no say in this matter. This is to ensure that frauds, which have reached serious proportions under the manual processing system, are kept in check. The area of computer fraud, however, is not addressed.

Foreign banks have started reducing staff under the Voluntary Retirement Scheme. Such packages for staff of weak PSBs remain under discussion.

Table 24 shows the number of staff deployed in scheduled commercial banks (SCBs), and the number of deposit accounts and borrowing accounts handled. As can be seen from the table, improvements must be made in branch service operations, staffing, and expansion in rural and semi-urban SCBs considering the high volume of banking transactions and the relatively smaller number of staff per branch compared with urban/metropolitan SCBs.

Priority Sectors

Indian banks have been assigned an important public role of allocating financial resources to specified priority sectors, a system that has contributed to the creation of assets, a green revolution, and a white revolution,[5] apart from strengthening the base of small-scale industries. The level of NPAs should not detract policymakers from supporting banks' roles in the development of the priority sectors. A fair, objective assessment of socioeconomic benefits is needed. Branch expansion in unbanked areas will have to continue to create wealth and prosperity. The

Table 24: Number of Offices, Deposits and Borrowing Accounts, and Staff in Scheduled Commercial Banks (inclusive of regional rural banks), as of March 1996

Branch Location	No. of Branches	No. of Staff	Amount of Deposit Accounts (Rs million)	Amount of Borrowing Accounts (Rs million)	Staff/ Branch	Deposit/ Branch	Borrowing/ Branch
Rural	32,981	196,031	112.9	28.8	6	3,423	873
Semi-urban	13,731	227,039	109.4	15.9	17	7,968	1,158
Urban	9,798	595,955[a]	88.5	7.0	34[a]	9,028	718
Metropolitan	7,946		81.2	4.9		10,224	621
Total	**64,456**	**1,019,025**	**392.0**	**56.7**			

[a] Includes metropolitan staff.
Sources: Reserve Bank of India, Indian Banks Association.

economic reforms cannot be molded to leave 60-70 percent of the country's population with only a trickle down effect from reforms.

The shackles of "directed lending" have been removed and replaced by the criteria of merit and commercial viability. Also, expansion in the definition of priority sector, upgrades in value limit to determine SSI status, and provisions for indirect lending through placement of funds with NABARD and SIDBI have lightened the performance load of banks. SSI and export financing take place more in metro and urban areas in a competitive environment. As such, priority sector financing is no longer a drain on banks.

There is also a need to simplify reporting formats and cutback on paperwork. This can be done by dividing bank capital for metro/urban areas branches and rural/semi-urban area branches, and imposing the discipline of the CAR and CAMELS model for internal performance evaluation at regional offices supervising such branches. The cooperative banking segment also needs urgent recapitalization support since its entire market and client base is in the priority sectors.

Priority sector financing is a continuing priority for survival of banks with large networks of rural and semi-urban branches.

Rural Banking

POSITION OF RURAL BANKS

RRBs (accounting for 30 percent of the branch network of SCBs) are prime candidates for merger to create a single large rural-oriented outfit with a commercial approach and competencies.

PSBs perceive RRBs as a drag on the system. Although RRBs sponsored by different banks are fragmented outfits, their staff unions have successively fought and secured wage parity with the staff of sponsor banks. As a result, there is a weak rural banking system of branches with highly paid staff instead of the original plan to create "barefoot bankers." RRBs as small banks will remain fragile and their recapitalization (Rs3.64 billion added so far to the Rs1.96 billion of the earlier paid-up capital) has remained a long haul, though the amounts required are much smaller than those received by sponsor banks themselves by way of recapitalization. A large-scale merger would force an appropriate recapitalization, which entails only a one-time cost to the taxpayer instead of a continuous annual invisible cost load.

Traditionally rural and semi-urban areas have been looked upon as requiring help and lacking in competent management. This mindset in policy formulation, regulations, and procedures governing the rural banking system has left the rural system ailing, as was revealed during recapitalization/restructuring exercises on RRBs, which had operated under adverse regulatory constraints.[6] Liberalization of RRBs' activities has permitted them to participate in more profitable businesses. A single, strong, merged RRB setup would bring to the rural economy a well-directed banking apparatus to take care of infrastructure, export financing, and traditional businesses.

This will require better management or setting up new RRB branches in district locations and state capitals, regional boards, and a central board for operational policy governance. Such a bank should be charged with developing linkages between rural and urban centers to provide commercial banking services and not merely rural finance. Agricultural product exports are increasing, establishing the need for new services even at rural and semi-urban level. Unfortunately, post-reform thinking has dampened the will of nationalized banks to serve such needs. Reform proponents have advocated pruning of priority sector credit from 40 to 10 percent for PSBs without considering how cooperative banks and RRBs can fill the void that may be created by withdrawal of major players from the activity.

CLEARING SYSTEM REFORM

Industrial location policy requires that apart from notified industries of a nonpolluting nature, new industries must be set up beyond the 25 kilometer radius of any city with a population of more than

one million. While this has forged close economic links and sparked a daily flow of banking transactions between city and rural bank branches, the latter are not admitted to the city's clearing house facilities. Check collection and related banking services are, as a result, riddled with delays, slowing down the circulation of money and adding to the amount of paperwork, interoffice transactions, and risk of fraud. Expansion of city clearing systems will radically simplify banking and reduce transaction costs of rural branches.

SUPERVISION

NABARD has a statutory supervisory role over 28 state cooperative banks, 364 district central cooperative banks, and 196 RRBs. It also exercises voluntary supervision over 19 state-level and 738 primary-level agricultural rural development banks by virtue of its refinancing and developmental role. An Expert Committee set up by NABARD in January 1998 recommended a comprehensive package of reforms, including extending the capital adequacy norm to cooperative banks and RRBs gradually within a period of five years and three years, respectively. The committee noted that a large number of cooperative banks (66) and RRBs (170) were debilitated and not in a position to meet even the minimum capital requirements because of heavy erosion of assets.

In order to improve the prudence of bank management, the internal auditing system must be improved systematically, for instance based on CAMELS rating model.

COMPUTERIZATION

Simple personal computer (PC)-based computerization of rural and semi-urban branches would cost about Rs1.8 billion (cost of PC [Rs40,000] X No. of branches [45,000]), or about $43 million for PSBs. The business of these branches is largely retail and better control on priority sector loans at these branches requires equipment upgrades. Staff training and system upgrades at these branches would have to follow.

Nonbanking Financial Companies

FRAGILITY OF NONBANKING FINANCIAL COMPANIES

Unlike in other Asian economies, the nexus between banks and NBFCs in India is not significant. From 1985 when mutual funds and merchant banking expanded, RBI emphasized that there should be an "arms' length" relationship between banks and their affiliates. This "Chinese Wall" is stronger now than ever before.

Private market lenders are considered to have stronger incentives or greater ability to monitor borrowers, and better positioned than public creditors to renegotiate contract terms or exercise control rights in the event of problems.

While banks and finance companies are equally likely to finance problematic firms, the latter tend to serve riskier borrowers, particularly those who are more leveraged. This is important for a country such as India, where nationalization of banks has, in many instances, diluted the informality that lower class of borrowers prefer. NBFCs and informal credit markets have thrived on lack of interest in this field among the PSBs and expanded their asset base, fed on appetite for deposits at high rates.

With strict capital adequacy, income recognition, and NPA norms in the offing and with the SSI sector remaining at the receiving end of the economic slowdown problems faced by large corporates, too many restrictions on NBFCs will create only a void in the credit chain that banks cannot fill. Like small private sector banks and primary urban cooperative banks, NBFCs have their place in the financial system and this should not be subject to sweeping changes by regulators. If depositors looking for high deposit rates are willing to take risks, there is no need for them to be cautioned, except in cases of frauds and misfeasance. NBFCs operate in different market segments with relevant marketing strengths such as in leasing, hire purchase, factoring, merchant banking, car financing, transport financing, and home financing. They have different risk profiles as well as asset-liability

composition. It is not pragmatic to club them together to be subjected to a strait-jacketed regulatory regime.

RBI announced guidelines for NBFCs in January 1998. Among other things, the directives linked the quantum of public deposits that can be accepted by NBFCs directly to their credit rating, and the excess deposits held were required to be repaid before 31 December 1998. The result was panic among the public. RBI has since then modified the rules but there is no assessment so far as to how many NBFCs will be deemed as unviable.

Credit rating is a relatively new field in India and public awareness of the nuances of credit rating grades remains poor. NBFCs are mainly deposit-taking companies and a depositor has no way to secure liquidity in the midst of a possible downgrade. Credit-rating agencies already have their hands full with corporate rating business and it is doubtful if NBFCs operating in remote corners of the country can achieve ratings to satisfy their depositors and RBI. And it is also unlikely that all NBFCs can be effectively regulated and inspected by RBI, as the cost would be out of proportion to the risk to be controlled. The best way out for the public affected by the dilemma would be to identify priority centers where bank branches should be opened as alternate service providers in place of NBFCs ceasing to operate or forced to close down.

NEED FOR INTER-NBFC MONEY MARKET

NBFCs will remain important as the Government has tasked them to retail the sales of Government securities to the saving public. Moreover, the public will need their services in all other areas not touched by banks. Like banks, NBFCs may have to develop a second tier money market in which borrowing/lending will automatically come under "credit limit" and "credit watch" discipline of the players in similar lines of business. Temporary cash flows must therefore find safe, acceptable investment avenues in the second tier money market. Entities such as mutual funds will welcome this. The gain on the whole will be market-regulated functioning of NBFCs.

Factoring Services

Several companies and SSI units are often exposed to credit risks on sales but do not have the required competencies in receivables portfolio management. Banks providing working capital finance do not give adequate attention to default risks and the quality of receivables. On the basis of recommendations of a Government Committee on economic reforms (1985), the system of factoring was looked into by another committee, and factoring companies were set up as subsidiaries by banks such as SBI and Canara Bank in 1992. In February 1994, perhaps to give further impetus to the factoring system, RBI directed that banks will also have the option to undertake the activity departmentally, though at select branches of the banks since factoring services require special skills and infrastructure.[7]

Aside from the four basic factoring services of administration of the sellers' sales ledger, provision of prepayment against the debts purchased, collection of debts purchased, and covering the credit risk involved, factoring companies can also provide certain advisory services to the client by virtue of their experience in credit and financial dealings and access to extensive credit information.

Credit information services are highly deficient in India and there is little sharing of information among banks. As a financial system combining all the related services, factoring offers a distinct solution to the problems posed by working capital tied up in trade debts, more than 70 percent of which arise in Indian businesses by virtue of selling "on account (A/C) terms of payment." This is a large volume over which Indian banks have had poor control. Bankers are relatively slow in responding to this important aspect of working capital finance management.[8]

Policy Recommendations

Some major issues are highlighted on the problems of the Indian banking system arising out of the discussion so far, and quoting, where relevant, Narasimham Committee (II) recommendations.

Nonperforming Asset Management

ASSET CLASSIFICATION

RBI should not relax NPA norms in response to a slowdown in the economy. For prudential norms relating to income recognition, it should adopt the Narasimham Committee (I) recommendation to gradually shorten norms from 180 to 90 days for incomes that stop accruing to be classified as NPAs.

Asset quality improvement should take place by tightening norms for classifying assets from substandard to the doubtful category. The downgrading of assets in the Indian system is lax as the move from substandard to doubtful category is made only if it is past due for 30 months or remains in the substandard category for 24 months. This has to be improved upon. Also, the quantifiable criterion for defining a weak bank should be: accumulated losses + net NPAs exceeding the bank's net worth. Payment defaults by borrowers are mainly due to neglect of the receivables portfolio of their current assets, a reason why banks ought to seriously launch factoring and receivable portfolio management services to improve velocity of receivables and the overall credit quality.

Net NPAs have to be brought down to below 5 percent by 2000 and to 3 percent by 2002. However, banks with international presence should reduce gross NPAs to 5 and 3 percent by 2000 and 2002, respectively, and net NPAs to 3 and 0 percent by the same period.

As discussed previously, RBI guidelines stipulate that interest on NPAs should not be charged and considered in the income account. The guidelines create some complications in the accounting system. For instance, if a loan has turned into an NPA shortly before the end of a financial year, the interest payments during that and the previous financial years are considered not yet earned and the corresponding book entries recognizing interest income should be reversed. The definition of income recognition has become a critical issue in presenting a clear picture on the profit/loss account of banks. A review and, if necessary, change in the guidelines and accounting system should be immediately undertaken.

Banks must adopt methods of converting debt into equities in NPA accounts whenever possible to either ensure turnaround in corporate performance or sell equities to limit future losses. Today banks do not have an exit route.

Analysis of NPAs needs to be carried out not only with reference to sectoral dispersal of NPAs but also to specific accounts of NPAs that are common in balance sheets of banks and AIFIs, to bring about harmonization of their recovery efforts. Among banks and AIFIs, research into cases handled by Credit Guarantee Schemes, Export Credit Guarantee Corporation and state-level institutions as well as by BIFR should help to crystallize core problems of lending systems and problem areas of economic activity.

PROBLEM OF THE REAL SECTOR VS. BANKING SECTOR REFORMS

Strengthening the viability of the real sector is important for improving Indian banking and the financial system as a whole, which is but an institution to facilitate effective transmission of policies and smooth flow of resources within the economy. The Committee on Capital Account Convertibility has not dwelt on the impact to the real sector of expected inflow of capital in relation to efficiency and absorptive capacity of that sector.

In short, the future of reforms will have to focus on how the real sector and banking sector strengthen each other.

PROVISIONS

Prudential norms requiring general provision of at least 1 percent on standard assets must be established. Also, the general provision should consider potential loss assets determined through historical accounts. International banks practice different general provision standards and these should be examined. General provision should also include tax holidays to be granted as an incentive to banks, to accelerate strengthening of their capital base.

A risk weight of 5 percent should be applied to investments in Government and other approved securities to hedge against market risk. Also, the entire portfolio should be marked to market in three years. Other non-SLR investment assets of banks need to be brought in line with risk weights assigned to loans and advances.

A 100 percent risk weight must be applied to foreign exchange open positions. Gap management is needed to correctly reflect foreign exchange risk exposure.

FOCUS ON NONPERFORMING ASSET MANAGEMENT

Raising interest rates and reflating the economy through increased Government expenditure must be avoided. The risks to the banks and financial institutions come from NPAs that may be generated by a continued industrial slowdown. Thus, NPA management can be carried out by maximizing attention to the extent of credit concentration and considering diversification of credit portfolios through consumer financing, housing loan provision, factoring, and agricultural and SSI financing.

Management of NPAs should also focus on improving management culture that permeates various organization levels instead of being restricted to concerns on recovery, capital adequacy, and accounting processes. The NPA problems and their consequences will need to be assessed on the extent of mismanagement, including fraud.

Disclosure, Accounting Framework, and Supervision

There should be consolidation of balance sheets of different entities of banks to reveal their strength and to disclose connected lendings, pattern of assets and liabilities (domestic and foreign) in different maturities, and NPAs. Some banks overseas are required to publish cash flows, a practice Indian banks have started. The disclosure should also include migration patterns of asset classification, e.g., from "standard" to "substandard", and vice versa, as a measure of the quality of management.

The Indian system of governance (in the public and private sectors) has long fostered a climate of resistance to bankruptcy and also a tendency to provide bailouts that distort the risk. As such, the reform process will be a long haul. The sequencing may not be perfect and will necessitate adjustments. Restructuring will also be required separately for institutions remaining in difficulty. Real sector reforms, especially in terms of international auditing standards, accounting, timely and accurate information to markets, and good governance practices, must be aggressively pursued to support improvements in the soundness of the financial system.

Regulation and Supervision

REGULATORY FRAMEWORK

The Narasimham Committee (II) suggested that the "Basic Core Principles of Effective Bank Supervision" be regarded as the minimum to be attained. Banks must be obligated to take into account market risk weights to foster a sound and stable system.

For RBI to effectively carry out its monetary policy, delineation of supervision/regulation from monetary policy is required. The executive associated with monetary authority should not be in the supervision board, to avoid weakening of monetary policy, or banking regulation and supervision. The separation of the Board of Financial Supervision (BFS) from RBI has to be initiated to supervise the activities of banks, FIs, and NBFCs. A new agency, the Board for Financial Regulation and Supervision (BFRS), would have to be formed. To bring about integrated supervision of the financial system, the Narasimham Committee (II) recommended putting urban cooperative banks (UCBs) within the ambit of BFS and proposed prudential and regulatory standards besides new capital norms for UCBs.

The Narasimham Committee (II) recommended amendments to the RBI Act and Banking Regulation Act with regard to the formation of BFRS. It

also gives more autonomy and powers to PSBs (Nationalization Act). As the changes in the legal framework affecting the working of the financial sector sought by the Narasimham Committee are wide ranging, an expert committee could be constituted.

Regulation and supervision have been strengthened through prescriptions that include the establishment of a statute for BFS. Independence and autonomy of BFS would not be impaired by being a part of RBI. What is important is autonomy for the RBI and dilution of Government ownership in banks.

Some legislative action may be needed to support the banking regulatory framework reforms. The reform issues should be examined by research institutions dealing with banking concerns.

REGULATION OF FINANCIAL CONGLOMERATES

The BIS Tripartite Group agreed that the term "financial conglomerate" should be used to refer to "any group of companies under common control whose exclusive or predominant activities consist of providing significant services in at least two different financial sectors [e.g., banking, securities, insurance]." Many of the problems encountered in the supervision of financial conglomerates arise when they offer not only financial services, but also nonfinancial services and products. Coordination between RBI, Insurance Regulatory Authority, and SEBI is increasingly urgent.

SEPARATING SUPERVISION

The likely conflict between monetary policy and supervisory concerns can be taken as the basis and the rationale for combining the two functions. Separate authority structures for the two functions have more likelihood of coming into conflict with each other. The regulatory and supervisory systems have to take into account peculiarities of the banking and financial structures. For instance, India's RRB structure is vast, its cooperative movement quite strong, but banks in this sector are generally quite weak.

Creating equal opportunities for banks and FIs has been slow. As a result, financial packaging and closure of projects (term loans and working capital) suffer. Progress on this structural reform has to be constantly monitored. IDBI, ICICI, and IFCI should move toward acquiring banking licenses to provide one-stop services. Since the 1960s, there has existed an unnatural divide between term-lending functions and working-capital finance. The solution lies in putting in place stringent credit monitoring in which banks and FIs should share their expertise and information.

There is no need for a super regulator as recommended in 1998/99 by the Khan Committee,[9] which examined harmonization of roles/functions of banks and FIs. RBI should remain the sole regulator to ensure that the financial system is well supervised and that the risks of the real sector do not get transmitted to the financial sector by default. The current worries about strengthening of the financial system stem more from the industry's lack of transparency, corporate governance standards, and accountability to shareholders. Requiring disclosure for quarterly results is changing this situation and making the information flow to investors more orderly. This requirement applies now to banks and FIs that have raised public money. Consequently, tightening of the financial system will be accelerated.

In 1998/99, the World Bank issued a directive that international audit firms cannot put their name to accounts of Indian companies that are not in line with high quality international financial reporting standards. Standards are indeed low but implementing the World Bank directive would not be practicable without Government legislation on standardization of various reporting systems and their incorporation into the Companies Act. The Government has to quickly remove these bottlenecks to boost investor confidence, attract foreign direct investment, and minimize damages to the financial sector.

Asset Liability Management

FOCUS ON ASSET LIABILITY MANAGEMENT

In general, the development of ALM operations has to be in the direction of an objective and comprehensive measurement of various risks, a pursuit of returns commensurate with the size of the risk, and a strategic allocation of capital and human resources based on the risk. The evolution in financial management with the sophistication of ALM operations has to be an autonomous response and not driven by regulators.

As banking and financial sector reforms have been under way in India for the last six years, the only factor that could affect their balance sheets is lack of ALM in terms of maturity and interest rate mismatches. Banks will have to participate actively in forming money markets and to enforce data generation at each branch level. RBI, in its Monetary and Credit Policy Review (30 October 1998), announced the introduction of interest rate swaps but these will be used only when banks discover the extent of mismatches that cannot be cleared through term-money markets.

With respect to "off-balance sheet" assets, there will be a need to create a corporate level knowledge base in banks about items that offer "price risk transferring" or "credit risk transferring" or both opportunities. Examples of the former are swaps, futures, options and loan caps, forward rate agreements, and credit enhancing guarantees. Credit risk transferring opportunities include letters of credit and note issuance facilities.

BILL CULTURE

In order to promote bill culture and the secondary market, RBI directives require borrowers to resort to bill financing to a minimum of 25 percent of receivables. Most borrowers, especially among SSIs, find compliance difficult and it is not known how many are forced to forgo financing from banks and resort to market borrowings. The "on account payment" invoicing is the dominant trade practice in India and unless banks introduce factoring, the legitimate bank credit needs of such borrowers will remain unmet. Deficiencies of Indian bills and money markets have persisted despite reports by high-level committees during the late 1980s. The quality of receivables continues to be unsupervised and securitization is still a remote possibility.

TRADING RISK MANAGEMENT

The trading portfolio of banks in India is becoming more diverse with a range of bonds, equities, and derivatives available, and RBI permitting investments in overseas markets. Debt swaps and interest rate swaps as well as currency swaps are entered into with foreign banks and such exposures need special monitoring. There is an eagerness to introduce a variety of derivatives but the regulatory and risk management apparatus is not fully ready.

INTERNAL AUDIT MACHINERY AND COMPLIANCE

There are dangers in banks' practice of cosmetic cleaning or "evergreening" of advances to prevent NPAs. In 1996/97, the Jilani Committee[10] observed that banks' internal audit machinery and compliance are weak. RBI stipulates that audit committees of boards should seek to ensure management's commitment to internal audit control. This can be made stronger by stating that internal audits are management's reporting responsibility to stockholders. The internal auditing system should be established by training bank inspectors and rotating their assignments.

With regard to computer audits, SBI and IBA have been doing work in this area since 1987. Computer audit skills are lacking even in India's chartered accountant firms. It is worth having computer audits as a statutory requirement. In the US, the Federal Reserve and FDIC have jointly issued manuals on electronic data processing audit on the grounds that "technology changes the way business is done in banks." The computer audit of computer service agencies by banks employing them is mandatory (with respect to outsourced work).

Certification of Information Systems Auditors (CISA) examinations from the US are now available in India, but few bank staff take them. Banks' inspectorates and chartered accountant firms should have CISA qualified auditors.

Similarly, banks, nonbanks, and companies require professionals qualified in handling foreign exchange trading. In fact, RBI has taken the lead to define risk management standards in PSUs that take on foreign exchange exposure.

There is also a need for professionals qualified to carry out securities and stock market trading in all the market intermediaries.

Capital Adequacy

A capital adequacy of 9 percent should be achieved by the year 2000 and 10 percent by 2002. This goal should be weighed against the expected financial support from banks for economic growth and protection of risk assets. In the first phase of reforms (1991-1997), banks changed their approach from "growth budgeting" to "balanced growth budgeting" (i.e., with reference to their own funds). The dilemma of banks' shortage of capital to cope with increasing credit demand must be resolved as a priority so that capital adequacy does not become an end in itself.

Measures should not be implemented in isolation. If the capital adequacy levels are being brought to international levels, then the concept of a tier-3 capital should also be introduced, i.e., as a subordinated debt instrument (of shorter maturity of two years) much like the bonds issued towards tier-2 capital (of five years maturity).

Other measures to strengthen banks should seek to eliminate the management dilemma. This can be done if banks themselves internalize a culture of self-evaluation under the CAMELS model by undertaking periodical management audits. The core message of capital adequacy and prudential norms is self-regulation.

Measures to be taken in the second phase of banking reforms should be based upon a study of the impact of reforms initiated in the first phase. But as the reforms were introduced in stages, it is too early to assess their impact. What has been achieved is transparency with respect to banks' financial statements, bringing Indian accounting standards closer to internationally accepted norms. One discernible impact has been that all but two PSBs (Indian Bank and United Commercial Bank), had met by 31 May 1997 the capital adequacy norm of 8 percent and some are already well above that threshold. For instance, that for SBI is 14.58 percent; UBI, 10.86 percent; BOI, 9.11 percent; DenaBank, 11.88 percent; and IDBI, 13.7 percent. The weaknesses that have emerged in the banking system are in fact weaknesses of the prereform period. The issues to be tackled in the second phase of reforms are large and cannot be delayed because the adjustment process would become increasingly difficult. As far back as 1961, RBI advised banks to aim for a CAR of 6 percent (of paid-up capital and reserves to deposits) because they had been increasing their assets without a corresponding augmentation in the capital base. This ratio declined from 9 percent in 1950 to 4 percent in 1960, and 1.5 percent in 1978.

Mergers and Recapitalization

The Narasimham Committee recommended that after the activities of DFIs and banks have converged for a period, the DFIs should be converted into banks, leaving only two types of intermediaries—banks and nonbanks. While mergers between strong financial institutions would make sense, the weak banks in the system would have to be given revival packages. The licensing of new private sector banks needs to be reviewed, while foreign banks will have to be encouraged to extend their operations.

The importance of the tasks ahead is underlined by the fact that Government recapitalization of nationalized banks has cost Rs200 billion. SBI has been an exception particularly because it has addressed (since 1974) the task of reflecting its financial strength through the building of reserves. This is due to the

requirement to raise lines of credit in the international market for itself and for Indian corporates. SBI has done this regularly for some years since 1972. It was late in establishing offices overseas but quickly caught up with international standards of management. One factor that has helped SBI has been the private shareholdings held in it even after 1955 when RBI acquired a majority share. As a result, SBI has been required to hold annual general meetings of shareholders and has benefited from the system of checks and balances, disclosure disciplines, and dividend expectations of shareholders.

With most nationalized banks incurring continuous losses since 1992/93, returns on capital have been negative, preventing buildups of reserves. Slow accretion in reserves was also due to higher provisioning requirements under the new prudential norms. With the Government no longer willing to provide further capital, the only route for PSBs to improve their capital base is through substantial improvement in generation of internal surplus so as to be in a presentable shape to approach the capital market. These features and the weaknesses of the rural banking system should determine the measures required in the second phase of reforms.

Government-guaranteed advances that have turned sticky should be classified as NPAs and, in cases where sovereign guarantee argument is advanced, there should be appropriate disclosure in the balance sheet of banks. Potential for conversion of such loan assets into Government debts in the form of securities issued to banks should be looked into as a way of removing contamination from banks' balance sheets. This way, a loan asset in a bank's balance sheet would be transformed into an investment asset.

The measure would not only help to clean up bank balance sheets but also strengthen the Government's resolve to eventually sell off or privatize the business units for which the Government provided a guarantee to a bank. This will in turn contribute to an improvement in the recovery climate.

Bank Restructuring

FISCAL IMPLICATIONS

All bank restructuring attempts have fiscal implications that are bad if considered in isolation. The advantage lies in taking on the fiscal impact and not allowing problems to fester. The Government should draw up a total balance sheet of bank nationalization and socioeconomic gains to strengthen PSBs, on which it will have to depend if it is to reduce the population/branch and ATM[11] ratio from 15,000 to 3,000.

ASSET RECONSTRUCTION COMPANY

The Government should not provide capital support or indirect financing to ARCs. The Narasimham Committee (II) recommended that there should be no further bank recapitalization other than the undisbursed amount of Rs4 billion from the previous budget provision that can be diverted as seed capital for ARCs. ARCs will be required for banks that are not viable over a three-year period. Such banks will have to be referred to the Restructuring Commission.

The Narasimham Committee proposed the establishment of ARCs to tide over the backlog of NPAs. Banks would undertake financial restructuring by hiving off their NPA portfolios to ARCs and obtaining funding from it through swap bonds or securitization. But the Indian banking sector does not require any emergency policy for rebuilding, despite the NPA problem. The only banks that need to be recapitalized in the near future are some rural and cooperative banks. The dangers of ARCs are obvious since it could prove to be an easy route for commercial banks to clean up their balance sheets, creating scope for staff to repeat mistakes instead of learning from them.

Banks have managed recoveries and creation of ARCs would only reverse the healthy recovery of management systems that banks are hoping to establish.

Operational Efficiency

The private sector's partial ownership of SBI has contributed to its exceptional operational efficiency even after 1955 when RBI acquired majority shares. This suggests that it is advisable in the long term for the Indian banking sector to increase the share of private ownership.

In order to reduce the social burden caused by banking sector inefficiency, banks should be given wider management autonomy. The Government should gradually but steadily reduce its ownership of the banking industry while maintaining rigorous prudential regulation and rationalizing its supervision capacity.

To bring about efficiency in banks, the Narasimham Committee (II) recommended a number of measures. These included revision and regular update of operational manuals, simplification of documentation systems, introduction of computer audits, and evolution of a filtering mechanism to reduce concentration of exposures in lending and drawing geographical/industry/sectoral exposure norms with the Board's concurrence. Besides, the Narasimham Committee suggested the assignment of full-time directors in nationalized banks. As outsourcing of services would improve productivity, it recommended that the same be introduced in the fields of building maintenance, cleaning, security, dispatch of mail, computer-related work, etc., subject to relevant laws. It also suggested that the minimum stipulated holdings of the Government/RBI in the equity of nationalized banks/SBI be reduced to 33 percent.

With regard to the tenure of a bank's chief executive, the Narasimham Committee indicated a minimum period of three years. However, a more reasonable length of tenure should not be less than five years. Managers should be given incentives to adapt their managerial structure to new developments in financial technologies and to changes in client demand for financial services. The Government needs to seriously consider an increase in management autonomy in the banking industry, because it is essential to efficient management.

Systems and methods in banks should be improved. Some of the issues are at the micro level and best achieved if banks internalize the system of self-evaluation under the CAMELS rating model.

Banks also need to effectively exploit their networks of branches established in the past at low cost. It is necessary for PSBs to introduce factoring services and also activate a short-term bill financing mechanism, both of which entail utilization of the branch network for collection of the factored invoices and bills for clients.

Autonomy and Governance

Autonomy and sound governance are likely to be achieved after privatization of banks has taken place. The Narasimham Committee's observation that most banks do not even have updated instruction manuals proves the point. RBI's selection of statutory auditors for banks may seem to conflict with the requirement for sound corporate governance. However, such regulatory intervention will remain useful until banks can fully strengthen their internal systems and procedures, risk management standards, and the required preventive and detective controls.

Recruitment and workforce management as well as remuneration management should be left for banks to handle. But apart from exceptional cases, this is not a priority area. Although the problem of overstaffing is a legacy not easy to get rid of, it has been halted since 1985/86 through restrictions in fresh recruitment.

All appointments of chairpersons, managing directors, and executive directors of PSBs and financial institutions should be determined by an appointment board. The Narasimham Committee felt that there was an urgent need to raise competency levels in PSBs through a lateral induction of talented personnel. It also indicated that the remuneration structure should be flexible and market driven.

The Government should quickly take steps to induct shareholder nominees on banks who have raised money from the public but do not have representation on the boards.

It will also have to reorient economic governance to ensure that transaction costs to the public, trade, industry, and financial sectors are reduced or eliminated. For example, in 1998, the Government released an autonomy package for nine more PSBs (totaling 14 as of 31 March 1998), which result in the elimination of consultations and delays in decision making. A step further would be to install regional boards for PSBs in order to delegate power and improve operational governance. Centralization has built rigidities, fostered mediocrity, and curbed bank expansion in the rural and semi-urban areas. If the Government's plan to computerize all branches is to be achieved, capital will be required that can be found only through cost cutting which itself is dependent on decentralization. Nationalized banks need to have regional boards of directors like SBI to decentralize decision making.

Human Resources Development

Human resources are not merely an asset but the real capital of a bank. Banking in the future will require knowledgeable workers. A bank should have a group of chief officers in a variety of fields so that the collective wisdom of their organization is at the fingertips of every employee. An integrated body of knowledge and professionalism in banking has to be in place to ensure continued financial viability. Staff morale plays a crucial role in developing good organizational culture. In that context, training is going to be an important factor.

Resuming recruitment of young trainees, training and retraining of personnel, accelerated promotions for young people through competition, studious habits, strong staff management, matching resources with emerging responsibilities, developing backup support to determine recruitment needs of new skills, and spread of an IT culture are among the issues that have to be addressed. The focus should be to create core competencies for handling various types of risks and customer sophistication, to meet all needs, from rural to urban.

There are several institutes and colleges that provide skills- and management-oriented training programs to staff every year. Some are dedicated to individual banks, while a few institutes cater to the needs of all Indian banks and FIs. However, there is only one institute that conducts professional examinations—the Indian Institute of Bankers,[12] which has completed 70 years of service to the banking industry in the country. It develops professionally qualified and competent bankers through examinations and continuing professional development programs.

Recognizing that the trend throughout the world is to acquire proficiency in management through Master of Business Administration (MBA) degrees, the institute has signed a memorandum of understanding with the Indira Gandhi National Open University, New Delhi, to offer an MBA in Banking and Finance. This program will enable a practicing banker to bridge professional experience with academic excellence. Banks need to encourage the attainment of relevant professional qualifications among staff, and the institute's activities are steps in the right direction.

Analysis of NPA management in banks has revealed that instruction manuals in most banks are not up-to-date. Audit systems concerned with exercise of preventive and detective controls cannot be effective in such an environment, while training systems will lack a proper foundation. RBI should assign proportionate punitive negative ratings to banks for such deficiencies. The Narasimham Committee (II) has also called for the updating of manuals in banks. Another area of training should concern codes of ethics and public accountability.

Reduction in Priority Sector Loans

Both Narasimham Committees recommended that the directed credit component needs to be reduced from 40 to 10 percent since contamination of banks' balance sheets has come from payment defaults in this sector. With more disintermediation and competition coupled with rising costs and falling income

margins in metro and urban centers, more than 70 percent of the branch network of PSBs situated in rural and semi-urban areas should look upon local market opportunities as being a "priority" for the banks themselves. These areas are rich in potential, which banks can tap only if they can introduce technology and computerization at relatively low investment costs. Banks' neglect in this area explains to some extent the growth of the informal sector and NBFCs. Yet the farming community in many states today is well educated and needs modern banking support, which neither foreign banks nor newly opened private sector banks would offer.

According to data quoted in the R. V. Gupta Committee Report (April 1998) on agricultural credit through commercial banks: "There has been an increase in the flow of credit to the agricultural sector from Rs112.02 billion by all agencies in 1991/92 to Rs286.53 billion in 1996/97, and to an estimated Rs342.74 billion in 1997/98. This has been possible on account of more refinance extended by NABARD to rural financial institutions, RBI's increased support by way of general line of credit to NABARD for the short term, and introduction of special agricultural credit plans by commercial banks for this sector. RBI has played a central role in motivating commercial banks to place a special emphasis on agriculture. In spite of these initiatives, there is a perception that investments in agriculture have not kept pace with demand."

There is a need to review the best banking practices that brought prosperity to rural and semi-urban areas. The causes of decline should be isolated and tackled.

Most of the factors causing NPAs in the priority sectors can be brought under control. The priority sectors include SSI financing, which is handled prominently at bank branches in metro and urban areas (not only in rural and semi-urban areas) and is commercial except that it is under priority credit. By the same argument, agriculture financing in rural and semi-urban areas is equally a commercial proposition. As such, the calculation of contamination coefficient of directed credit[13] requires review and should not lead to policies that curtail financing to important economic segments. Most important, a rural banking system under control of NABARD is too weak to shoulder the burden of rural credit.

The Government and banks interpret the term "directed" as "targeted" in reference to the Narasimham Committee (I) recommendation for a "directed credit allocation to the priority sector." The shift in focus should be towards timely and adequate credit to eligible borrowers. The "service area approach" introduced in 1987 that allocated command areas to rural banks restricted the choice of bank for borrowers and choice of borrowers for banks that allocated command areas to rural banks. The freedom to manage advocated by Narasimham Committee (II) warrants abandonment of this "service area approach."

Freedom also should exist for reporting performances in lending to agriculture with reference to harvest periods instead of using a fixed date of 31 March, which is the banks' balance sheet date, when demand for agriculture credit is depressed.

The Gupta Committee has identified core human resources problems such as staff of rural/semi-urban branches commuting daily from places where their families can stay comfortably. Lack of recognition of performance at such branches by their senior management is another problem.

The issue of merging RRBs to create a single rural-oriented banking institution deserves support since recapitalization of more than 140 sick RRBs has still not been decided. Also, capital infusion into cooperative banking is long overdue. This contrasts sharply with the urgency with which nationalized banks received a large amount of recapitalization support from the Government. India cannot have a strong banking system only for metro and urban services if it wants to be globally competitive.

Rural Banking

RURAL BANKING AND SMALL INDUSTRIAL CREDIT

In the wake of computerization of banks, the management challenge concerns staff redundancies. Branch expansion in rural and semi-urban areas would be a logical way to deploy the excess staff. Some 600 million people (out of a population of more than 900 million) live in these areas. The population-branch ratio of 12,000 on a gross basis needs to be reworked separately for rural and semi-urban areas (making allowance for good communication and transportation networks that are available in metro and urban areas) and improved significantly. Economic liberalization since 1991/92 has failed to fully bring forth the "trickle down" benefits to the rural and semi-urban poor and has instead resulted in high investment in the luxury goods sector. The bias should be corrected by boosting Government investment in rural infrastructure and expanding banking activities.

RRBs are presently under the control of four regulators: the sponsor bank, state governments, NABARD, and indirectly RBI (under a system of consolidated supervision to which the parent bank of the RRB is subjected). A single countrywide entity merging 196 RRBs of more than 14,000 branches (functioning in 23 different states and 435 districts) could end this fragmentation and develop a focused system. This system could mobilize a large volume of deposits through active management and low-cost technology to achieve a reduction in transaction costs, have its own dedicated training system, establish internal controls, regionalize supervision and audits, create payment networks by having branches at each district under which present rural branches of any RRB fall, and provide timely, need-based credit at each rural area.

More than 14 countries have benefited from "Project Microbanker," a customized version of which can be used by RRBs. Alternatively, software can be developed that will be feasible and cost effective if RRBs are amalgamated. A nationwide payment and remittance system at rural level is necessary because there has been a regular migration of people from different states as farm laborers and industrial workers and these need remittance services.

Amalgamation will result in creation of a strong national rural banking apparatus if commercial orientation and management upgrades are also tackled alongside recapitalization. Such a large bank should have branches at districts and state capitals to foster strong links between these centers and outlying rural areas where the majority of RRB branches operate. Besides creating a strong nationwide payment network, it would achieve harmonization of policy and growth strategies—especially in agriculture and agro-industry exports for which adequate services are not available from commercial banks (centers where the business potential is high). The amalgamation of RRBs could take place through four to five subsidiaries; i.e., groups of RRBs in contiguous regions, or by having a single amalgamated bank structure with regional boards and a central board based on the SBI structure.

The Government has introduced a Rural Infrastructure Development Fund, which is administered by NABARD, for financing state governments. Perhaps a strong commercial rural-oriented banking vehicle can deliver better results.

Currently, RRBs are standalone institutions with branches functioning in a highly adverse and isolated environment. A centralized institution of RRBs by merger could attract better managerial talent and also take its cues from the corporate sector and multinationals, which regard the rural economics of India as potentially a fast developing market. In fact, some corporates and multinationals today are engaging MBA degree holders qualified in rural development subjects. Some rural areas are potential candidates for development into export centers for which modern banking facilities should be made available, instead of making the customers commute to urban centers to meet their international banking needs.

There are other justifications for merging RRBs into a single unit. It is true that the merger of weak

units cannot build strength but the merger will attract the required attention to the system in which the scope for synergy is high. The risk of putting RRBs in the same club as cooperative banks is that the method of supervision fails to distinguish the ownership pattern and differences between the two sets. NABARD should benefit from realignment of its supervisory load if RRBs are merged and provided a strong central management. This rural banking apparatus can create competition, which is absent totally in the rural banking field. RRBs are already permitted to invest in shares and debentures and units of mutual funds up to 5 percent of their incremental deposits. All RRBs, if merged, could generate a sizable corpus of funds and also management competencies to handle such an investment portfolio, which today each RRB has to separately develop.

The Narasimham Committee proposed that the operation of rural financial institutions be reviewed and strengthened in their appraisal, supervision, follow-up loan recovery strategies and development of bank-client relationships, in view of the higher NPAs in PSBs due to directed lending. With regard to CAR, RRBs and cooperative banks should reach a minimum of 8 percent over five years. Also, all regulatory and supervisory functions over rural credit institutions should rest with the proposed BFRS.

Banks would have to offer financial solutions to the agricultural sector and put to use expertise in private equity, venture funding, and corporate finance to tap the potential of agri-based businesses in India.[14]

Banks and corporates as well as cooperatives will have to take into account changes in consumer attitude toward processed food and modernize the distribution and retail systems. There should be proper advisory services, project financing, venture capital, strategic and private equity and asset financing—including off-balance sheet financing—to come up with investments in this sector. Though India is the third largest producer of fruits and vegetables in the world, it lacks a market information system. The rural banking system will have to develop this. Profits from agriculture produce are heavily dependent on infrastructure and market information. Market information system is the key to development of infrastructure for rural markets. The system would include all information regarding prices, investments, manufacturing, and requirements of all products. The Government National Information Centers have a big database in each state, but market-oriented use and the sharing of it with banks are required.

Nonbanking Financial Companies

The NBFC reform agenda is complex because of the large number of NBFCs, their locational spheres, varied composition of assets and liabilities, failure rate, and incidences of fraud that have caused a loss of depositors' confidence. There are also new requirements of credit rating, capital adequacy, statutory liquidity, and registration with RBI. In many areas, there might be forced or voluntary closures of NBFCs that are not able to comply with the norms. RBI should identify such places and ask banks to open branches to provide alternatives to depositors where none exists.

Factoring Services

Factoring services have not taken off even though they improve velocity of receivables, thus affording better credit control. Only three important factoring systems have been established, namely, SBI, Canara Bank, and SIDBI. Experience of existing factoring companies in India is that average credit period of receivables is cut by more than 25 percent resulting in cost reduction of working capital. The rigorous follow-up by factoring companies also decreases debt delinquency.

Application of electronic data interchange (EDI) needs to be progressively adopted to accelerate growth of factoring services. Banks, corporates, medium-size industries, and SSIs should unite to develop electronic message formats in receivable portfolio management and collection systems.

The adoption of EDI will allow computer-to-computer exchanges of business transactions such as purchase orders, invoices, shipping notices and other standard business correspondence between trading partners. Exporters and importers as well as domestic traders can translate all foreign or domestic trade-related documents electronically without any human intervention from their own premises, drastically reducing paperwork and increasing efficiency. Even though measures are being taken to increase exports and earn foreign exchange, the nonimplementation of EDI is proving to be a major obstacle to boosting exports because many countries carry out trade transactions mostly electronically.

External Sector

External sector development, particularly with respect to trade, should continue to be a major concern if stable growth is to be encouraged and economic competitiveness enhanced.

If export performance does not improve, the consequences for the banking and financial sectors might be serious. External assistance to the export sector should be extended by multilateral agencies through the Indian banks and FIs. During 1989/90, the World Bank extended loans to Indian banks to finance export projects and to allow repayments to be retained as equity for banks. This should be undertaken again in the current and future financing activities of multilateral loan institutions.

Capital Account Convertibility vs. Banking Sector Vulnerability

Current account convertibility (CAC) is not going to benefit Indian banks, which still have to get to grips with the full-scale convertibility on current accounts in force for the last few years. At the macroeconomic level, there are two aspects that merit special attention: India's external debt is now close to $100 billion; and it has a strong parallel economy (black market), which can weaken its balance of payments in a CAC type of regime. The Government should improve its utilization of aid funds and foreign capital rather than just basing economic growth requirements on free capital inflows (which cannot be obtained unless outflows are freed).

Indian banks need to become competitive with branches of foreign banks in centers where both exist, and the number of such centers ought to be enlarged to promote modernization in Indian banks. There is no risk of Indian banks being dislodged from their prime position in the home market if more branches of foreign banks open at important centers nor can their foreign branches become internationally competitive since capital that Indian banks can spare for foreign branches is marginal and low.

Universal Banking

Caution must be applied on universal banking because of the following considerations:

- disintermediation (i.e., replacement of traditional bank intermediation between savers and borrowers by a capital market process) is only a decade old in India and has badly slowed down due to loss of investor confidence;
- there is ample room for financial deepening (by banks and DFIs) since loans market will continue to grow;
- DFIs as holders of equity in most of the projects promoted in the past have never used the tools advantageously;
- DFIs are now only moving into working capital finance, an area in which they need to gain a lot of experience and this involves creation of a network of services (including branches) in all fields: remittances, collections, etc.; and
- reforms of India's capital market is still at the halfway stage. The priority will be to ensure branch expansion, financial deepening of the credit markets, and creation of an efficient credit delivery mechanism that can compete with the capital market.

Money Market

The Narasimham Committee recommended that banks and primary dealers alone should be allowed in the interbank call and notice money market. NBFCs would get access to other forms of instruments in the money market such as bill rediscounting, commercial papers, and T-bills. It also suggested opening the T-bill market to FIIs to broaden its base. The imperfections of money market lie in the traditional nomenclature used; for instance, the "call money market," which, instead of allowing clearance only of temporary surpluses and deficits, is actually treated as a source of regular funding by banks (particularly foreign banks). The need is to remove the word "call" from various reports and publications of RBI and define it clearly as a composite money market for call funds and term funds. There is little activity in the term funds market even though the liability structure of banks and DFIs has undergone a considerable transformation.

Notes

[1]The State Bank of India (SBI) and Associate Banks of SBI were formerly Imperial Bank of India, Ltd. and Major Princely State Banks, respectively. It is legally prescribed that RBI must hold at least 55 percent of SBI.

[2]The ordinance came into effect on 31 October 1998.

[3]Debt Recovery Tribunals (DRTs) are established consequent upon enactment of the Recovery of Debts due to Banks and Financial Institutions Act of 1993 (pursuant to recommendations of Narasimham Committee [I]) but have not made much impact on recovery performance of banks. The number of DRTs has remained inadequate with disposal of cases slow, as gathered from data recorded in para 2.95 of RBI Report on Trends and Progress of Banking in India, 1997-1998. DRTs are known to have functioned with multiple states jurisdiction and inadequate infrastructure, a reason why the Working Committee on DRTs was set up in 1998 by RBI/Government to look into the related problems.

[4]India's judges/people ratio is the lowest in the world. The accumulation of and age of cases remaining undisposed are large and recovery suits filed by banks lie in the queue. The Reserve Bank of India's Health Code Scheme in the 1980s impelled segregation of loan assets by quality of bank balance sheets, which until 1992 (when the formal reform process started) showed a rosy picture. Banks did not take full advantage of the Health Code classification with the result that bad borrowers got an extended breather to saddle banks with loss assets.

[5]Production of milk. India is among the world's biggest producers.

[6]The mindset is loaded with concerns over poverty more than recognizing that rural banking promoted since 1969 up to 1991 has transformed several poverty regions to high levels of prosperity.

[7]These activities should be treated on par with loans and advances and should accordingly be given risk weight of 100 percent for calculation of capital-to-risk-asset ratio. Further, the extant guidelines on income recognition, asset classification, and provisioning would also be applicable to them.

A bank's exposure shall not exceed 25 percent of the banks' capital funds to an individual borrower and 50 percent to a group of borrowers. The facilities extended by way of equipment leasing, hire purchase finance, and factoring services would also be covered within the above exposure ceiling.

Banks undertaking factoring services departmentally should carefully assess the clients' working capital needs taking into account the invoices purchased. Factoring services should be extended only in respect of those invoices that represent genuine trade transactions. Banks should take particular care to ensure that by extending factoring services, the client is not overfinanced. No worthwhile progress has taken place, reflecting apathy of banks towards factoring.

[8]The Government appointed in 1985 a committee under the chairmanship of Dr. Sukhamoy Chakravasti to review the workings of the monetary system. The report of this committee provided several directions to the future shape of financial sector reforms. Among its various recommendations, the Committee advocated stricter credit discipline and a reduction in the importance of cash credit, greater resort to financing of working capital through loans, bills, and receivables.

[9]RBI constituted in 1997 a working group under the chairmanship of S. H. Khan, Chairman of Industrial Development Bank of India, to (i) review the roles, structures and operations of development finance institutions (DFIs) and banks in the emerging operating environment; (ii) suggest measures for bringing about harmonization in lending and working capital finance by banks and DFIs; (iii) examine scope for increased access to short-term funds by DFIs; and (iv) strengthen organization, human resources, and related issues of DFIs and banks in the prospect of introduction of capital account convertibility.

[10]To strengthen internal audit and inspection machinery of banks, RBI felt the need for a review of existing systems for which a working group under the chairmanship of Rashid Jilani, chairman of Punjab National Bank, was set up in 1996. The committee made several important recommendations, which RBI accepted and directed banks to follow.

[11]ATM is deemed as a branch, being a service provider.

[12]The main objectives of the institute are as follows:

- to encourage the study of banking and institute a system of examinations, certificates, scholarships, and prizes;
- to promote information on banking and related subjects through lectures, discussions, books, correspondence with public bodies and individuals, or otherwise; and
- to collect and circulate statistics and other information relating to the business of banking in India.

[13]See p. 25, paragraph 3.31 of the Narasimham Committee (II) report.

[14]A McKinsey & Company/Faida Report estimated the future market size of India's basic food sector as follows: dairy, $11 billion; animal feed and poultry, $10 billion; wheat milling and processing, $6 billion; and beverages, $4 billion by 2005. There would emerge the concept of "large market high growth segment" for India and the need for the development of larger food and agriculture companies and necessary funding arrangements.