

REPORT

OF

THE COMMITTEE

THE FINANCIAL SYSTEM

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ON
THE FINANCIAL SYSTEM

NOVEMBER 1991

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M Narasimham

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November 8, 1991

Dear Mr Finance Minister.

I have pleasure in sending you the Summary of the Report of the Committee on the Financial System, along with a note by Prof M. Datta Chaudhuri and Shri M R Shroff.

The Committee is now engaged in finalising the Main Report and we hope to be able to submit it shortly.

With regards,

Yours sincerely,

M. Narasimham

(M Narasimham)

Encl: Summary of the Report

Dr Manmohan Singh
Union Minister of Finance
Government of India
NEW DELHI

Report of the Committee on the
Financial System

SUMMARY

1. The Committee's approach to the issue of financial sector reform is to ensure that the financial services industry operates on the basis of operational flexibility and functional autonomy with a view to enhancing efficiency, productivity and profitability. A vibrant and competitive financial system is also necessary to sustain the ongoing reform in the structural aspects of the real economy. We believe that ensuring the integrity and autonomy of operations of banks and DFIs is by far the more relevant issue at present than the question of their ownership.

2. The Indian banking and financial system has made commendable progress in extending its geographical spread and functional reach. The spread of the banking system has been a major factor in promoting financial intermediation in the economy and in the growth of financial savings. The credit reach also has been extensive and the banking system now caters to several million borrowers especially in agriculture and small industry. The DFIs have established themselves as a major institutional support for investment in the private sector. The last decade has witnessed considerable diversification of the money and

capital markets. ³ New financial services and instruments have appeared on the scene.

3. ~~Weakness~~ Despite this commendable progress serious problems have emerged reflected in a decline in productivity and efficiency, and erosion of the profitability of the banking sector. (The major factors responsible for these are: (a) directed investments; and (b) directed credit programmes. (1) In both these cases, rates of interest that were available to banks were less than the market related rates or what they could have secured from alternate deployment of funds. (2) There has been a deterioration in the quality of the loan portfolio which in turn has come in the way of banks' income generation and enhancement of their capital funds. (3) Inadequacy of capital has been accompanied by inadequacy of loan loss provisions. The accounting and disclosure practices also do not always reflect the true state of affairs of banks and financial institutions. (4) The erosion of profitability of banks has also emanated from the side of expenditure as a result of fast and massive expansion of branches, many of which are unremunerative especially in the rural areas, a considerable degree of over-manning especially in the urban and metropolitan centres and inadequate progress in updating work technology. Both management weaknesses and trade union pressures have contributed to this. (5) There have also been weaknesses in the internal organisational structure of the banks, lack of sufficient delegation of authority and inadequate internal controls and

deterioration in what is termed 'housekeeping' such as balancing of books and reconciliation of inter-branch and inter-bank entries.)

(The DFIs also suffer from a degree of portfolio contamination. This is more pronounced in the case of the SFCs. Being smaller institutions the internal organisational problems of the DFIs have been less acute than those of the banks. However, both banks and the DFIs have suffered from excessive administrative and political interference in individual credit decision making and internal management.)

(The deterioration in the financial health of the system has reached a point where unless remedial measures are taken soon, it could further erode the real value of and return on the savings entrusted to them and even have an adverse impact on depositor and investor confidence. This diagnosis of the problems indicates the lines of solution which the Committee proposes with a view as much to improving the health of the system as for making it an integral part of the ongoing process of economic reforms.)

Major steps

4. The Committee is of the view that (the SLR instrument should be deployed in conformity with the original intention of regarding it as a prudential requirement and not be viewed as a major instrument for financing the public sector.) (In line with Government's decision to reduce the fiscal deficit to a level consistent with macro-economic stability, the Committee recommends that the SLR be brought down in a phased manner to 25 per cent over a period of about five years, starting with some reduction in the current year itself.)

5. (As regards the cash reserve ratio, the Reserve Bank should have the flexibility to operate this instrument to serve its monetary policy objectives. The Committee believes that given the Government's resolve to reduce the fiscal deficit, the occasion for the use of cash reserve ratio to control the secondary expansion of credit should also be less. The Committee accordingly proposes that the Reserve Bank consider progressively reducing the cash reserve ratio from its present high level. With the deregulation of interest rates there would be more scope for the use of open market operations by the Reserve Bank with correspondingly less emphasis on variations in the cash reserve ratio.)

6. The Committee proposes that (the interest rate paid to banks on their SLR investments and on CRR, in respect of impounded deposits above the basic minimum should be increased.) As discussed later, (the rates on SLR investments should be progressively market related while that on cash reserve requirement above the basic minimum should be broadly related to banks' average cost of deposits.) However, during the present regime of administered interest rates, this rate may be fixed at the level of banks' one year deposit rate.

7. With respect to directed credit programmes, the Committee is of the view that they have played a useful purpose in extending the reach of the banking system to cover sectors

which were neglected hitherto. Despite considerable unproductive lending, there is evidence that the contribution of bank credit to growth of agriculture and small industry has made an impact. This calls for some re-examination of the present relevance of directed credit programmes at least in respect of those who are able to stand on their own feet and to whom the directed credit programmes with the element of interest concessionality that has accompanied it, has become a source of economic rent. The Committee recognises that in the last two decades banking and credit policies have been deployed with a redistributive objective. However, the Committee believes that the pursuit of such objectives should use the instrumentality of the fiscal rather than the credit system. Accordingly, the Committee proposes that the directed credit programmes should be phased out. This process of phasing out would also recognise the need that for some time it would be necessary for a measure of special credit support through direction. The Committee therefore, proposes that the priority sector be redefined to comprise the small and marginal farmer, the tiny sector of industry, small business and transport operators, village and cottage industries, rural artisans, and other weaker sections. The credit target for this redefined priority sector should henceforth be fixed at 10 per cent of aggregate credit which would be broadly in line with the credit flows to these sectors at present. The Committee also proposes that a review may be undertaken at the end of three years to see if directed credit

programmes need to be continued. (As regards medium and large farmers, and the larger among small industries, including transport operators, etc., who would not now constitute part of the redefined priority sector, the Committee proposes that to further encourage banks to provide credit to these erstwhile constituents of the priority sector, the Reserve Bank and other refinancing agencies institute a preferential refinance scheme in terms of which incremental credit to these sectors would be eligible for preferential refinance subject to normal eligibility criteria.)

8. The Committee is of the view that the present structure of administered interest rates is highly complex and rigid.

This is so in spite of the recent moves towards deregulation.

(The Committee proposes that interest rates be further deregulated so as to reflect emerging market conditions.) (At the same time, the Committee believes that a reasonable degree of macro economic balance through a reduction in the fiscal deficit is necessary for successful deregulation of interest rates.) (Premature moves to market determined interest rates could, as experience abroad has shown, pose the danger of excessive bank lending at high nominal rates to borrowers of dubious credit-worthiness, eventually creating acute problems for both the banks as well as the borrowers. Accordingly, the Committee recommends that for the present, interest rates on bank deposits may continue to be regulated, the ceilings on such rates being raised as the SLR is reduced progressively) as suggested by us earlier.

Similarly, (2) the interest rate on Government borrowing may also be gradually brought in line with market-determined rates which would be facilitated by the reduction in SLR. (4) Meanwhile, the Committee would recommend that (5) concessional interest rates should be phased out. (5) The structure of interest rates should be a broad relationship to the Bank rate which should be used as an anchor to signal the Reserve Bank's monetary policy stance.

(6) It would be desirable to provide for what may be called a prime rate, which would be the floor of the lending rates of banks and DFIs. (7) The spreads between the Bank rate, the bank deposit rates, the Government borrowing rates and the prime rate may be determined by the RBI broadly in accordance with the criteria suggested by the Chakravarty Committee so as to ensure that the real rates of interest remain positive.

9. (8) The inadequacy of capital in the banking system is a cause for concern. (9) While progress towards BIS norms is desirable, the Committee recognises that this will have to be phased over time. The Committee suggests that (10) the banks and financial institutions should achieve a minimum 4 per cent capital adequacy ratio in relation to risk weighted assets (11) by March 1993, of which Tier 1 capital should be not less than 2 per cent. The BIS standards of 8 per cent should be achieved over the period of the following 3 years, that is, by March 1996. For those banks with an international presence it would be necessary to reach these figures even earlier.

10. (1) The Committee believes that in respect of those banks whose operations have been profitable and which enjoy a good reputation in the markets, they could straight-away approach the capital market for enhancement of their capital. (2) The Committee, therefore, recommends that in respect of such banks, issue of fresh capital to the public through the capital market should be permitted. (3) Subscribers to such issues could include mutual funds, profitable public sector undertakings and employees of the institutions besides the general public. (3) In respect of other banks, the Government could meet the shortfall in their capital requirements by direct subscription to capital or by providing a loan which could be treated as subordinate debt.)

11. Before arriving at the capital adequacy ratio for each bank, it is necessary that the assets of the banks be evaluated on the basis of their realisable values. The Committee proposes that the (banks and financial institutions adopt uniform accounting practices particularly in regard to income recognition and provisioning against doubtful debts.) There is need also for adopting sound practices in regard to valuation of investments on the lines suggested by the Ghosh Committee on Final Accounts.

12. In regard to income recognition the Committee recommends that in respect of banks and financial institutions which are following the accrual system of accounting, no income should be recognised in the accounts in respect of non-performing assets.

An asset would be considered non-performing if interest on such assets remains past due for a period exceeding 180 days at the balance sheet date. The Committee further recommends that banks and financial institutions be given a period of three years to move towards the above norms in a phased manner beginning with the current year.

13. For the purpose of provisioning, the Committee recommends that, using the health code classification which is already in vogue in banks and financial institutions, the assets should be classified into four categories namely, Standard, Sub-standard, Doubtful and Loss Assets. In regard to Sub-standard Assets, a general provision should be created equal to 10 per cent of the total outstandings under this category. In respect of Doubtful Debts, provision should be created to the extent of 100 per cent of the security shortfall. In respect of the secured portion of some Doubtful Debts, further provision should be created, ranging from 20 per cent to 50 per cent, depending on the period for which such assets remain in the doubtful category. Loss Assets should either be fully written off or provision be created to the extent of 100 per cent. The Committee is of the view that a period of 4 years should be given to the banks and financial institutions to conform to these provisioning requirements. The movement towards these norms should be done in a phased manner beginning with the current year. However, it is necessary for banks and financial institutions to ensure

that in respect of doubtful debts 100 per cent of the security shortfall is fully provided for in the shortest possible time.

14. The Committee believes that the balance sheets of banks and financial institutions should be made transparent and full disclosures made in the balance sheets as recommended by the International Accounting Standards Committee. This should be done in a phased manner commencing with the current year. The Reserve Bank, however, may defer implementation of such parts of the standards as it considers appropriate during the transitional period until the norms regarding income recognition and provisioning are fully implemented.

15. The Committee suggests that the criteria recommended for non performing assets and provisioning requirements be given due recognition by the tax authorities. For this purpose, the Committee recommends that the guidelines to be issued by the Reserve Bank of India under Section 43 D of the Income Tax Act should be in line with our recommendations for determination of non-performing assets. Also, the specific provisions made by the banks and institutions in line with our recommendations should be made permissible deductions under the Income Tax Act. The Committee further suggests that in regard to general provisions, instead of deductions under Section 36 (1) (vii) being restricted to 5 per cent of the total income and 2 per cent of the aggregate average advances by rural branches, it should

be restricted to 0.5 per cent of the aggregate average non-agricultural advances and 2 per cent of the aggregate average advances by rural branches. This exemption should also be available to banks having operations outside India in respect of their Indian assets, in addition to the deductions available under Section 36 (1) (viii).

16. Banks, at present, experience considerable difficulties in recoveries of loans and enforcement of security charged to them. The delays that characterise our legal system have resulted in the blocking of a significant portion of the funds of banks and DFIs in unproductive assets, the value of which deteriorate with the passage of time. The Committee, therefore, considers that there is urgent need to work out a suitable mechanism through which the dues to the credit institutions could be realised without delay and strongly recommends that Special Tribunals on the pattern recommended by the Tiwari Committee on the subject be set up to speed up the process of recovery. The introduction of legislation for this purpose is long overdue and should be proceeded with immediately.

17. While the reform of accounting practices and the creation of Special Tribunals are essential, the Committee believes that an arrangement has to be worked out under which part at least of the bad and doubtful debts of the banks and financial institutions are taken off the balance sheet so that the banks

could recycle the funds realised through this process into more productive assets. For this purpose, the Committee proposes the establishment, if necessary by special legislation, of an Assets Reconstruction Fund (ARF) which could take over from the banks and financial institutions a portion of the bad and doubtful debts at a discount, the level of discount being determined by independent auditors on the basis of clearly stipulated guidelines. The ARF should be provided with special powers for recovery somewhat broader than those contained in Sections 29-32 of the State Financial Corporation's Act 1951. The capital of the ARF should be subscribed by the public sector banks and financial institutions.

18. It is necessary to ensure that the bad and doubtful debts of banks and financial institutions are transferred to the ARF in a phased manner to ensure smooth and effective functioning of the ARF. To begin with, all consortium accounts where more than one bank or institution is involved should be transferred to the ARF. The number of such accounts will not be large but the amounts involved are substantial to make a difference to the balance sheets of banks. Gradually, depending on the progress achieved by the ARF, other bad and doubtful debts could be transferred over time. Meanwhile, banks and institutions should pursue recovery through the Special Tribunals. Based on the valuation given in respect of each asset by a panel of at least two independent auditors, the ARF would issue bonds to the concerned institution carrying an interest rate equal to

the Government bond rate and repayable over a period of 5 years. These bonds will need to be guaranteed by the Government of India and should be treated as qualifying for SLR purposes. The advantage to banks of this arrangement would be that their bad and doubtful debts would be off their books though at a price but they would have in substitution of these advances bonds upto the discounted value with a certainty of interest income which would be an obviously important aspect from the point of view of income recognition, and further by making these bond holdings eligible for SLR purposes, banks' fresh resources could become available for normal lending purposes. We wish to emphasise that this proposal should be regarded as an emergency measure and not as a continuing source of relief to the banks and DFIs. It should be made clear to the banks and financial institutions that once their books are cleaned up through this process, they should take normal care and pay due commercial attention in loan appraisals and supervision and make adequate provisions for assets of doubtful realisable value.

19. Selling these assets to the Fund at a discount would obviously mean an obligation on the banks/DFIs to write off these losses which many of them are in no position to do now, given their weak capital position. We propose that to enable the banks to finance the write off represented by the extent of the discount, the Government of India would, where necessary, provide, as mentioned earlier, a subordinated loan counting for capital.

As far as the Government of India itself is concerned, we believe that the rupee counterpart of any external assistance that would be available for financial sector reform could be used to provide this type of capital to the banks and DFIs.

20. The ARF would be expected to deal with those assets which are in the process of recovery. In respect of sick units which are under nursing or rehabilitation programmes, it is necessary to work out a similar arrangement to ensure smooth decision making and implementation in respect of such nursing programmes. The Committee recommends that in respect of all such consortium accounts which are under a nursing programme or in respect of which rehabilitation programmes are in the process of being worked out, the concerned lead financial institution and/or lead commercial bank should take over the term loan and working capital dues respectively from other participating institutions and banks. Such acquisitions should be at a discount based on the realisable value of the assets assessed by a panel of at least two independent auditors as in the case of transfer of assets to ARF.

21. In regard to the structure of the banking system, the Committee is of the view that the system should evolve towards a broad pattern consisting of:

- (a) 3 or 4 large banks (including the State Bank of India) which could become international in character;

- (b) 8 to 10 national banks with a network of branches throughout the country engaged in 'universal' banking;
- (c) Local banks whose operations would be generally confined to a specific region; and
- (d) Rural banks (including RRBs) whose operations would be confined to the rural areas and whose business would be predominantly engaged in financing of agriculture and allied activities.

The Committee is of the view that the move towards this revised system should be market driven and based on profitability considerations and brought about through a process of mergers and acquisitions.

22. The Committee is of the view that the structure of rural credit will have to combine the local character of the RRBs and the resources, skills and organisational/managerial abilities of the commercial banks. With this end in view the Committee recommends that each public sector bank should set up one or more rural banking subsidiaries, depending on the size and administrative convenience of each sponsor bank, to take over all its rural branches and, where appropriate, swap its rural branches with those of other banks. Such rural banking subsidiaries should be treated on par with RRBs in regard to

CRR/SLR requirements and refinance facilities from NABARD and sponsor banks. The 10 per cent target for directed credit which we have recommended as a transitional measure should be calculated on the basis of the combined totals of the parent banks and their subsidiaries. The Committee proposes, that while RRBs should be allowed to engage in all types of banking business, their focus should continue to be to lend to the target groups to maintain at a minimum the present level of their lending to these groups. With a view to improving the viability of their operations, the Committee proposes that the interest rate structure of the RRBs should be in line with those of the commercial banks. The Committee would leave the option open to the RRBs and their sponsor banks as to whether the RRBs should retain their identity so that their focus on lending to the target groups is not diffused or where both the RRBs and the sponsor banks wish to do so they could be merged with the sponsor banks and the sponsor banks in such cases should take them over as 100 per cent subsidiaries by buying out the shares from other agencies at a token price, and eventually merge them with the rural banking subsidiaries which we have proposed. For those RRBs that retain their identity and whose viability would need to be improved, we propose that instead of investing in Government bonds as part of their SLR requirements, they could place the amounts stipulated under SLR as deposits with NABARD or some special federal type of agency that might be set up for this purpose. This would also be

consistent with the statutory requirements in this regard and NABARD or this agency could pay interest on such balances by investing or deploying these funds to the best advantage on their behalf and thus help to augment the income of the RRBs.

23. The Committee proposes that Government should indicate that there would be no further nationalisation of banks. Such an assurance will remove the existing disincentive for the more dynamic among the private banks to grow. The Committee also recommends that there should not be any difference in treatment between the public sector and the private sector banks. The Committee would propose that there be no bar to new banks in the private sector being set up provided they conform to the start-up capital and other requirements as may be prescribed by the Reserve Bank and the maintenance of prudential norms with regard to accounting, provisioning and other aspects of operations. This in conjunction with the relevant statutory requirements governing their operations would provide adequate safeguards against misuse of banks' resources to the detriment of the depositors' interests.

24. The Committee recommends that branch licensing be abolished and the matter of opening branches or closing of branches (other than rural branches for the present) be left to the commercial judgment of the individual banks.

25. The Committee also believes that, consistent with other aspects of Government policy dealing with foreign investment, the policy with regard to allowing foreign banks to open offices in India either as branches or, where the Reserve Bank considers it appropriate, as subsidiaries, should be more liberal, subject to the maintenance of minimum assigned capital as may be prescribed by the Reserve Bank and the statutory requirement of reciprocity. Joint ventures between foreign banks and Indian banks could also be permitted, particularly in regard to merchant and investment banking, leasing and other newer forms of financial services.

26. Foreign banks when permitted to operate in India should be subjected to the same requirements as are applicable to domestic banks. If, in view of certain constraints such as absence of branch network, the foreign banks are unable to fulfil certain requirements such as directed credit (of 10 per cent of aggregate credit) the Reserve Bank should work out alternative methods with a view to ensuring a level playing field.

27. The Committee is of the view that the foreign operations of Indian banks need to be rationalised. In line with the structure of the banking system visualised above, there would seem to be scope for one or more of the large banks, in addition to the SBI, to have operations abroad in major international financial centres and in regions with strong Indian ethnic

presence. Pending the evolution of a few Indian banks with an international character, the Committee recommends as an interim measure that those Indian banks with the largest presence abroad and strong financial position could jointly set up one or more subsidiaries to take over their existing branches abroad. The SBI operations abroad can continue and indeed be strengthened in the course of time. The Government may also consider the larger banks increasing their presence abroad by taking over existing small banks incorporated abroad as a means of expanding their international operations.

28. The Committee believes that (the internal organisation of banks is best left to the judgment of the managements of individual banks, depending upon the size of the bank, its branch spread and range of functions.) (However, (for the medium and large national banks the Committee proposes a three-tier structure in terms of head office, a zonal office and branches. In the case of very large banks, a four-tier organisation, as is the case with the State Bank, with head office, zonal office, regional office and branch may be appropriate. Local banks may not need an intermediate tier between the branch and the central office.)

29. The Committee endorses the view of the Rangarajan Committee on Computerisation that (there is urgent need for a far greater use of computerised systems than at present.)

Computerisation has to be recognised as an indispensable tool for improvement in customer service, the institution and operation of better control systems, greater efficiency in information technology and the betterment of the work environment for employees. These are essential requirements for banks to function effectively and profitably in the increasingly complex and competitive environment which is fast developing in the financial services segment of the economy.)

30. Consistent with the Committee's view that the integrity and internal autonomy of banks and DFIs is far more important than the question of ownership,) the Committee makes the following recommendations regarding recruitment of officers & staff and appointments of chief executives and constitution of the boards of the institutions:

31. The Committee recommends that instead of having a common recruitment system for officers (individual banks should be free to make their own recruitment.) (Thus there is no need for setting up a Banking Service Commission for centralised recruitment of officers nor for their recruitment, as at present, through Banking Service Recruitment Boards (BSRBs).) (This will provide scope for the banks to scout for talent and impart new skills to their personnel.) The Committee, however, predicates this recommendation on the assumption that the banks will set up objective, fair and impartial recruitment procedures and, wherever appropriate, they could voluntarily come together to

have a joint recruitment system. As regards clerical grades, the present system of recruitment through BSRBs may continue but we would urge that the appointment of the Chairmen of these Boards should be totally left to the coordinating banks.

32. The Committee believes that there has to be a recognition on the part of managements and trade unions that the system cannot hope to be competitive internally and be in step with the wide-ranging innovations taking place abroad without a radical change in work technology and culture, and greater flexibility in personnel policies. We have been reassured to know that organised labour is as much convinced of the importance of enhancing the viability and profitability of the banking industry and providing efficient customer service. It is equally incumbent on management of banks to adapt forward looking personnel policies which would help to create a satisfying work environment.

33. The Committee recommends that the various guidelines and directives issued by the Government or the Reserve Bank in regard to internal administration of the banks should be reviewed to examine their continuing relevance in the context of the need to ensure the independence and autonomy of banks. Such guidelines which relate to matters of internal administration such as creation and categorisation of posts, promotion procedures and similar matters should be rescinded.

34. The Committee believes that the Indian banking system, at present, is over-regulated and over-administered.) Supervision should be based on evolving prudential norms and regulations which should be adhered to rather than excessive control over administrative and other aspects of bank organisation and functioning. The Committee would also like to place greater emphasis on internal audit and internal inspection systems of banks. The inspection by the supervisory authorities should be based essentially on the internal audit and inspection reports. Their main concern should be to ensure that audit and inspection machinery (which will cover the credit appraisal system and its observance) is adequate and conforms to well laid down norms.

35. The Committee is firmly of the opinion that the duality of control over the banking system between the Reserve Bank and the Banking Division of the Ministry of Finance should end and that the Reserve Bank should be the primary agency for the regulation of the banking system.) The supervisory function over the banks and other financial institutions, the Committee believes, should be hived off to a separate authority to operate as a quasi-autonomous body under the aegis of the Reserve Bank but which would be separate from other central banking functions of the Reserve Bank. The Committee recognises that as long as the Government has proprietary interest in banks and financial institutions, it would be appropriate for the Ministry of Finance to deal with other Government departments and Parliament and

discharge its other statutory obligations but not to engage in direct regulatory functions.

36. (Central to the issue of flexibility of operations and autonomy of internal functioning is the question of depoliticising the appointment of the chief executive (CMD) of the banks and the boards of the banks and ensuring security of tenure for the CMD. The Committee believes that professionalism and integrity should be the prime considerations in determining such appointments and while the formal appointments have to be made by Government, they should be based on a convention of accepting the recommendations of a group of eminent persons who could be invited by the Governor of the Reserve Bank to make recommendations for such appointments. As regards the boards of public sector banks and institutions, as long as Government owns the banks, it would be necessary to have a Government director to take care of 'proprietary' concerns but we believe that there is no need for the Reserve Bank to have a representative on the boards.

37. (As regards development financial institutions, the main issue with regard to their operations are to ensure operational flexibility, a measure of competition and adequate internal autonomy in matters of loan sanctioning and internal administration.) The Committee proposes that the (system recommended for commercial banks in the matter of appointment of chief executives and boards should also apply to DFIs.) The

present system of consortium lending has been perceived as operating like a cartel. The Committee believes that consortium lending should be dispensed with and, in its place, a system of syndication or participation in lending, at the instance not only, as now, of the lenders but also of the borrowers, should be introduced. The Committee also believes that commercial banks should be encouraged to provide term finance to industry, while at the same time, (the DFIs should increasingly engage in providing core working capital.) (This will help to enhance healthy competition between banks and DFIs.) The Committee proposes that the present system of cross holding of equity and cross representation on the boards of the DFIs should be done away with. The Committee welcomes the removal of the tax concession enjoyed by IDBI as an important step in ensuring equality of treatment between various DFIs. As a further measure of enhancing competition and ensuring a level playing field, the Committee proposes that the IDBI should retain only its apex and refinancing role and that its direct lending function be transferred to a separate institution which could be incorporated as a company. (The infected portion of the DFI's portfolio should be handed over to the ARF on the same terms and conditions as would apply to commercial banks.)

38. In the case of state level institutions, it is necessary to distance them from the State Governments and ensure that they function on business principles based on prudential norms and have a management set-up suited for this purpose. We

propose that an action plan on these lines be worked out and implemented over the next 3 years.

39. As regards the role of DFIs in corporate take-overs, the Committee believes that DFIs should lend support to existing managements who have a record of conducting the affairs of the company in a manner beneficial to all concerned, including the shareholders, unless in their opinion the prospective new management is likely to promote the interests of the company better. In doing so we would expect the institutions to exercise their individual professional judgment.

40. The DFIs should seek to obtain their resources from the market on competitive terms and their privileged access to concessional finance through the SLR and other arrangements should gradually be phased out over a period of three years.

41. The last decade has witnessed a considerable growth in capital market operations with the emergence of new instruments and new institutions. The capital market, however, is tightly controlled by the Government whose prior approval is invariably required for a new issue in the market, the terms of the issue and its pricing. The process of setting up Securities and Exchange Board of India (SEBI) for overseeing the operations of the market is still not complete with the legislation for this purpose yet to be enacted. We

believe the present restrictive environment is neither in tune with the new economic reforms nor conducive to the growth of the capital market itself.

42. The Committee strongly favours substantial and speedy liberalisation of the capital market. Prior approval of any agency -- either Government or SEBI -- for any issue in the market should be dispensed with. The issuer should be free to decide on the nature of the instrument, its terms and its pricing. We would recommend, in this context, that the SEBI formulate a set of prudential guidelines designed to protect the interests of investor, to replace the extant restrictive guidelines issued by the Controller of Capital Issues (CCI). In view of the above, the office of the CCI will cease to have relevance. In the Committee's view, SEBI should not become a controlling authority substituting the CCI, but should function more as a market regulator to see that the market is operated on the basis of well laid down principles and conventions. The capital market should be gradually opened up to foreign portfolio investment and simultaneously efforts should be initiated to improve the depth of the market by facilitating issue of new types of equities and innovative debt instruments. Towards facilitating securitisation of debt, which could increase the flow of instruments, appropriate amendments will need to be carried out in the Stamp Acts.

43. In the last decade several new institutions have appeared on the financial scene. Merchant banks, mutual funds, leasing companies, venture capital companies and factoring companies have now joined hire purchase companies in expanding the range of financial services available. However, the regulatory framework for these new set of institutions has still to be developed.

44. The Committee recommends that the supervision of these institutions which form an integral part of the financial system should come within the purview of the new agency to be set up for this purpose under the aegis of the RBI. The control of these institutions should be principally confined to off-site supervision with the on-site supervision being resorted to cases which call for active intervention. The SEBI which is charged with the responsibility of ensuring orderly functioning of the market should have jurisdiction over these institutions to the extent their activities impinge on market operations. In regard to mutual funds there is a good case for enacting new legislation on the lines obtaining in several countries with a view to providing an appropriate legal framework for their constitution and functioning. The present guidelines with regard to venture capital companies are unduly restrictive, and affecting the growth of this business and need to be reviewed and amended.

45. As in the case of banks and financial institutions there is need to lay down prudential norms and guidelines governing the functioning of these institutions. These prudential guidelines

should relate, among other things, to capital adequacy, debt equity ratio, income recognition provisioning against doubtful debts, adherence to sound accounting and financial policies, disclosure requirements and valuations of assets. The eligibility criteria for entry, growth and exit should also be clearly stipulated so that the growth of these institutions takes place on proper lines.

46. The Committee would like to emphasise that a proper sequencing of reforms is essential. Deregulation of interest rates can only follow success in controlling fiscal deficits. Asset reconstruction, institution of capital adequacy and establishment of prudential norms with a good supervisory machinery have to be proceeded with in a phased manner over the next 3 to 5 years but, we believe, it is important that the process must begin in the current year itself.

47. The above set of proposals would necessitate certain amendments in existing laws which the Government should undertake expeditiously.

48. The Committee's approach thus seeks to consolidate the gains made in the Indian financial sector while improving the quality of the portfolio, providing greater operational flexibility and most importantly greater autonomy in the internal operations of the banks and financial institutions so as to nurture a healthy, competitive and vibrant financial sector. This will,

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above all else, require depoliticisation of appointments, implying at the same time a self-denial by Government and the perception that it has distanced itself from the internal decision-making of the banks and the financial institutions. The proposed deregulation of the financial sector and the measures aimed at improving its health and competitive vitality would, in the Committee's view, be consistent with the steps being taken to open up the Indian economy, enable the Indian financial sector to forge closer links with the global financial markets, and enhance India's ability to take competitive advantage of the increasing international opportunities for Indian trade, industry and finance.

Note by Prof M Datta Chaudhuri and Shri M R Shroff

The Summary Report starts with the following statements: :

"The Committee's approach to the issue of financial sector reform is to ensure that the financial services industry operates on the basis of operational flexibility and functional autonomy with a view to enhancing efficiency, productivity and profitability. A vibrant and competitive financial system is also necessary to sustain the ongoing reform in the structural aspects of the real economy. We believe that ensuring the integrity and autonomy of operations of banks and DFIs is by far the more relevant issue at present than the question of their ownership."

The Committee has thus rightly identified the question of "ensuring the integrity and autonomy of operations of banks and DFIs" as the principal concern of the Report. The Committee predicated its various recommendations on the belief that it is possible to achieve these objectives without bringing in the question of ownership. These recommendations go a long way in creating conditions whereby market disciplines can be brought into the functioning of the public sector banks and financial institutions. But we believe that in the prevailing political culture of the country, it is important to move further to make the autonomy of these institutions credible.

In line with the above and the concept of self-denial by the Government of its ownership rights, which the Committee has rightly advocated, we think that the Government should not

appoint its officials on the boards of public sector banks and financial institutions. The Banking Division of the Ministry of Finance, as at present constituted, should consequently be abolished.

We are conscious of the Government's accountability to Parliament and the public as owner of these institutions. But accountability need not mean involvement in functions which are the responsibility of boards and managements and can be ensured by an adequate system of reporting through the Reserve Bank which, the Committee has rightly stressed, should be the prime agency for the regulation of the banking system. The continuance of Government directors on the boards of the banks and financial institutions will come in the way of ending the duality of control between the Reserve Bank and the Banking Division as recommended by the Committee.

We think that a decision by the Government not to have its representatives on the boards of public sector banks and financial institutions will serve as a strong message of autonomy to the system and will create a climate conducive to the successful implementation of the other recommendations of the Committee.

M. Narasimham

Administrative Staff College of India
Bella Vista
Hyderabad 500 049

November 16, 1991

Dear Mr Finance Minister,

Further to my letter of November 8, 1991, I have pleasure in now submitting the Main Report of the Committee on the Financial System. A note by Prof M Datta Chaudhuri and Shri M R Shroff is also appended.

The Committee expresses its appreciation to the large number of representative organisations and individuals who submitted written memoranda to the Committee at its request on the subjects of the Committee's enquiry, and especially to those organisations who, at their request, tendered oral evidence to the Committee in addition to submission of their views in writing.

The other members of the Committee and I would like to place on record our appreciation of the contribution to the work of the Committee made by our Member-Secretary, Shri K Jayabharath Reddy, who brought to bear on the deliberations of the Committee his intimate knowledge of the issues pertaining to the financial sector. The Committee would also like to record its appreciation of the assistance received from Smt Anita Kapur and Shri K K Bhargava (of the Banking Division of the Ministry of Finance), S/Shri K Sivaraman and R J Fernandes (of the Reserve Bank of India), S/Shri D Basu and D J Kanvinde (of the State Bank of India) and Shri R Nangia of ICICI.

The Reserve Bank of India provided excellent logistic support and the Committee would like to convey its special appreciation for this to the Bank.

Shri Samuel Abraham of the Administrative Staff College of India bore the brunt of the stenographic and typing work and his services deserve special mention.

With best regards,

Yours sincerely,

M. Narasimham

(M Narasimham)

Encl: Report

Dr Manmohan Singh
Union Minister of Finance
Government of India
NEW DELHI

CHAPTER I

THE COMMITTEE'S APPROACH

The financial system has a crucial role to play in mobilisation of savings and their allocation to the most productive uses if it is to be, in the words of the Finance Minister in his Budget Speech, "an essential adjunct to economic growth".

In the last few months, major changes have been effected by the Government of India in the areas of industrial, trade and exchange rate policies. These changes are designed to correct the macro-economic imbalance and effect structural adjustment with the objective of bringing about a more competitive system and promoting efficiency in the real sectors of the economy. Economic reforms in the real sectors of the economy will, however, fail to realise their full potential without a parallel reform of the financial sector, in order, broadly speaking, to enhance the efficiency of financial intermediation. Financial sector reform is, therefore, a necessary concomitant of trade and industrial policy liberalisation so that the competitive spirit and efficiency that we are seeking to bring about in the real economy would cover the critically important financial sector and be further sustained by it. With increasing deregulation of industry and the emergence of more competitive conditions the responsibilities devolving on the financial system in mobilising resources and allocating them efficiently and responding flexibly to emerging situations would be

much greater. An efficient and market oriented financial system could thus be regarded as a complement to market based decision making in the real sector.

To be able to perform these tasks effectively, the financial system itself needs to tone up its productivity and efficiency and improve its health. The object of reform should be not only to correct the present financial weaknesses but seek to eliminate the causes which have brought about this situation. The strategic objective for the financial sector, as indeed for the rest of the economy should be competitive efficiency. Issues of functioning of the system, and organisation and structure need to be fitted into that strategy.

The need for reform of the financial sector arises from several reasons. Despite impressive quantitative achievements in resource mobilisation and in extending the credit reach, several distortions have, over the years, crept into the financial system, especially in respect of allocation of financial resources. Productivity and efficiency of the system have suffered, its profitability has been eroded and its portfolio quality has deteriorated. Customer service has been poor, work technology remains out-dated and transaction costs are high. In the process, several banks and institutions have themselves become weak financially and unable to meet the challenges of a competitive environment.

Several factors have contributed to this, as we discuss in later chapters, but perhaps the most important among them has been the impact of policy induced rigidities such as an excessive degree of central direction of their operations in terms of investments, credit allocations, branch expansion, and even internal management aspects of the business. Apart from such administrative direction, there has also been an element of political interference to which the system has been subjected to and which has come in the way of institutions operating on the basis of their commercial judgment and in the framework of internal autonomy. Indian banks operating as they do within the confines of a rigidly controlled system have virtually ceased being competitive or innovative.

The Committee has approached the task of financial sector reform by placing emphasis on the steps needed to improve the financial health of banks and development financial institutions (DFIs) to make them viable and efficient so as to better serve the emerging needs of the real economy in which the spirit of competitive efficiency is being ignited. Greater market orientation of the financial system would improve efficiency especially as the markets for financial assets are increasingly being characterised by a wide range of financial products and innovative services.

Resources of the financial system are held by financial institutions in trust and have to be deployed for the maximum benefit of their owners -- viz., depositors and investors. The

safety of their funds should be the primary concern of banks and regulatory authorities and ensuring the solvency, health and efficiency of the institutions should, therefore, be central to effective financial reform.

The restoration of financial health of banks and financial institutions and making them competitive call for several policy and structural changes designed to enhance competitive efficiency, productivity and profitability and to reduce with a view to its eventual elimination the degree of administrative intervention in their management and centralised direction over funds deployment. It is also imperative that political interference be eliminated in the working of banks and DFIs.

The restoration of operational autonomy in credit decision making and in matters of internal organisation and management, thus, is the critical element in the process of reform as we conceive it. Ensuring integrity and autonomy of functioning of banks and DFIs is in our view, by far the more relevant issue than ownership. Issues of competitive efficiency and profitability are, in this sense, ownership neutral. It is how the institutions function or are allowed to function that is more important. Institutions should operate in an environment where their decisions are not influenced by extraneous pressures but are based on their own commercial judgment and their professional appraisal of loan proposals under competitive conditions. This calls for development of professional skills while, at the same time,

complying with essential prudential norms and safeguards to govern their operations so that depositor and investor confidence in the system is sustained. Such prudential norms should cover aspects such as liquidity, asset portfolio quality, capital adequacy and transparency in accounts. The aim of regulation would thus be to promote the healthy growth of the system and not to interfere with its operations. Rule based regulation rather than discretionary controls should inform the functioning of the financial sector and provide for the needed measure of discipline without stifling the spirit of innovation and calculated risk taking which is the characteristic of a dynamic financial sector.

Finance is the most important bridge between the present and the future in the economic system. Risk and uncertainty form the background to the operations of the financial system and financial institutions should also be able to develop the strength to withstand the risks inherent in lending and investment and secure returns commensurate with risk. Objective criteria for risk assessment and a measure of judgmental evaluation based on experience are the special skills required of a manager in the financial system. Such expertise and experience are in our view best fostered under the impetus of competition.

We desist from the temptation of laying down a wholly new design or structure from top down. Rather, we suggest creation of those conditions through removal of existing obstacles

and generation of new attitudes and practices in which the innovative spirit of individual elements of the system will have ample play to evolve institutional structures and instruments which can provide a wide range of financial services in an efficient and profitable manner.

Our approach to the consideration of the issues referred to us is thus set by the vision of a healthy, competitive, market oriented, efficient and professionally managed financial system which would make its distinctive contribution to the growth of the Indian economy in the challenging decades ahead.

Chapter II

TWO DECADES OF PROGRESS

A major developmental objective in this country has been the building up of a financial infrastructure geographically wide and functionally diverse to help in the process of resource mobilisation and to meet the expanding and emerging needs of a developing economy. The prime focus of attention has been the banking system and the nationalisation of banks in 1969 was seen as the major step to ensure that timely and adequate credit support would be available for viable productive endeavour. Nationalisation was a recognition of the potential of the banking system to promote broader economic objectives, such as growth, better regional balance of economic activity and the diffusion of economic power. It was designed to make the system reach out to the small man and the rural and semi-urban areas and to extend credit coverage to sectors hitherto neglected by the banking system and through positive affirmative action provide for such expansion of credit to agriculture and small industry in place of what was regarded as a somewhat oligopolistic situation where the system served mainly the urban and industrial sectors and where the grant of credit was seen to be an act of patronage and receiving it an aspect of privilege.

The two decades since nationalisation have seen progress with respect to its various objectives. As the

extension of the geographical spread of banking was given prime importance both as an instrument for deposit mobilisation on the one hand and purveying credit especially in the rural hinterland of the economy on the other, attention was focussed on branch expansion. In the roughly two decades since bank nationalisation, the number of commercial bank branches has increased over seven-fold, to a little over 60,000 offices. Such a pace of expansion has few, if any, parallels in the history of banking development anywhere. The result of this expansion has been a sharp increase in the density of banking coverage as reflected in the sharp fall in the number of people served by a banking office. While in 1969 each office served 65,000 of the population, the figure now is down to 12,000. Most of the branch expansion has occurred in the rural and semi-urban areas, reflecting the concern to achieve a more balanced spatial distribution of credit and today there is a bank office in almost all the 5,000 odd development blocks of the country. Between 1969 and 1990, of the total increase of over 51,000 offices, as many as 33,600 were in the rural areas and over 7,900 in the semi-urban areas, making for a total of over 80 per cent. Today, nearly 3 out of 4 bank offices are in the rural and semi-urban areas. That banks have expanded so rapidly in rural areas, in many of which they have been circumscribed by inaccessibility, poor infrastructure and other discomforts is a tribute to their devotion to the public purpose.

Another indicator of the spread of the banking system and in particular its endeavour to even out the disparities in banking

presence as between different parts of the country is reflected in the state-wise distribution of banking offices. In 1969, five States (Maharashtra, Gujarat, Tamil Nadu, West Bengal and Punjab) accounted for a little under half of the total number of offices. By 1990, the share of the other States had risen to nearly 80 per cent, reflecting the greater emphasis placed on opening offices in the hitherto under-banked regions of the country.

The other indicator of banking expansion has been the growth in volume of transactions in relation to gross domestic product. In 1969, deposits amounted to 13 per cent of G D P income and advances to 10 per cent. By 1991, deposits had risen to 38 per cent and advances to 25 per cent, indicating the extent to which the banking system has been increasing its involvement in a growing and inter-dependent economy. The growth of deposits has been as much a function of the level of income and savings on the one hand as of institutional factors on the other. Massive branch expansion has perhaps been the most important institutional factor in deposit expansion. New branches opened have helped considerably in deposit mobilisation and the figures suggest that of the incremental deposits a large proportion has been from the branches opened since 1969. The increase in rural deposits as a proportion of the total from 3 per cent to 15 per cent is a manifestation of this. The rural penetration of the banking system has in fact played an important part in the transformation that has been occurring

in the pattern of assets holding of the community. Bank deposits now constitute nearly two-fifths of the financial assets held by the household sector. Banks have thus contributed significantly to the growth in the volume of financial savings and to their increasing share in aggregate savings. The financial intermediation and the incremental financial inter-relations ratios have been steadily rising. The share of financial assets in the total assets of the community has grown sharply. The growing financial intermediation and the widening and deepening of the financial infrastructure can be rightly regarded as a major developmental contribution of the banking system through an expansion of both its geographical and functional coverage in the last two decades.

The growth of deposits through a wide network of branches has provided the banking system with an increasing volume of resources at its disposal though admittedly the growth of these resources has not kept pace with the increasing demands made on them. The claims of the Government and public sector on the banking system's resources have been steadily rising through the mechanism of the Statutory Liquidity Ratio (SLR) which today accounts for 38.5 per cent of the net demand and time liabilities of the system. As for the resources remaining after such pre-emption, bank credit has, in the light of the increasing demands made on it, had to be apportioned between competing users and in the light of their perceived contribution to the

furtherance of broader economic objectives. It was this reconciliation of need with availability that was the rationale for diverting an increasing proportion of credit to the sectors important for the national economy in terms of their contribution to growth, employment generation and broadening the base of income distribution but which were relatively neglected until that time by the banking system. Agriculture, small-scale industry and small enterprise generally represented what came to be regarded as the priority sectors. These sectors accounted for no more than 14 per cent of aggregate bank credit at the time of nationalisation; in respect of agriculture the figure was 5 per cent which itself was the result of a large but somewhat unplanned step up in agricultural credit by the commercial banks in the two years that preceded nationalisation. The figure for priority sector lending has now reached the current target of 40 per cent of aggregate bank credit with the incremental ratio for such credit in the total naturally being much higher. A significant part of the expansion in the priority sector credit has been in respect of agriculture, where the credit extended by commercial banks has increased over 20-fold since 1969 and has enabled banks to meet the sub-target for this sector of 18 per cent of aggregate credit. Small scale industry comprising both industry, transport and the self-employed represents the other important priority sector and the attention which the banks have been paying to meeting the needs of this sector is reflected in the growth of credit to it to a level of Rs 15,900 crores in 1990; representing 16.5 per cent of total bank credit and in fact almost reaching

about two-fifths of the level of credit to medium and large scale industry. There has been thus a remarkable transformation in the portfolio composition of advances.

Even more than the growth in deposit and credit volume has been the growth in the number of deposit accounts and in that of borrowal accounts, especially in the priority sector. There are today over 300 million deposit accounts which even allowing for some multiple deposit ownership represents the depth of the coverage of the system. On the side of bank credit, there were barely 400,000 accounts in the priority sector in 1969. By 1990, the number of such accounts had risen to over 35 million and with this the average size of the credit has come down sharply with its obvious and corollary implications of rising unit costs of administering such loans. Not merely has the quantum of priority sector credit increased, the rates of interest for such lending have also been concessional with consequences to banks' income -- an aspect we discuss later.

The superimposition of credit needs of the priority sector over those of the traditional sectors of trade and industry has not been without problems. Given the overall resource constraint, an increase of credit to the priority sector has meant a certain pruning of credit to the other sectors. There have been attempts at making an objective evaluation of the credit needs of the traditional sectors and the inculcation of financial discipline as evidenced by the norms prescribed in respect of working capital requirements for industry in terms of the recommendations of Tandon

and Chore Committees though it should also be admitted that compliance with these norms has not been all that satisfactory. The relative insulation of priority sector advances from overall credit restriction during periods of tight monetary policy has meant both a reduction in relation to requirements of such credit to the ^{conventional} sectors and an increase in the cost of such credit as an aspect of cross subsidisation to recompense the lower rates earned on priority sector credit. In the process, it has led to the traditional sectors looking for funds from sources other than ^{the} banking system either through approaching the capital market and other institutions or through raising deposits ~~directly~~ from the public leading to the emergence of a measure of banking disintermediation.

The expansion of priority sector lending and the emphasis on the area approach has led to a degree of evening out of regional disparities in banking. The degree of concentration of banking business is less now and despite the obvious limitations of the credit deposit ratio on a state-wise basis or of the credit deposit ratio in rural and semi-urban areas compared to the urban areas ^{of better spatial balance} as a reliable measure ^{of} the figures nonetheless reflect the greater involvement of the banking system in the relatively under-banked States and their contribution to increasing the absorptive capacity for credit in the rural and semi-urban areas and the hitherto under-banked regions of the country and arresting and reversing the regressive flow of resources from the poorer to the better off areas of the country.

Alongside the quantitative expansion and functional diversification of the banking system, the last few decades have witnessed a significant expansion of the activities of term lending or development financial institutions (DFIs). With commercial banks confining themselves to their traditional provisioning of working capital requirements of trade and industry the role of specialised financial institutions was seen as meeting the requirements of medium and long term finance for industry. The network of financial institutions comprising the three all-India development banks (IDBI, ICICI, IFCI) and 18 State Financial Corporations and 26 State Industrial Corporations have thus brought about a countrywide coverage of term lending facilities. If the investment institutions such as the LIC, GIC and UTI were also to be included, the total financial assets of the term lending and investment institutions today exceeds over Rs 100,000 crores. The industrial DFIs were created and organised from the top to meet the perceived lacunae that existed in the financial system for meeting adequately the requirements of industry for term finance and equity capital and foreign currency resources. These lacunae arose primarily from the inadequately developed state of the capital market on the one hand and the traditional preference of commercial banks to providing working capital requirements to trade and industry with only marginal provision of term finance.

In the four decades of their existence the DFIs have been largely successful in meeting their primary objective of providing funds for industrial investment and in relation to the

total investment in the private corporate sector between 1985 and 1990, the contribution of the three all India term lending institutions has been 20 per cent. The institutions have had a commendable record of providing much needed finance for the term requirements of industry at a time when the capital markets were not sufficiently developed and have contributed significantly to industrial development in the last few decades. The assistance sanctioned by the All India Development Banks, viz., IDBI, ICICI, IFCI and also IRBI during the Seventh Plan aggregated over Rs 42,000 crores which was nearly thrice the corresponding figure for the Sixth Plan with high priority industries like sugar, textiles, fertilizers, chemicals, cement, metals, metal products, machinery and electricity generation accounting for a significant portion of total assistance. Institutions have also tried to channel an increasing flow of assistance to industrially less developed states and backward areas. While the all-India institutions have catered to the needs of larger enterprises, the state level institutions (SFCs and SIDCs) have been meeting the term financial requirements of the small and medium scale sector in the respective areas of their jurisdiction. The IDBI has subscribed to 50 per cent of the equity capital of the state financial corporations thus helping in addition to provision of to bring about a coordinating function in refinance. The DFIs have also attempted a wide range of promotional activities including a major thrust towards entrepreneurship development programmes, identifying industrial promotion needs of deserving segments of the industrial sector and evolving measures for their growth and for providing avenues for commercialisation of indigenous resources.

A significant fact in the operation of the institutions is that they have, on the basis of assured sources of funds, also purveyed credit at relatively stable lending rates. Against the background of a fiscal system which has effectively encouraged debt finance in relation to equity, the Indian corporate sector has over the years had high leveraging ratios and become increasingly dependent on DFIs for investment finance. The dominance of the public financial institutions in the area of corporate debt has had the effect of narrowing, if not virtually eliminating the choice of the borrower to choose his financier as, in their operations, institutions have generally operated on a consortium basis in which the investment institutions also have been involved. While inter-institutional coordination has undoubted merit, this has also engendered misgivings that the operations of the DFIs have tended to assume the character of a lenders' cartel.

The DFIs now account for the major share of corporate debt, and an aspect of the increasing reliance of the corporate sector on the DFIs for finance is that the latter now have nominees on the boards of assisted concerns and often have covenants relating to aspects of management and deployment of financial surpluses such as in respect of dividend distribution and get involved in what should be regarded as aspects of internal management of companies.

The term lending institutions have also invested in equity of the private corporate sector, both through the operation of the convertibility clause in respect of credit to assisted concerns and through their underwriting commitments. The public investment institutions, such as the LIC, GIC, UTI and now the mutual funds, of course, have, in any case, been operating in the market. Consequently, the public sector financial institutions apart from accounting for a major share of corporate debt have also increasingly become holders of corporate equity through their investment operations. Often the combined institutional holding of equity is even if it is not a majority of the total equity of a company, the largest single block which gives the institutions considerable influence in voting and puts them in a position to influence decisions with regard to mergers and acquisitions.

In the evolution of the structure of development financing institutions, the creation of specialised institutions to cater to the financial needs of rehabilitation of sick industrial units, export finance, agriculture and rural development have been of significance. The Industrial Reconstruction Bank of India (IRBI) acts as a principal credit and reconstruction agency for rehabilitation of sick industrial units. The Export-Import Bank of India (EXIM Bank) was set up in 1982 for financing, facilitating and promoting India's foreign trade. With a view to strengthening the institutional network catering to the short term, medium term and long term credit needs of agriculture, rural and allied

sectors, the National Bank for Agriculture and Rural Development (NABARD) was established in 1982. In 1986, the Shipping Credit and Investment Company of India Ltd (SCICI) was set up to promote development and investment in shipping, fishing and related industrial areas. In order to meet the distinctive needs of the tourism industry, a specialised financial institution, viz., Tourism Finance Corporation of India Ltd., was set up in 1989. IDBI has also recently promoted the Small Industries Development Bank of India (SIDBI). SIDBI has been designated as the principal financial institution for the promotion, financing, development and rehabilitation of the small sector covering a wide spectrum of units in the small scale, village and cottage sectors and for coordinating the functions of existing institutions engaged in similar activities. To encourage finance for the housing sector, a National Housing Bank has been established. The Bank provides refinance facilities to primary lenders such as housing finance companies, cooperative institutions and scheduled commercial banks and, where appropriate, subscribes to the equity of housing finance companies. Apart from share capital and bonds, the resources for housing finance also come from the home loan accounts scheme which now comprises over 4 lakh accounts.

In the last decade the Indian capital market has been growing in strength and diversity and new issue activity and market transactions have taken a veritable quantum jump. The volume of new issues was nearly Rs 6,500 crores in 1989, representing a phenomenal increase over the decade. Market

capitalisation is a multiple of what it was barely five years ago. The phenomenon of securitisation of debt has also reached India. New financial institutions, such as merchant banks, leasing companies, mutual funds and venture capital companies have come on the scene and there is a growing institutional continuum between the money and capital markets with banks entering into business one normally associates with the capital market by floating mutual funds and going into leasing, venture capital and factoring finance. New financial instruments such as convertible debentures have appeared in the capital market. In the money market, commercial paper and certificates of deposits have made their appearance and among money market institutions, the most notable addition has been that of the Discount and Finance House of India. A Securities and Exchange Board has been set up and credit rating agencies are now operational. Specialised savings and investment institutions are catering to the needs of a growing market. The proliferation of financial institutions and instruments now provides the saver with a wider choice of assets depending upon his perception of risk, liquidity and yield, and has begun to impart a measure of competition in financial services.

The system has evolved under the aegis of an activist promotional policy appropriate to the early phases of financial development and the policy of promotion combined with regulation

to instill depositor confidence has achieved notable success in terms of resource mobilisation and credit extension to agriculture and industry and has thus assisted in meeting major development objectives and creating a specialised and diversified structure against the background of reasonable stability. The institutional developments and the undoubtedly impressive quantitative achievements of the banks and DFIs have not been without cost as reflected in some deterioration in the quality of their loan portfolio and the decline in productivity and efficiency of operations and erosion of profitability of the banking system. It is to these aspects that we now turn our attention.

Chapter III

MAJOR ISSUES IN THE FINANCIAL SECTOR

The impressive progress made by the Indian banking sector in achieving social goals in the form of extending the geographical reach and functional spread of banking services has, as the previous Chapter has outlined, been a major developmental input of the financial services industry. However, this progress has exacted a heavy toll in the form of a decline in productivity and efficiency of the system and in consequence a serious erosion of its profitability even to the point of raising doubts about the viability of some important constituents of the system. This erosion of profitability has adversely affected and continues to affect the ability of the system to expand further its range of services, especially in the context of assisting in the creation of competitive vitality and efficiency in the real economy.

Though the erosion of profitability of banks is not an exclusively Indian phenomenon, the ratios of profitability to assets or working funds of the Indian banking system are certainly much lower than they are in relation to international averages and impairs their prospects for continued and healthy growth. Gross profits (i.e., surplus before provision) have been declining for the banking system over the past decades and in 1989-90, such profits (before provisions) were no more

than 1.10 per cent of working funds; if allowance were to be made, even for a measure of inadequate provisioning in respect of sticky advances and against loan losses, the situation cannot but be a cause for concern. While this represents the average for the system, there are several banks in whose case the incremental cost of operation per rupee of working funds was higher than the incremental income per rupee of working funds. In its basics, profitability is a function of cost reduction and return maximisation and in the area of banking it boils down to efficient assets management, especially of the liquidity and credit portfolios and liability management in terms of deposits and capital funds apart from operational aspects in terms of branched and personnel. In other words, the decline in profitability has emanated both from factors operating on the side of income and on the side of expenditure of the banking industry. Factors both external to banks in terms of the macro policy environment as well as internal to them in terms of organisation, staffing and branch spread have been responsible for this.

As regards macro aspects of the economic environment and broader policy goals, the point has been made that the responsibility thrust on banks for what might broadly be called social banking has tended to depress potential income and been a factor in banks' declining profitability. Banks have used their social obligations to rationalise their inadequate performance

in terms of low productivity and profitability. In the Committee's view, there is no inherent contradiction between social obligations and profitable banking. The very fact that a few banks in our system have done well both in terms of meeting their social obligations and in terms of reaching adequate levels of profitability is enough evidence of this.

One of the major elements constricting the operational flexibility of banks and depressing banks' income earnings has been the system of directed investment in terms of the minimum statutory liquidity ratios. This together with the variable cash reserve ratios today, account for a pre-emption of well over half of the total resources mobilised by the banking system. The SLR is currently at 38.5 per cent of net demand and time liabilities while the variable cash reserve ratio is at a basic figure of 15 per cent plus a 10 per cent incremental ratio since May 1991, making for a total of 63.5 per cent at the margin and somewhat less than this on the average. The statutory liquidity ratio derives its legal sanction from Section 24 of the Banking Regulation Act 1949 and was essentially conceived as a prudential safeguard. The definition of liquid assets included gold, cash, balances with themselves or with other banks and unencumbered Government securities, reflecting the concept of immediate mobilisation or liquefaction of the assets. Over the years, however, the SLRs' potential as a monetary instrument in terms of diverting credit away from "general uses" came to be realised especially at a time when the cash reserve ratio

itself was not variable and, in effect, the system that was operated was a variable statutory liquidity ratio. Even though subsequent legislative amendments introduced the concept of variable cash reserve ratios the potential of the SLR as an instrument to mobilise bank resources for the public sector was clearly evident and the SLR has increasingly been thus used as an instrument for diverting part of the household sector's savings mobilised by the banking system to finance public sector investment. Banks have thus become, along with the insurance and provident fund systems, a part of the captive market for public borrowings. There is, of course, nothing inherently wrong in using a part of the banking system's resources for the finance of public sector investment, given that until recently the public sector accounted for over half of aggregate investment. However, in recent years with large revenue deficits being incurred it could be argued that, at the margin banks' investments through their meeting their SLR obligations have been in effect financing Government current expenditure or what in effect has been low yielding public investment. The high level of SLR investments has also tended to "crowd out" the non-Government sector's access to bank funds, thus depriving more productive activities of resources from the banking system.

By itself, a high level of SLR requirements need not have affected profitability of banks if interest earnings on investments were remunerative but when the rate paid on Government obligations was less than market related rates or

that on alternative deployment in credit, the imposition of high SLR requirements was in effect acting as a tax on the banking system and, at one remove, on savings routed through banks by lowering the competitive returns that banks could offer their depositors. Though in the last few years coupon rates of interest on Government borrowings have been enhanced, this would only help to augment earnings at the margin; for the bulk of the investments, the average earnings still remain way below market related rates and especially so at a time when rates on bank deposits whose maturity is in any event much shorter than that of investments are commanding steadily increasing rates. It is thus the level of the interest rate on the SLR investments as much as the quantum, that has affected the income of banks. The recent increase in bond yields creates problem of a different type to banks in terms of depreciation in the market value of these investments for which prudence would suggest adequate provisions. In view of the lower yield on investments banks have not surprisingly sought to effect some cross subsidisation within the framework of administered interest rates by putting up the rates to the generality of their customers. In the process, high interest rates for productive activity have also contributed to making ours a high cost economy.

As regards the cash reserve ratio, we recognise that this is an important instrument for monetary control, but in terms of the income effect on banks, the impact of high cash reserve requirement once again is related to the

interest that is paid on deposits above the basic minimum of 3 per cent. The Reserve Bank has been paying interest on additional deposits impounded with it of 10.5 per cent on eligible cash balances as on March 1990 and 5 per cent on incremental cash balances thereafter, but these rates are below the current rate for one year bank deposits and, considering that well over half of bank deposit resources are term deposits, the loss in potential income as a result of the "reserve requirement tax" has adversely affected profitability.

Another factor that has tended to depress banks' potential income has been the system of directed credit programmes. One of the major objectives of our developmental credit policy, as enunciated at the time of nationalisation of banks, has been to seek to extend the reach of bank credit both geographically and functionally -- geographically in the sense of covering the under-banked regions of the country especially the rural hinterland and functionally to expand credit to agriculture, small industry and the self-employed -- sectors which were deemed important in terms of their contribution to national income growth, expansion of employment opportunities and diffusion of economic power but which also were relatively neglected upto that time in terms of their access to institutional, especially commercial bank, credit and to which it was felt credit should be increasingly directed by vesting them with priority status in credit allocation.

The principal instrument chosen for directing the credit flow into the priority sectors was, after an initial experiment with preferential refinance schemes, the stipulation of

progressively increasing percentages of the total volume of bank credit to be deployed in these sectors by specific target dates. Currently, as indicated in the previous Chapter, the targeted proportion is 40 per cent of total bank credit. Over the years, more categories have been added to the priority list and sub targets set for specific sectors, eg., agriculture in respect of which the target is currently 18 per cent of aggregate bank credit and within agriculture for small and marginal farmers. In addition to the designated 'priority' sectors, banks have, through a combination of exhortation, direction and preferential refinance, been asked over the years to extend credit in increasing measure to the export sector and for food procurement operations, the latter, in particular, taking on the character of pre-emption of bank funds.

In the two decades after nationalisation, the banking system has, as was pointed out in the previous Chapter, made impressive progress in extending credit to the priority sectors and the system has reached the targeted figure of 40 per cent of a vastly expanded credit total. Part of the increase in priority sector credit would be on account of accumulated interest arrears which is added to the outstanding credit amount.

Most of this expansion in volume and in the number of borrowal accounts has been in respect of the agricultural sector. Agricultural credit deployment has risen to a level of over Rs 14,000 crores at which point it exceeds what the cooperatives

who have been in this business for several decades have been able to achieve, and, incidentally, is also a multiple of the total of all bank credit in 1969. The expansion of priority sector lending and the emphasis on a better spatial distribution of credit has also led to some evening out of regional disparities in credit deployment.

The system of directed credit programmes has contributed to an expansion of credit in the directions that were considered necessary. In purely quantitative terms this expansion must be regarded as a successful fulfilment of the objectives of such redirection. However, this achievement has been brought about at the cost of a deterioration of the quality of the loan portfolio, the growth of overdues and consequent erosion of profitability. Fixation of targets for specific sector lending was essentially the means to achieve the broader goals of credit allocation but over the years the means appear to have become ends in themselves. The desire to attain credit targets has, we fear, meant, inadequate attention to qualitative aspects of lending and consequent rise in loan delinquencies. The objective of developmental credit policy was to forge a link between technological upgradation in agriculture and small industry and the availability of finance to enable such technological upgradation. This was the basis for the emphasis of purpose oriented credit as distinct from the earlier security orientation. This was also the rationale for the concept of

supervised credit. Unfortunately, over the years the nexus between credit expansion and productivity has been weakened and is reflected in the blurring of the distinction between the concepts of credit need and credit worthiness. The institution of credit guarantee was designed as a backdrop to credit extension but has had the unintended effect of the primary lender not undertaking the needed appraisal in the mistaken belief that loan recovery was not in question. Meanwhile, collateral requirements have been eased and this combined with inadequate appraisal of credit applications in terms of productive use of credit and insufficient post credit supervision has affected recovery of dues and increased loan delinquencies. The disturbing growth in overdues is a consequence of the measure of laxity and departure from the principles of sound banking.

But by far the most serious damage to the system and one which has contributed to the decline in portfolio quality has been the evidence of political and administrative interference in credit decision making. Populism and political and administrative influence bordering on interference should have no place in the lexicon of banking and finance but unfortunately, over the years, competitive populism has affected banking and credit operations. The experience with regard to IRDP is instructive in this regard. In many cases of IRDP lending banks have virtually abdicated their responsibilities in undertaking need based credit assessment and appraisal of potential viability and instead have tended to rely on lists of identified borrowers prepared by Government authorities. The

phenomenon of loan melas was quite contrary to the principles of a professional appraisal of bank credit needs. There was hardly any serious appraisal of credit need; potential productive activity or provision for effective post credit supervision. The intended socially oriented credit, in the process, degenerated into irresponsible lending. Loan waivers have added an additional element of politicisation of banking apart from the grave damage to the concept of credit discipline by encouraging defaults. The political element which condones overdues should also have paid regard to the social obligation which banks owe to their depositors to invest their funds with due prudence.

Altogether, the proportion of the infected portfolio in agricultural and small industrial credit is estimated to be as high as over 20 per cent. It might be pointed out at this stage that not all the contamination of the loan portfolio in terms of delinquent accounts can be laid at the door of directed credit programmes to the priority sectors. There is at least as much incidence of delinquency in respect of the conventional (i.e., medium and large scale) sectors as there is in the case of priority sectors. The phenomenon of credit to 'sick' industries is the most telling evidence of this. Apart from the deterioration in credit accounts in respect of these industries, banks have been, through general and sometimes specific instructions from Governments, both at the Centre and the States, been forced to continue extending credit to sick industrial units often against their better commercial judgment. Banks have also had problems arising from the 'advice' from BIFR and directions even from Courts to extend credit to sick units. This

could be regarded as a different form of directed credit. There is, therefore, urgent need to address the issue of infected loan portfolio in the various directed credit sectors.

The contamination of the portfolio of priority sector lending has had adverse implications for banks' operating results. If proper standards of income recognition were employed, the import of this degree of poor portfolio quality would be reflected in lower 'true' income, inadequate provisioning and erosion of profitability. There is also the larger macro economic effect of this lock up of funds diverting credit from more productive uses and in respect of which the basic self-revolving character of bank credit would have been evident.

Directed credit programmes have had adverse implications for the profitability of banks also because of the stipulation of concessional lending rates on priority sector credit and the element of subsidy on such lending which now accounts for a not insignificant portion of banks' spread. Subsidisation of this type of lending arises from the mis-conception that socially oriented credit should also be low cost credit. Subsidisation of credit is clearly a case of misplaced emphasis as experience in India as elsewhere has shown that it is the timely and adequate access to credit that is of more importance than its cost. Institutional finance (even if it is not subsidised overtly or otherwise) is in any case a cheaper source of finance than the alternative of obtaining it from the unorga-

nised or informal sector. There is no need for a further element of subsidisation which only weakens the ability of the banking system to build its strength to extend the coverage of credit even wider. In this sense there is a regressive character to the subsidisation in that the beneficiaries of subsidised credit have become a new class of the privileged whose satisfaction is at the expense of those continuing to be denied the benefit of institutional credit. Apart from this overt subsidisation, loan delinquencies could also be viewed as an element of unintended and unwarranted subsidisation with attendant adverse effects on income and profitability.

Thus, it is both the depression in interest income available to banks within their directed investment and directed programmes on the one hand and the deterioration in the quality of the loan portfolio both to the priority sectors and to the traditional sector that have been responsible for erosion of earnings and profitability.

The squeeze on profitability has also emanated from the side of expenditure. Apart from the steady increase in interest cost of deposits both as a result of higher rates and a shift in maturity pattern of deposits towards longer term deposits, perhaps the single most important cause for the further increase in expenditure has been the impact of the phenomenal expansion of branch banking. Growing diversification of functions, particularly with respect to extending the coverage

of bank credit to agriculture and small industries where the unit costs of administering the loan tend to be high in proportionate terms have also contributed to a faster growth in expenditure. The rapid extension of banking into the rural hinterland has often been cited a major factor affecting the earning capacity of banks. Many of the semi-urban and rural branches of banks have been described as unremunerative in the sense that many of them are primarily deposit centres and do not generate adequate credit business and, consequently, income. Even if these deposit centres were paid interest on rational transfer pricing principles by their head-offices, their advance business would continue to be somewhat unremunerative. This is because lending to agriculture and small industries which constitute a significant if not a major proportion of the business in rural and semi-urban branches is generally at effectively subsidised rates and, therefore, impinges on banks' earnings, as discussed earlier.

The system is finding it difficult to cope with the load of servicing more branches as the operational methods and procedures have remained largely unchanged. Extensive geographical spread and lines of command and control have tended to weaken central office supervision, without necessarily leading to greater delegation and accountability. There has been significant deterioration in what is referred to as "housekeeping" in the areas of balancing of books and reconciliation of entries. The record of submission of internal control returns by branches to head offices has been unsatisfactory and there has been some weakening of internal inspection and audit and increase in

unreconciled inter branch and inter bank entries. Though we understand there has been some improvement in this regard more recently, it still represents an area of weakness. Consequent to the rapid expansion of branches, establishment costs have risen given that the structure of salaries and wages do not make any real distinction between urban and rural branches. More recently, the Reserve Bank has indicated the need to moderate the expansion in branches, and is laying increasing stress on extension of branches on the basis of demonstrated need and potential viability of branches, and on the qualitative improvement in terms of efficiency and profitability of the existing branches.

The rapid growth in the numbers of staff and accelerated promotions have also diluted the quality of manpower. There has consequently been a perceptible decline in the quality of supervisory and managerial staff in banks. Over-manning at various levels has become an unfortunate aspect of banks' organisational systems over time. While trade unions have performed their legitimate function of looking after the service conditions of their members, they also appear to have contributed to the proliferation of restrictive practices in terms of work norms, resistance to mechanisation and computerisation, and obstacles to rational policies in respect of promotions and staff transfers. Some of these practices have affected discipline and work culture and, in the process, also affected productivity

and efficiency. The technology of bank operations has, over the past few decades, shown little improvement despite the manifold expansion of business which again has come in the way of providing efficient customer service in an industry which is essentially a service industry. A situation has arisen today where emoluments of bank staff and their revisions are no longer directly related to either productivity or profitability of either individual banks or of the system. This has aggravated the position of some of the weaker constituents of the system. Studies undertaken by the Reserve Bank indicate that labour productivity (measured either in terms of per capita net income or in terms of cost of different activities per rupee of established costs) has been declining. The rate of growth in staff costs has been higher than that of the surplus of banks. It is in this context that the Reserve Bank has advised banks to seek to limit the expansion of their staff to around one per cent per annum as against an average of 7 per cent per annum between 1980 and 1985. The reduction in the yearly expansion of staff has effected some potential savings in establishment costs. There is, however, still considerable scope for containing manpower growth in banks and to effect necessary re-deployment of staff between urban and metropolitan branches on the one hand and the rural semi-urban offices on the other. Both management weaknesses and trade union pressures have contributed to this degree of over-manning in the urban and metropolitan centres and inadequate progress in updating work technology.

The deterioration in portfolio quality and the related erosion of profitability of the banking system has led to other serious short-comings in the system which also call for remedial action. As a result of declining profitability Indian banks have not been able to add to their own resources in the form of reserves sufficiently. The ratio of capital funds of Indian banks to risk weighted assets is low on the average even on the basis of published balance sheets. This average conceals the point that some banks are seriously under-capitalised. In respect of public sector banks, there has been injection of capital from the Government in recent years but the position still is a matter for concern. These figures, of course, are on the basis of published balance sheets which do not adequately reflect the true state of affairs of banks and financial institutions. Accounting practices of Indian banks are not uniform. Nor is there any way of gleaning from the published balance sheets and profit and loss accounts the adequacy or otherwise of provisions for loan losses and bad and doubtful debts. Though the Reserve Bank has recently indicated a model format for balance sheet purposes and presentation of accounts, it still remains necessary for banks to adopt transparent and uniform accounting practices and full disclosure statements in conformity with international norms and practices in this regard.

The other major set of issues relates to the need for ensuring a degree of operational flexibility and, more importantly, internal autonomy for the banks in their decision making process not only in respect of credit sanctions but in all aspects of

Internal management. While the directed investments and directed credit programmes have tended to inhibit operational flexibility, the more serious danger to the system has emanated, as indicated earlier in this Chapter, through excessive administrative and political interference in credit decision making which has seriously abridged the autonomous functioning of banks. Further, the directions which bank managements receive either formally or as is more often the case, informally, regarding aspects of internal management including cases of postings and transfers of officials, have contributed to a measure of de-motivation of bank managements and seriously affected their ability to take innovative decisions in the furtherance of their business. The issues of autonomy and operational flexibility are also related to the need for imparting a greater degree of professionalism in banking operations which would be fully in keeping with one of the more important objectives of bank nationalisation. Thus the issues facing the banking sector relate both to the content of their business and the manner in which such business is being conducted. The deterioration of the financial health of the system would not only impair its ability to serve efficiently the emerging needs of the real economy but could further erode the real value of and return on the savings to it entrusted by the depositors and eventually have an adverse effect on depositor and investor confidence. The present situation calls for urgent remedial measures. We address these issues in greater detail in the subsequent chapters.

Chapter IV

DIRECTED INVESTMENTS AND CREDIT PROGRAMMES AND INTEREST RATES: SOME PROPOSALS

The diagnosis of the problems affecting banks' performance and their ability to cope with the increasing demands being placed on them also suggest the direction in which improvements would need to be effected to improve the efficiency, productivity and profitability of the system and to enhance its competitive vitality.

As regards the directed investments in terms of SLR and CRR requirements we are of the view that the SLR requirements would need to be related, as they were originally intended to be, to prudential requirements and not as a monetary instrument or, as they have since become, a major instrument of mobilisation of the household sector's financial savings in the form of its deposits with the banking system to finance the public sector. In a situation of large revenue deficits as we have now, credit to the Government at the margin, is as we mentioned earlier, going to finance what in economic terms is consumption rather than be available for financing investment ^{productive} and activity. The reduction in the fiscal deficit which is high on the economic agenda of Government should provide the background for a gradual winding down of the statutory liquidity ratio from its present levels which could be regarded as being unsustainable in terms of limiting the operational flexibility of

banks, in depressing their potential earnings and in 'crowding out' the legitimate needs of the commercial sector for bank credit. If, as is now intended, the Government fiscal deficit were to come down to 6.5 per cent of GDP this year and in the next few years to a level which could be regarded as consistent with broad macro economic stability, it should be possible for the SLR also over the next five years to revert to 25 per cent of net demand and time liabilities. The Committee recommends that such a phased reduction be effected in the SLR, starting preferably with a reduction in the current year itself. A reduction in SLR levels should enable banks to allocate their resources on a flexible and efficient basis to promote investment and production in agriculture, industry and trade with due regard to the productive use of their resources. The Committee also suggests that Government borrowing rates should progressively be market related and this should also help to augment banks' income from their SLR investments.

As regards the cash reserve ratio, it is our view that we should allow the Reserve Bank the requisite freedom to operate this instrument in terms of its monetary policy goals. In a monetary system like ours where the more traditional forms of credit control are not particularly effective given the narrowness of the securities market and the existence of administered interest rates, there is likely to be, for some time, reliance on the variable reserve ratio as an instrument of monetary and credit control. However, with the expected reduction in the

Government deficit in relation to GDP the scope for an expansion of the high power reserve money base leading to potential secondary expansion of credit would also be correspondingly less. While thus the Reserve Bank should have the freedom to operate this instrument, it would seem to us that the occasion for maintaining this high level of CRR would also diminish with the reduction in the fiscal deficit itself. Further, if, as is now intended by the Government and monetary authorities interest rates are progressively freed from the rigid administered system which has prevailed for so long, this in itself should give some scope for the use of open market operations as another instrument of credit control and thus relieve the variable cash reserve ratio from being the principal instrument of such control. The Committee accordingly proposes that the Reserve Bank consider a progressive reduction in the CRR from its present high level. In any event, it is our view that if the instrument of CRR were deployed, the Reserve Bank should pay interest on impounded deposits above the basic minimum, at a rate which would be broadly related to the banks' average cost of deposits. However, during the present regime of administered rates, the rate may be fixed at the level of banks' one year deposit rates. A movement towards market related rates would not impair bank earnings or impose a tax effectively on the depositor.

With respect to directed credit programmes, the Committee is of the view that they have played a useful role

In extending the reach of the banking system to cover sectors which were hitherto neglected. The Committee, however, believes that the pursuit of distributive justice should use the instrumentality of the fiscal rather than the credit system. Therefore, the Committee would like to view directed credit programmes not as a regular feature but rather as a case of extraordinary support to certain sectors in the absence of economic compulsions to make credit available to them and designed to correct perceived imperfections in the credit market. Such intervention should be seen as a temporary rather than a permanent feature. The Committee believes that the issue is how to consolidate the quantitative gains that have been made while improving the quality of the loan portfolio and health of the banking system. Macro credit guidance should continue to be a legitimate aspect of developmental credit policy but micro credit intervention, sometimes bordering on behest lending should be eschewed.

Directed credit programmes have led to segmentation of credit markets and introduced an element of inflexibility in bank operations. Further, the stipulation of high proportion of allocation coming on top of informal direction in favour of food procurement and allied activities after pre-empted uses of bank resources through the SLR/CRR mechanism has meant that the traditional sectors of medium and large industry and trade have often been subject to severe restriction with consequent deleterious effects on the growth of industrial investment and production.

The growth of agriculture and small industry in India has now reached a point where the legitimate productive requirements of these sectors (or large parts of them) could be met by banks on the basis of their commercial judgment. The question can, therefore, be raised as to whether and to what extent there is a need for continuing this type of special credit support. If the logic of extension of credit to the priority sector is to make these sectors economically viable by enhancing production and productivity, two decades of such preferred credit is a long enough period to attempt an evaluation of its continuing need. Despite considerable unproductive lending, there is evidence that the contribution of bank credit to growth of agriculture and small industry has made an impact and served its purpose. There is, therefore, need for re-examination of the continued relevance of such directed credit programmes at least in respect of those who are able to stand on their own feet and to whom the directed credit programmes with the element of interest concessionality that has accompanied it, has become a source of economic rent. Even as two decades ago the quantitative expansion needed a measure of credit direction, the present emphasis on quality improvement would seem to suggest that we de-emphasise the quantitative targets and try to limit such credit direction only to the really needy, such as the small and marginal farmers in agriculture and the tiny sector in industry. The large and medium farmer and most of small scale industry should be able to stand on their feet even without such privileged access to

credit through direction and on the basis of productive use of credit granted by banks relying only on their commercial judgment.

The Committee, therefore, suggests that the system of directed credit programmes should be gradually phased out. This process of phasing out would also recognise the need that for some time it would be necessary for some special credit support through direction to be in operation and that some sectors may continue to need such credit support. The Committee, therefore, proposes that directed credit programmes should cover a redefined priority sector, consisting of the small and marginal farmer, tiny sector of industry, small business and transport operators, village and cottage industries, rural artisans and other weaker sections. The Committee proposes that the credit target for this redefined priority sector henceforth be fixed at 10 per cent of aggregate bank credit which, the Committee has observed, would be broadly in line with the credit flows to these sectors at present. The Committee further proposes that a review may be undertaken at the end of three years to see if directed credit programmes need to be continued. Simultaneously, the stipulation of concessional interest to the redefined priority sector would need to be reviewed with a view to its eventual elimination in about three years. Credit for agriculture and small industry should be on the basis of supervised credit and on a proper techno-economic appraisal of proposals and

without any interference, either political, administrative or judicial in credit decisions.

With regard to the large and medium farmer and small industries now enjoying the benefit of concessional credit and to whom the direction would no longer apply, we need to consider ways of phasing out their present 'priority' status by making it economically worthwhile for banks to expand their lending to these sectors without detriment to loan quality or banks' income. In this context, we would recommend non-invasive means of credit direction such as a return to the system of preferential refinance from the Reserve Bank in respect of incremental credit by a bank to agriculture and small industry without, at the same time, any loosening of eligibility criteria for such refinance. This would make it profitable and attractive for the banks to enlarge their credit to these sectors but would leave the primary decision making to the banks themselves on the basis of their credit judgment and their perception of the income generating aspects both in respect of the enterprises being financed and for the banks themselves. It would revert to the original postulate of social banking, viz., that credit should be an instrument of enhancing productivity over large areas of agriculture and small industry. In this sense, the Committee believes that there would be no conflict between the postulates of sound banking on the one hand and social banking on the other.

The level and structure of interest rates and the way they are determined are relevant not only for the wider goals of macro-economic management and for providing a competitive environment to financial institutions, but also for ensuring the financial strength of banks and financial institutions.

The present administered structure of interest rates is characterised by great complexity and an inverted yield pattern. The complexity stems from the multiplicity of authorities involved and ad hoc decisions by them with regard to rates of return on various types of instruments or tax concessions and the attempt to serve certain social objectives through differential interest rates. The inverted yield pattern is largely a consequence of inflation and the desire of the Government to shield long-term investments from the penalty of high interest rates caused by inflation. Commercial bank lending rates to trade and industry also reflect the cross subsidisation being effected to make up for concessional interest rates to the priority sectors. Lending rates of term lending institutions consequently are typically below the minimum lending rates of commercial banks applicable to cash credits for trade and industry.

The level of interest rates has been influenced to a great extent by the Government's desire to contain its own interest burden in the face of its mounting fiscal deficits.

Although interest rates on Government loans have been raised over the past decade, they are still not high enough to attract voluntary subscribers, though it should be added that individual subscriptions to Government borrowing have been through Savings Certificates and similar instruments rather than through marketable debt. The market for Government loans is in effect a captive market. The other considerations governing the level of interest rates are resource mobilisation and, lately, the anxiety of the authorities to help the banks and financial institutions to attain viability. Allocative efficiency has not been a major desideratum of policy.

The Committee believes that interest rates should increasingly be allowed to perform their main function of allocating scarce loanable funds among alternative uses. For them to do so, rates will have to be allowed broadly to be determined by market forces. The Committee has noted that the Reserve Bank has already moved a considerable distance in the direction of deregulation of interest rates. There is no longer a ceiling on the lending rates of commercial banks or of the term lending institutions but floors have been specified. While concessional rates continue to be in force for lending to priority sectors there has recently been an element of rationalisation by limiting the concession to small borrowers. The ceiling on interest rates that can be offered by corporate entities for debentures has also been removed, though not for

public deposits. Bank deposit rates are still capped, though the ceilings have been raised both for banks and non-bank finance companies. However, the ceiling on company deposits has not been raised. These rates as also Government's own borrowing rates are, however, below what market-determined rates are likely to be.

The Committee is of the view that easy and timely access to credit is far more important than its cost and hence in line with its general thinking on directed lending to priority sectors, it would recommend that concessional rates of interest for priority sector loans of small sizes should be phased out. This would remove a major disincentive for banks to seek clients in the neglected sectors. Lending to preferred sectors should be encouraged as already indicated, by permitting commercial rather than concessional rates to the erstwhile constituents of the priority sector and by instituting a preferential refinance scheme without any prescription of the final rate to the ultimate borrower. Subsidies in some of the development programmes, eg., IRDP should also be withdrawn as they have distorted the pattern of lending. Withdrawal of such concessionality would reduce the need for cross subsidisation and lead to some averaging of credit interest rates paid by different sectors.

The Committee would also recommend that any further deregulation of interest rates be phased to be in step with measures to reduce the fiscal deficit. Interest rates on

Government loans have been progressively raised over the past decade. While this has provided some though inadequate relief to the banks during a period when the SLR was also being gradually raised, it has also put pressure on the revenue account of the Government. Interest costs now constitute a significant proportion of revenue expenditure. Any sudden increase in coupon rates could jeopardise the Government's efforts to control its deficit. The Committee would, however, recommend that as the SLR is progressively reduced, as suggested earlier, the Government may bring about a graduated increase in its nominal borrowing rates to bring them in line with other market rates of interest.

The Committee has noted that interest rates in India have been, by and large, positive. More recently the inflation rate has gone up, but there is a general expectation that it will come down as measures to restore macro-economic balance begin to take effect. The current lending rates of banks and DFIs which is to some extent a reflection of the current monetary situation are on the high side and there is little scope for any further increase. There may be a case for raising the ceiling on deposit rates to maintain their positive character in real terms but a total deregulation is likely to give a further upward push to the lending rates which, we believe, is not desirable, at least until competitive forces come into full play to provide a mechanism for reduction in rates as the inflation rate comes down or in response to change in demand for and supply of

funds. The Committee would suggest that, as in the case of Government borrowing rates, further increases in the bank deposit rates should be considered along with the suggested reduction in SLR.

The Committee believes that the medium term objective should be to move towards market determined interest rates. It would, however, advocate a cautious approach to deregulation. In the absence of reasonable macro-economic balance and control of inflation; total deregulation could pose the danger, as experience abroad has shown, of excessive bank lending at high nominal rates to borrowers of dubious credit-worthiness eventually creating acute problems for the banks as well as the borrowers. The Reserve Bank should aim at simplifying the structure of interest rates. Government for its part should also assist in this process by rationalising the discriminatory fiscal concessions in respect of different savings instruments and desisting from introducing such ad hoc concessions in the future. The Reserve Bank should be the authority to determine the level and structure of interest rates. It should use the Bank Rate as an anchor rate to signal changes in the direction and level of rates. The Reserve Bank should use the Bank Rate as its basic refinance rate and a floor or prime lending rate with a stipulated spread above the Bank Rate should also be indicated. The spreads between the Bank Rate, Government borrowing rate, banks' deposit rate and the prime lending rate may be indicated by the Reserve Bank in accordance with the criteria suggested by the Chakravarty Committee while ensuring that real rates of interest remain positive.

Chapter V

CAPITAL ADEQUACY, ACCOUNTING POLICIES AND OTHER RELATED MATTERS

The ratio of capital funds in relation to a bank's deposits or its assets is a well recognised and universally accepted measure of the strength and stability of the institution. As mentioned in an earlier Chapter, the capital ratios of Indian banks are generally low, and some banks are seriously under-capitalised.

The Basle Committee on Banking Regulations and Supervisory Practices appointed by the Bank of International Settlements (BIS) has prescribed certain capital adequacy standards to be followed by commercial banks and these standards have been accepted for implementation by several countries. The BIS standard, as it is popularly known, seeks to measure capital adequacy as the ratio of capital to risk weighted assets. It has prescribed weightages for different categories of assets which include certain off-balance sheet items as well. The Committee believes that it is necessary that banks in India also conform to these standards in a phased manner.

For the purpose of calculating capital adequacy, risk weightages have to be assigned to different categories of assets. While these weights have to conform broadly to the requirements of the BIS standard, the specific circumstances obtaining in India

would need to be taken due note of in assigning such weights. We recommend that the Reserve Bank of India do so while issuing its guidelines to the banks in this regard.

For the purpose of the calculation of capital, BIS has classified capital into two broad categories, namely, Tier 1 capital consisting of share capital and disclosed reserves and Tier 2 capital consisting of undisclosed and latent reserves, general provisions, hybrid capital and subordinated debt. It has also been indicated that Tier 2 capital should not exceed Tier 1 capital. The Committee recommends that the BIS basis of classification in this regard should be adopted by banks in India.

The BIS norm for capital adequacy is 8 per cent of the risk weighted assets. The Committee recommends that all banks in India reach this figure in a phased manner. For those banks which operate on an international scale, the norm should be achieved as early as possible and in any event within three years, i.e., by March 1994. As far as other banks are concerned, they should achieve a capital adequacy norm of 4 per cent by March 1993 (of which Tier 1 capital should not be less than 2 per cent) and the 8 per cent norm in full within the next three years, i.e., by March 31, 1996.

Before, however, the norms of capital adequacy are complied with by Indian banks it is necessary to have their

assets revalued on a more realistic basis and on the basis of their realisable value. Banks and DFIs have not been following a uniform practice in respect of income recognition, valuation of investments as also provisioning against doubtful debts. Necessary adjustments in this regard have to be made as recommended by us later in this Chapter. After making these adjustments it would be necessary to inject further capital to achieve the capital adequacy norms. The Committee recommends that in respect of banks which have had a consistent record of profitability and enjoy a good reputation in the markets it should be possible for them to tap the capital market by issuing fresh capital to the public. Mutual funds, insurance companies and profitable public sector companies could subscribe to such equity, besides employees of the banks and the general public. In respect of other banks it may be necessary for the Government to supplement the capital either by direct subscription to equity or through a loan which could be treated as a subordinate debt.

The Ghosh Committee on the Final Accounts of the banks had made certain recommendations in regard to valuation of investments in banks' portfolios. That Committee recognised that a significant portion of a bank's portfolio would be held till maturity and, therefore, it would not be necessary to provide for diminution in the value of such investments based on market quotations. It, therefore, recommended that a bank's investment portfolio should be bifurcated into two parts, viz.,

"permanent investment" and "current investment" and suggested that it would not be necessary for banks to provide for diminution in the value of permanent investment but that full provision would need to be made in the depreciation in the value of current investments. The Committee endorses the recommendations of the Ghosh Committee in this matter.

The Committee believes that a proper system of income recognition and provisioning is fundamental to the preservation of the strength and stability of the banking system. A proper asset classification will, however, have to precede this exercise. The Reserve Bank of India has now prescribed that all advances of a bank should be classified under the following Health Codes:

| <u>Code No</u> | <u>Title</u> |
|----------------|---|
| 1. | Satisfactory |
| 2. | Irregular |
| 3. | Sick: viable/under nursing |
| 4. | Sick: non-viable/sticky |
| 5. | Advances recalled |
| 6. | Suit-filed accounts |
| 7. | Decreed debts |
| 8. | Debts classified by the banks as bad/doubtful |

In regard to income recognition the Reserve Bank has directed that in respect of advances covered by Health Codes 5 to 8 interest income should not be recognised until it is realised. The Committee believes that a policy of income recognition should be objective and based on record of recovery rather than on any subjective considerations. The international practice is that an asset is treated as "non-performing" when interest is overdue for at least two quarters. In respect of such non-performing assets interest is not recognised on accrual basis but is booked as income only when actually received. The Committee is of the view that a similar practice should be followed by banks and financial institutions in India and accordingly recommends that interest on non-performing assets should not be booked as income on accrual basis. The non-performing assets would be defined as an advance where, as on the balance sheet date

- (a) in respect of term loans, interest remains past due for a period of more than 180 days,
- (b) in respect of overdraft and cash credits, accounts remain out of order for a period of more than 180 days,
- (c) in respect of bills purchased and discounted, the bill remains overdue and unpaid for a period of more than 180 days,
- (d) in respect of other accounts, any amount to be received remains past due for a period of more than 180 days.

An amount is considered past due when it remains outstanding 30 days beyond the due date.

The Committee further recommends that in view of the different practices hitherto followed by banks and financial institutions in this regard they be given a period of 3 years beginning with the year 1991-92 to conform on a uniform basis to the above norms.

The Committee is of the view that for the purposes of provisioning, banks and financial institutions should classify their assets by compressing the Health Codes into the following broad groups:

- i) Standard
- ii) Sub-standard
- iii) Doubtful and
- iv) Loss

The RBI should prescribe clear and objective definitions for these 4 categories to ensure a uniform, consistent and logical basis for classification of assets. Broadly stated, sub-standard assets would be those which exhibit problems and would include assets classified as non-performing for a period not exceeding two years. Doubtful assets are those non-performing assets which remain as such for a period exceeding two years and would also include loans in respect of which instalments are overdue for a period exceeding 2 years. Loss assets are accounts where loss has been identified but the amounts have not been written off.

The Committee believes that in the Indian context, given the delays in the legal system there is bound to be a time lag between an account becoming doubtful of recovery, its recognition as such and the realisation of the security. In making provisions, this factor has to be kept in mind, besides the market

value of the security charged to the banks and institutions. The Committee, therefore, recommends that the basis of provisioning against bad and doubtful debts should be as under:

1. In respect of 'loss' assets, either the entire assets should be written off in the books or if the asset is permitted to remain in the books for certain reasons, 100 per cent of the outstandings should be provided for.
2. In respect of doubtful debts, it would be necessary for the banks to provide 100 per cent of the security shortfall, that is, the full extent to which the loans and advances are not covered by the realisable value of the security. Over and above this, it will be necessary for banks and institutions, to make a further specific provision to the extent of a certain percentage of even the secured portion. This percentage could vary from 20 to 50 per cent depending on the period for which an asset remains in the doubtful category.
3. In respect of sub-standard assets, a general provision of 10 per cent of the total outstandings should be created.

We propose that the Reserve Bank lay down specific prudential guidelines in this regard keeping these recommendations in mind. The Committee further recommends that banks and financial institutions be given a period of 4 years beginning with the current year itself to comply with the above basis of provisioning. However, they should ensure that the

unsecured portion of the doubtful debts are fully provided for as soon as possible. Loss assets should either be written off or fully provided for immediately.

In order that the banks and financial institutions are in a position to comply with the above criteria for income recognition and provisioning, it is necessary that there should be as little divergence as possible between book profits and taxable profits and that there ^{should} be appropriate incentives in the tax laws to induce banks and financial institutions to adopt the desired accounting practices. The Committee has noted with satisfaction that in terms of a recent amendment to the Income Tax Act, the Reserve Bank has been vested with the necessary authority to issue guidelines in regard to income recognition. The Committee suggests that the Reserve Bank keep in mind our recommendations in this regard while formulating the guidelines to be issued by it. The Committee further recommends that all specific provisions made in respect of doubtful assets should be allowed as a deduction under Section 36(1)(vii) of the Income Tax Act. Also, the deduction available for general provisions under Section 36(1)(vii)(a) of the Income Tax Act 1961 should be modified to provide for a ceiling of 0.5 per cent of the aggregate average non-agricultural advances in India instead of a ceiling of 5 per cent of the net income. This deduction should also be available to banks having operations outside India in respect of their Indian assets in addition to the deductions

available under Section 36(1)(viii). In respect of agricultural advances, the present provision of allowing deductions to the extent of 2 per cent of such aggregate advances may be allowed to continue.

The Committee believes that concurrent with proper procedures for income recognition, provisioning and maintenance of capital adequacy, there should be greater transparency in the financial statements of banks. In this context we endorse the recommendations of Ghosh Committee on Final Accounts in this regard. After the Ghosh Committee submitted its report the International Accounting Standards Committee issued its standard on "Disclosures in the financial statements of banks and similar financial institutions". The Committee recommends that this standard be adopted by Indian banks and financial institutions in a phased manner, commencing with the current year. At the same time, the Committee would suggest that the Reserve Bank may defer implementation of such parts of the standards as it considers appropriate during the transitional period.

Banks and financial institutions at present face considerable difficulties in recovery of dues from the clients and enforcement of security charged to them due to the delays in the legal processes. A significant portion of the funds of banks and financial institutions is thus blocked in unproductive assets, the values of which keep deteriorating with the passage

of time. Banks also incur substantial amounts of expenditure by way of legal charges which add to their overheads. The question of speeding up the process of recovery was examined in great detail by a committee set up by the Government under the Chairmanship of the late Shri Tiwari. The Tiwari Committee recommended, inter alia, the setting up of Special Tribunals which could expedite the recovery process. This Committee is in full agreement with the recommendations made by the Tiwari Committee and strongly recommends to the Government that special legislation on the lines recommended by Tiwari Committee be introduced forthwith. The Committee is of the view that unless a proper judicial framework is established which could help banks and institutions in enforcing the claims against their clients speedily, the functioning of the financial system would continue to be beset with problems. We regard the setting up of the Special Tribunals as critical to the successful implementation of the financial sector reforms.

The Committee recognises that the impact of the setting up of the Special Tribunals will be felt by banks only over a period of time. The appointment of the Tribunals, the finalisation of their working procedures and equipping them with the necessary infrastructure for proper functioning would all take some time. In the meanwhile it is necessary to work out an arrangement to deal with that portion of the portfolio of banks which has already become bad and doubtful and whose recovery is being hampered by the slow legal process. To continue to

keep such assets in banks' balance sheets would not be desirable even on the assumption that substantial provisions are made thereagainst as recommended by us. It would be far more appropriate if these assets were taken off the balance sheets of banks and institutions, so that the funds realised through this process can be recycled into more productive assets. The Committee has looked at the mechanism employed under similar circumstances in certain other countries and recommends the setting up of, if necessary by special legislation, a separate institution by the Government of India to be known as 'Assets Reconstruction Fund' (ARF) with the express purpose of taking over such assets from banks and financial institutions and subsequently following up on the recovery of the dues owed to them from the primary borrowers. The share capital of this Fund could be subscribed to by the Government of India, the Reserve Bank of India, public sector banks and financial institutions.

The Fund would acquire from banks and DFIs the bad and doubtful debt assets which are in the process of recovery, at a discount. The quantum of discount itself would be determined by independent auditors, i.e., auditors other than those of either the banks/DFIs or borrowers concerned and, on the basis of guidelines clearly set down for this purpose by an expert body of chartered accountants. The transfer of assets to the ARF by the banks/DFIs would be accompanied by the primary lenders renouncing in favour of the ARF claims on the

collateral pledged in respect of the loans inclusive of any guarantees by Central or State Governments or any other bodies.

The Fund would pay for the acquisition of these assets from banks/DFIs at a discounted price in the form of five-year bonds which would bear interest at market related rates. The bonds would be guaranteed by the Central Government and thus would qualify for inclusion as SLR assets. The advantage to banks of this arrangement would be that a portion of their bad and doubtful debts would be off their books though at a price, but they would have in substitution of these advances, bonds upto the discounted value with a certainty of interest income which would be an obviously important aspect from the point of view of income recognition. Further, by making these bond holdings eligible for SLR purposes, fresh resource could become available for normal lending purposes.

Selling these assets to the Fund at a discount would obviously mean an obligation on the banks/DFIs to write off these losses which in the case of many of them they may not be in a position to do given their weak capital position. We propose that to enable the banks to finance the write off represented by the extent of the discount, the Government of India should provide a subordinated loan. As far as the Government of India itself is concerned, we believe that the rupee counterpart of any external assistance that would be available for financial sector reform could be used to inject this type of capital to the banks and DFIs.

We view with equal importance vesting the ARF with full authority to enable it to collect the dues and invoke the guarantees for expeditious clearance. These powers could be much broader than those contained in Sections 29 to 32 of the State Financial Corporations Act 1951. Once the dues are collected by the ARF, it should be in a position to use the receipts to redeem the bonds. If, on the other hand, there were a deficit, the Government of India would need to take such a deficit over. Once the ARF completes its task of collecting the dues and redeeming the bonds, we would expect that it would wind itself up.

We wish to emphasize that this proposal should be regarded as an emergency measure and not a continuing source of relief to banks and DFIs. It should be made clear to the banks and financial institutions that once their books are cleaned up through this process they should in future take normal care and pay due commercial attention in loan appraisals and supervision and make adequate provisions for assets of doubtful realisable value.

With a view to ensuring that the new institution is not burdened with a large number of accounts disproportionate to the infrastructure likely to be available to it, it is necessary that such transfers of assets are done in a phased manner. To begin with, all consortium accounts where more than one bank or institution is involved should be transferred to the ARF. The number of such accounts will not be large but the amounts

involved would be substantial enough to make a difference to the balance sheets of banks/DFIs. Gradually, depending on the progress achieved by the ARF, other bad and doubtful debts could be transferred over a period of time. Meanwhile, banks and institutions should pursue recovery through the Special Tribunals.

The mechanism of Special Tribunals and the ARF are intended to facilitate recovery of dues from clients in respect of whom banks and DFIs have already taken a decision to recall the loan and proceed with the enforcement of security. There are, however, a significant number of sick accounts in the portfolio of banks and DFIs which are under various stages of nursing programmes. These accounts represent dues from units which are generally considered viable and which given appropriate and timely assistance could be expected to show improvement. Past experience, however, has shown that the rehabilitation programmes of most such sick units are hampered by inordinate delays in decision making, particularly when several banks and financial institutions are involved under a consortium arrangement. There are sometimes disagreements between the consortium partners in regard to some insignificant details which hold up decisions. There have been instances where even after agreement is reached on the rehabilitation programme, there are delays in the disbursement of funds for one reason or another. As a result of these delays even potentially viable units face prospects of closure and winding up jeopardising funds already invested in

them by the financial system. Several attempts have been made in the past to bring about greater coordination between the various institutions but these have not produced any worthwhile results.

The Committee believes that in respect of such sick units which are under nursing or rehabilitation programme, it should be possible to work out an arrangement similar to what is contemplated under the ARF to ensure smooth decision making and implementation in respect of such nursing programmes. The Committee recommends that in respect of all consortium accounts which are classified as sick accounts and in respect of which nursing programmes have already been ^{formulated} or/are in the process of implementation, the concerned lead financial institution and/or lead commercial bank should take over the term loan and working capital dues respectively from other participating institutions and banks. Such acquisitions should be at a discount based on the realisable value on the assets assessed by a panel of at least two independent auditors as in the case of transfers of assets to the ARF.

In respect of accounts where the amounts of dues to the banks and DFIs are very large, the process recommended by us could raise certain issues of 'exposure'. There are understandable limitations even for a large institution or a commercial bank to increase its exposure in respect of individual accounts. Here again, there is a need, as in the case of transfer of assets

to ARF, to implement the arrangement in a phased manner. To start with, it should be possible to confine this arrangement in respect of accounts where the total dues do not exceed a sum of Rs 10 crores by way of term loans and Rs 20 crores by way of working capital dues. This should, we believe, address the problem of individual exposure. Gradually, this arrangement could be extended to other accounts. In respect of very large accounts which could create exposure problems, the consortium arrangements may have to be continued. We understand, however, that such accounts are very few in number.

As in the case of the ARF, the Committee recommends the above measure as a one-time arrangement to take care of the special circumstances in which a fairly large number of units have fallen sick and need to be rehabilitated. The Committee is also conscious of the burden this proposal could place on some lead institutions and banks. Once the cases of existing units are dealt with, banks and institutions should in future ensure that problems of this nature do not arise. The decision to nurse a unit which is facing problems should be taken purely on professional and commercial considerations. The formulation of an appropriate and considerate exit policy by the Government, providing proper safeguards for the workers should help in this process. The assumption of the liabilities of the participating members of a syndicated loan at a discount should then be a purely voluntary arrangement between the concerned parties based on normal commercial considerations and without any extraneous pressures.

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Chapter VI

STRUCTURAL ORGANISATION OF THE BANKING SYSTEM

One of the terms of reference of the Committee is the question of structural organisation of the banking system. The present structure of banks in India has been the result of historical evolution and, barring the creation of the regional rural banks after 1975, the structure remains broadly what it was at the time of nationalisation of banks. The issue of restructuring the public sector banks has been studied at various times and by at least three committees in the past and though certain recommendations were made in the direction of restructuring the system, no action was taken towards implementing these proposals in the light of the perceived administrative problems.

(Our examination of the problem and our discussions with representative organisations of banks, bank labour, industry and trade have brought home to us the need for effecting structural changes with a view to bringing about greater efficiency of operations.) We were struck by the broad spectrum of support to the idea that there should be a substantial reduction in the number of public sector banks from their present number of 28.) We are aware, as indeed were the representatives of bank managements and labour, of the administrative and staffing problems

that are likely to be faced in doing so but agree with those representatives of management and labour with whom we discussed ^{the} issues that these problems have to be tackled in the larger interest and with cooperation from bank staff.

The Committee attaches the utmost importance to banks' functioning within the framework of operational flexibility and internal autonomy and, is therefore of the view that any move towards restructuring and reducing the number of banks through mergers and acquisitions should evolve on the basis of market driven and profitability considerations and with understanding support from bank officers and staff. This would emphasize the voluntary character of the exercise and avoid the type of problems associated with a top down approach.

Consistent with this approach, the Committee would like to put forward the broad pattern ^{towards} which the banking structure should evolve. In our view, this broad pattern should consist of

- (a) 3 or 4 large banks (including the State Bank of India) which could become international in character;
- (b) 8 to 10 national banks with a network of branches throughout the country engaged in general or universal banking;
- (c) Local banks whose operations would be generally confined to a specific region; and

- (d) Rural banks (including RRBs) whose operations would be confined to the rural areas and whose business would be predominantly engaged in financing of agriculture and allied activities.

The Committee believes that each of the above categories should have differential start up capital requirements stipulated by the Reserve Bank based on the area of operations and branch network. The start up capital requirements would, of course, be supplemented by the maintenance of capital adequacy on the lines discussed in an earlier chapter in respect of the large, medium and local banks. Subject to the maintenance of minimum capital requirements related to area of operations there should be no restrictions on banks operating in any part of the country though we would expect that the local banks would largely confine their branch operations to particular regions and have link offices in major centres outside their regional area of operations.

The State Bank of India has already evolved into a bank with considerable amount of domestic strength and a strong international presence. In due course of time it has the potential of evolving into a strong international bank. It is necessary to think in terms of two or three other banks which could be encouraged to replicate the State Bank of India's pattern of growth. This could come about through a process of mergers of some of the leading public sector banks which already have a reasonably strong international presence. Recent events have

amply demonstrated the difficulties for banks maintaining a strong international presence unless they have a degree of strength in domestic banking. Mergers of such banks with extensive domestic operations and an international presence would thus help to create strong banks and of reasonable size to take care of fluctuations in business which mark operations in international banking. Thus, in addition to the SBI, we could have two or three large banks having operations abroad in major international financial centres and in regions with strong Indian ethnic presence. Pending the evolution of such strong Indian banks with an international character, the Committee recommends as an interim measure that those Indian banks with the largest presence abroad and strong financial position could jointly set up one or more subsidiaries to take over their existing branches abroad. The SBI operations abroad should continue and indeed be strengthened in course of time. The Committee also proposes that consideration be given to the larger banks increasing their international presence and operations by taking over existing small banks incorporated abroad. The Committee believes that these steps would help to rationalise the foreign operations of Indian banks.

A national bank, as we envisage it, would be typically one which has a wide network of branches across the country. While the public sector banks today would qualify for this definition as a result of their branch expansion not only in the regions of their origin but across the country, this expansion

was somewhat unplanned and haphazard with the result that considerable strains have been placed on their organisational structure. Such organisational weaknesses have, as we indicate in the next Chapter, affected efficiency and productivity. Further, due to the operation of various other factors, as discussed in earlier Chapters, the health of quite a few banks has been affected because of the deterioration in the quality of their assets over a period of time. While pursuing measures outlined in earlier Chapters to improve the profitability of the system, we believe a measure of restructuring of the system by reducing the number of the remaining public sector banks would be desirable. There is clearly need for a degree of consolidation of the structure and this could be brought about essentially through a process of negotiated rather than imposed mergers based, as mentioned earlier, on profitability considerations as well as for reasons of business strategy. The managements of the various banks with appropriate help and, where necessary, a measure of persuasion by the Government and the Reserve Bank should, we believe, work towards this end. In our view, the number of national banks, given the needs of the country and the optimum size of operations both from the business and organisational points of view, should not exceed eight to ten.

The assumption that every bank should be national in character was perhaps responsible for encouraging the public sector banks, including even those who prior to nationalisation had a strong regional character, into expanding in all parts of

of the country. This assumption is questionable as in any structure of banking there is always room for banks with a regional character and these could function within their area of operations as efficiently and profitably as national banks. Local banks have undoubtedly several strengths and given appropriate business strategies could offer healthy competition to banks of larger size. The Committee, therefore, visualises that, given the freedom of entry into the financial system, there could be strong possibility that several new banks with a predominantly local character would be set up and existing local banks would find the environment congenial for increasing the size and scope of their operations.

The Committee recommends that freedom of entry into the financial system should be liberalised and the Reserve Bank should now permit the establishment of new banks in the private sector, provided they conform to the ^{minimum} start up capital and other requirements and the set of prudential norms with regard to accounting, provisioning and other aspects of operations.

The Committee also recommends that there should not be any difference in treatment between the public sector and private sector banks and any restrictions in this regard which are at present in operation should be removed.

The Committee proposes that the Government should make a positive declaration that there would be no further nationalisation of banks. Such an assurance would remove the

existing disincentive for the more dynamic private sector banks to grow.

In recommending freedom of entry into the financial system which would result in the possible establishment of new banks in the private sector, the Committee is conscious of the possibility of misuse of banks by certain vested interests to their special advantage and to the detriment of depositors' interests. The Committee believes that ensuring strict compliance with the prudential guidelines laid down by the Reserve Bank of India together with the relevant statutory requirements governing private bank operations should provide adequate safeguards against such misuse of banks' resources.

The Committee also believes that consistent with the other aspects of Government policy dealing with foreign investment, the policy with regard to allowing foreign banks to open offices in India either as branches or, where the Reserve Bank considers it appropriate, as subsidiaries, should be more liberal subject to the statutory requirement of reciprocity and the maintenance of such minimum assigned capital as may be prescribed by the Reserve Bank. The Committee is of the view that the joint ventures between foreign banks and Indian banks should not only be permitted but be actively encouraged particularly in regard to merchant and investment banking, leasing and other newer forms of financial services. The entry of foreign banks into the country, we believe, would have a beneficial impact from the point of view

of improving competitive efficiency of the Indian banking system as also upgrading work technology. In the short run it could create problems to the Indian banks but over a period of time, we believe, Indian banks would so reorganise their operations and improve their efficiency as to meet the competition posed by the foreign banks. While permitting operations of foreign banks we would emphasise the importance of ensuring a level playing field. Foreign banks in the country are not subjected to the same social obligations as have been imposed on the domestic banks and this has given an edge to the foreign banks in regard to their profitability. The Committee, therefore, recommends that foreign banks in India when permitted to operate in the country should be subjected to the same requirements as are applicable to domestic banks. If, in view of certain constraints, such as absence of branch network, the foreign banks are unable to fulfil certain requirements, such as a minimum proportion of directed credit (equal, as we have earlier proposed, to 10 per cent of aggregate credit) the Reserve Bank should work out alternative methods with a view to removing any possible competitive disadvantage to the Indian banks.)

The Committee has given consideration to the present system of licensing of branches. While on the one hand the present policy has placed restrictions on commercial banks opening offices purely on profitability considerations, it has, on the other, directed banks to open offices in centres with the object of providing banking services especially in the rural and semi-urban areas regardless of the fact that such branches are likely

to be unremunerative. This policy was perhaps desirable and necessary for extending geographical spread in the formative years of expanding the financial infrastructure. With this objective having been substantially achieved, the policy needs to be reviewed. With the banking system now having extended its branch network over a vast area of the rural hinterland and successfully achieved an increase in banking density, the Committee sees no further need to continue the system of branch licensing and we accordingly propose that branch licensing be abolished. Indian commercial banks should be given full freedom to open or close branches (other than rural branches for the present) or swap their rural branches with those of other banks on the basis of their commercial judgment.

One of the major achievements of the banking system in the period following nationalisation has been the substantial branch expansion into the rural areas and the increase in provision of credit to agriculture and allied activities but, as discussed earlier, this achievement has exacted a price in terms of erosion of profitability and organisational strain. Most of the rural branches of banks are unremunerative and lack viability in their operations. The management of the rural branches has proved to be a daunting task in regard to manpower deployment. Internal controls over rural branches have become weak and ineffective. Information retrieval has been hampered by delays and inaccuracies and quality of assets severely affected by, amongst other things, absence of effective post-credit supervision.

Any attempt to restructure the banking system in the country cannot but take note of and deal with these problems.

The institution of Regional Rural Banks (RRBs) was designed to provide a low cost alternative to the operation of commercial bank branches but the functioning of the RRBs also gives much cause for concern. To a large extent, this has been the result of the restrictions placed on the business they can engage in. The wage and salary scales of the RRBs also have been rising and the recent award of a tribunal would lead to these scales approximating to those of the commercial banks. The low earning capacity and the rising expenditure have seriously affected their viability and, barring a handful, almost all the banks are working at considerable loss with little relief in sight. With the increase in salary scales, an important rationale for the setting up of the RRBs has ceased to exist. The managements of the RRBs continue to vest with the sponsoring banks who also have their own rural branches in the very area of operations of the RRBs which have been sponsored and are managed by them. This has given rise to certain anomalies and to avoidable expenditure on controls and administration. The problem of the RRBs is, therefore, one of improving their viability without sacrificing the basic objective for which they were set up.

The Committee believes that the solution lies in evolving a rural banking structure which could combine effectively the advantages of the local character of the RRBs and the financial

strength and organisational and managerial skills of the commercial banks. While competition should be a relevant factor in the business of banking, in the particular circumstance of rural banking this proposition needs to be qualified. Given the credit gap which exists in rural community, and the distance still required to be covered before the rural banking needs are fully taken care of, the need is to establish a viable banking structure which could effectively meet rural credit needs.

The Committee believes that it would be advantageous for the sponsor banks to segregate the operations of their rural branches through the formation of one or more subsidiaries, depending on the size, administrative convenience and business assessment of each sponsor bank. Each subsidiary should have a compact area of operations. This would be particularly desirable from the point of view of recruitment and deployment of manpower apart from providing the needed thrust to business operations and effective improvements in the control, supervision and information systems. If our recommendations in regard to abolition of branch licensing is implemented, the sponsor banks should have the freedom to swap their rural branches with those of other banks which would facilitate banks which have fewer rural branches in certain districts to cede them in favour of those banks which have a

larger presence. Through this process it should be possible to evolve a rational structure of subsidiaries of national banks which could handle rural banking in a more efficient and cost effective manner.

Such subsidiaries of the national banks should be treated on par with the RRBs in regard to cash reserve and statutory liquidity requirements and refinance facilities from NABARD with a view to improving the viability of rural operations. This combined with considerable saving in costs of administration brought about through the process of rationalisation suggested above and the phasing out of concessionality in lending to agriculture and small industry should make the subsidiaries more viable and eventually profitable. The 10 per cent target for directed credit which we have recommended as a transitional measure should, we suggest, be calculated on the basis of the combined aggregate of the parent banks and their subsidiaries.

The administrative problems which this rationalisation exercise would involve cannot, however, be ignored. The manpower problems associated with this cannot also be minimised. It is quite possible that a large number of employees would hesitate to get themselves absorbed in the newly formed subsidiaries and would prefer to remain with their respective parent banks. They may have to be initially treated on deputation and replaced by employees who are recruited afresh and locally. The training process of the newly recruited employees could also take quite some time. These are essentially

transitional problems and while some of them could pose difficulties to banks, the Committee believes that it would be necessary to face them squarely. It is perhaps the failure to take note of these problems in the past that has partly been responsible for the present structural deficiencies of the system. These problems would not disappear under any structure. It would, in our view, be better to find long term solutions as suggested above while meeting the transitional difficulties in as best a manner as possible.

In regard to Regional Rural Banks, the Committee would recommend that to impart viability to their operations they be permitted to engage in all types of banking business. Though their focus should continue to be to lend to the target groups they should not be forced to restrict their operations to the target groups. However, to ensure that the assistance at present available to the target groups is not in any way reduced, the Committee proposes that, the RRBs should ensure that the level of credit to this sector is maintained as was obtaining during the year 1989-90. We would also propose that the interest rate structure of the RRBs should be in line with those of the commercial banks. This should make the operations of the RRBs viable over time. To improve the viability further the Committee recommends that a mechanism be worked out under which the RRBs could place surplus funds with

either NABARD or with a special federal type of agency that might be set up for this purpose. Similarly, instead of RRBs investing in Government and Government guaranteed securities for purposes of SLR compliance they could keep cash balances with NABARD or the special agency which could pay interest on such balances by investing or deploying these funds to the best advantage on their behalf and thus help augment the income of the RRBs. Such placement of funds by RRBs would also be consistent with the statutory requirements in relation to SLR. These steps, we believe, would help to improve the viability of such of the RRBs as would wish to retain their identity.

The Committee would, however, leave the option open to the RRBs and their sponsor banks as to whether the RRBs should retain their identity or whether they should be merged on a voluntary basis with the sponsor banks' rural banking subsidiaries. Such mergers should be decided mainly on commercial and developmental considerations. In cases of such mergers, the Committee recommends that the sponsor banks take them over as 100 per cent subsidiaries in the first instance by buying out the shares in the RRBs now held by other agencies at a token price and eventually merge them with their rural banking subsidiaries which we have proposed.

The Committee believes that the steps we have outlined to rationalise the functioning of rural banking institutions would

go a long way in improving the viability of the concerned institutions and help to build a strong and broad based structure of rural credit.

Chapter VII

ORGANISATION, METHODS AND PROCEDURES IN BANKS

Flexibility of operations, productivity and efficiency of the banking system could be regarded as a function of the organisational systems, methods and procedures followed by the banking system. An important point that emerges on a review of the organisational systems in the banking industry is, as mentioned in an earlier Chapter, that the methods of operation and procedural systems have not changed in any major qualitative sense in spite of a phenomenal growth in the volume of business, an extended geographical reach and a major diversification of functional activities. As mentioned in earlier Chapters, lines of command and control have lengthened to the point of weakening central office supervision without effectively decentralising decision making and operations. Internal returns are not submitted either on time or accurately; internal audit and inspection systems have not geared themselves sufficiently to expansion of business and unreconciled inter-branch and inter-bank entries (in spite of some improvement in 'housekeeping' in recent years) remain areas of concern in view of the possibility of such unreconciled entries giving scope for fraud. In the result, the expansion and diversification of business have put severe internal strains on the system.

The Committee is of the view that the form of internal organisational structure is a matter best left to the judgment of individual banks depending upon ^{the size of the banks, the} the volume of their operations, the spread of their branch network and the range of their functions. There is in fact no need to have a uniform structure for all the banks. It would, however, be pertinent to note that the way the internal organisational structure of banks has evolved is for the larger banks to have a four-tier structure, starting with the branch, followed by the regional office controlling about 30 to 40 branches, a zonal office controlling three or four regions and a head or central office at the top. The case of the State Bank is somewhat unique in the sense that its equivalent of zonal office is ^{the} Local Head Office, which functions in many respects as a bank within a bank. The Committee believes that for the medium and smaller banks a three-tier structure consisting of the branch, the regional offices and central office would be adequate while for a small and local banks, such as, for instance, the regional rural banks, a two-tier structure with the branch reporting directly to the central office would appear adequate and appropriate. However, as stated earlier, the Committee would not wish to prescribe a uniform pattern but leave it to the banks to decide on a structure most appropriate to their needs. A general point could, however, be made, namely that in any such multi-tier structure, there should be a considerable measure of decentralisation, especially with respect to routine operations and credit decision making upto well

defined limits, so that the upper-tiers of the system are not unduly burdened. The role of controlling offices, whether at the zone or at the central office should be primarily one of effective monitoring and providing guidance to the lower-tiers in respect of their operations. Effective branch control is quite consistent with an autonomous and decentralised structure provided the boundaries of delegated authority are well laid down and conformed to by both the levels and supported by an effective reporting system. As a rule, administrative offices which are essentially cost rather than profit centres should be lean and efficient outfits as against the present situation where one sees a considerable proliferation of staff as a result of unplanned and haphazard growth and insufficient delegation down the line.

The branch is the cutting edge of the banking industry where there is the direct interface with the depositor and the credit customer. It is the functioning of the branch that is thus a measure of the efficiency in respect of customer services. Banks would, therefore, need to give close attention to the organisation, staffing, work technology, work culture and attitudes of branch staff. The manning of rural branches have posed problems for banks owing to the reluctance of urban oriented and recruited staff to work in rural branches and the lack of motivation to do so. More local recruitment and improved working conditions in rural areas should help to meet this problem. In most branches the work is fairly simple and routine. Deposit, bank remittances

simple advances and bill business do not indeed require much skill or expertise to process. Procedures and accounting policy are simple and staff training for these set of operations should not present serious problems. Even if such simple and repetitive work in a branch should expand it could be handled especially in non-metropolitan centres by additional staff. Beyond a point, however, opening new ledgers and appointing more staff cannot solve the problem as a larger volume of work brings in its train a host of other problems such as handling reconciliation of entries, balancing of accounts and the like which require a measure of mechanisation and computerisation. It is instructive to compare the experience of foreign and Indian banks in this regard. Foreign banks were in the lead in introducing mechanisation and computerisation, and in the process, their customer service has improved, their standards of efficiency are rated better and they have, in consequence, reaped considerable competitive advantage. If Indian banks are to maintain and enhance their competitive efficiency, they would also need to go in for a measure of mechanisation and computerisation at least in the bigger branches and especially in the urban and metropolitan centres. While a majority of branches would be engaged in general business, the increasing diversification of the portfolio and larger volume in diverse areas would call for staff with special skills. As work in these specialised areas expands, banks could think in terms of having separate functional divisions in branches to handle business of a particular type of clientele with each specialised division catering to a particular market segment and manned by

staff equipped with the necessary skills for this purpose and provided with decision making abilities. The divisions could maintain their own books of accounts and carry only the totals to the branch general ledger. The State Bank of India's experience with such divisionalisation in terms of market segments is indicative of the benefits of such an approach. If the volume of business expands beyond even what a division in a branch could undertake, there could perhaps be scope for what has been termed 'dedicated' branches which cater to only one market segment, providing all the services of a particular type of clientele's needs and man its staff, specially skilled and trained, to handle this type of business. It has been observed that such dedicated branches are conducive both to efficiency and to enhanced customer satisfaction. We, however, would suggest that the question whether branches should be divisionalised or a system of dedicated branches instituted is a matter which individual bank managements have to decide on based on their perception of the volume of business and requirements of their clientele.

With regard to the middle-tier, whether zonal or regional offices, their main function, as mentioned earlier, would be one of monitoring the operations of the sub-tiers and providing the latter with direction and guidance within a scheme of delegated authority. The Committee believes that even where banks are now operating a multi-tier organisation, the extent of delegation of authority is inadequate. Nor is there a clear enough perception

and reviewing the activities of the branches and supervising them effectively. The Committee believes that what is needed is a judicious blend of on-site and off-site controls with a middle-tier ensuring that the branches adhere to prescribed norms and guidelines.

As regards the head office, the Committee observes that these are organised in different banks on different lines with some controlling operations of the branches on a zonal or geographical basis while others have attempted a functional organisation at the head office level. This again is a matter, which we believe, is best left to individual institutions. We would, however, utter a note of caution against frequent changes in the structure of head office organisation depending upon the changing perceptions of individual chief executives. The central office, in our view, should be so organised as to enable the top management to pay undivided attention to the key areas of the banks' operations and pursuit of broader corporate goals in the areas of productivity and profitability as well as customer service with the help of appropriate inputs from their staff and line functionaries.

More than the formal hierarchical structure of internal organisation it is the methods of conducting bank business that the Committee believes is at the heart of the issues of efficiency, productivity and customer service. There has been, as stated earlier, little change in the basic methods of operation of the banking system in the last two decades, despite the large growth

In the volume of business and its functional diversification. The work technology remains virtually the same and changes in the hierarchical patterns have not addressed the problems posed by the explosion of banking business. It has been stated that one of the reasons coming in the way of improving systems and procedures and adapting them to emerging needs is the resistance from organised labour to any change. As stated in an earlier Chapter, while bank trade unions have performed their legitimate function of protecting service conditions of the employees, they also appear to have contributed to the growth of restrictive practices in areas such as work norms and other aspects of operations such as transfers of staff leading to a lop sided situation where many urban and metropolitan branches are over-manned even as staff shortages have been a feature of several rural branches. There is also some evidence of weakening of discipline which has affected managerial functioning.

The Committee has heard the view that it is the resistance from organised labour to mechanisation and computerisation that has come in the way of improvement in work technology. In the Committee's view, it would be taking a simplistic view to perceive mechanisation and computerisation as substituting labour. In respect of repetitive operations it could perhaps be argued that mechanisation could substitute labour but there are limits to which even this can go and, as mentioned earlier, if customer service is to be improved, especially at the metropolitan centres, even

in respect of fairly routine banking transactions, such as servicing the depositor, a measure of mechanisation and computerisation may be necessary. In any event, modern banking involves a great deal of processing of masses of information. Timely and adequate information about various aspects of the business have become an essential constituent of an efficient management information system. This, along with the increasing use of electronic aids to cheque clearance and transmission of funds is something which cannot be efficiently or effectively done by employing more hands as these activities do not lend themselves to efficient manual handling. In this sense, computerisation should not be regarded as a substitute for labour but in fact as an aid to handling a larger volume of business and, in that sense, leading to larger employment opportunities. In the services sector, machines and computers bring about a qualitative change in the nature of service and where time is an essential input in the quality of service, labour and machines cease to be substitutes but assume complementary roles. As pointed out by the Rangarajan Committee on Computerisation, the programme of computerisation envisaged would not result in any reduction of labour but some reallocation of work and the objective of mechanisation is not to replace man with machines but make work life more meaningful and reduce the drudgery involved in routine work. That Committee pointed correctly that the work force in the banking industry must look upon computerisation as a means to improve customer service and efficiency which would lead to growth and thus help to expand

employment. In today's conditions, when banks are in competition with highly computerised and fully automated financial companies, we believe that for providing efficient services, there would need to be a greater measure of computerisation. We are confident that the enlightened leadership of labour unions would realise that it is in their own interest to strengthen the competitive ability of the banking industry, so that its viability and growth would help not merely to protect but enlarge job opportunities in the industry. The Committee believes that there has to be a recognition on the part of bank managements and labour that the system cannot hope to be competitive internally and keep in step with the wide ranging innovations taking place in the banking industry abroad without a radical change in work technology and culture. We have been reassured to know that organised labour is as much convinced of the importance of enhancing the viability and profitability of the banking industry and providing efficient customer service and, therefore, are hopeful that they would appreciate the importance of computerisation and mechanisation and have their fears allayed regarding the loss of potential employment opportunities in the industry. It is equally incumbent on bank managements to adopt forward looking personnel policies which are seen also to be objective and consistent so as to help create a satisfying work environment.

In this connection, the Committee is constrained to observe that management of banks also do not appear to have exerted themselves sufficiently in furthering the process of

mechanisation and computerisation and have taken shelter behind the perceived opposition of organised labour. Some constituents of the system, however, have embarked on the move towards mechanisation and computerisation. As mentioned earlier, foreign banks have been in the van in this regard but among the Indian banks, the State Bank has gone farther than the others. The question legitimately arises that if the State Bank could do so why could not the others. In more recent years there has been some progress in the matter of introducing modern work technology. The Reserve Bank has introduced electronic clearing in major centres and some mechanisation is being attempted in central and zonal ^{of banks} offices. However, the progress with regard to developing appropriate software for management information systems and internal control returns is still somewhat uneven. In this connection, the Committee strongly endorses the recommendations of the Rangarajan Committee on computerisation of banking activity and would urge bank managements to discuss with organised labour the issues involved. In the Committee's view, the system of industry-wide negotiations may have something to do with the slow progress in this regard. In a sense, industry-wide negotiations, which incidentally predate nationalisation of banks, tend to obscure the problems and potential of individual banks and at least in respect of non-wage areas to start with the Committee would like bank managements to explore the possibility of negotiations with organised labour on an individual bank basis.

The discussion on organisational methods and systems would not be complete without reference to the issues of human resource development and training. In the emerging competitive conditions in the financial services industry, in which banks will continue to be the major players, the need for specialised expertise in assessing the needs of the corporate sector and evolving suitable products to meet these needs cannot be over-emphasised. The task of pricing various services, providing for access to information technology, evolving appropriate computer software and insights into the international money and capital markets would need staff with special expertise. In this connection, the Committee urges a review of the system of recruitment and promotion in the banks. Given the increasing diversity and sophistication of business, it may be necessary for banks to go to the market for recruiting manpower with special skills from time to time and, it would be, therefore, necessary to establish a convention whereby a certain percentage of posts in several cadres in a bank may be recruited from the open market. The attitude of officers' associations which some have termed 'closed shops' would, therefore, have to undergo a change if banks are to stay competitive and be able to take advantage of the emerging opportunities in the financial services market. It would also be necessary to reward specially skilled and talented persons of proven merit with accelerated promotional opportunities if banks are to retain the bright members of their staff and not lose them to competitors in the financial services industry. With branch expansion tapering off, opportunities for promotion are likely

to be through the expansion of business through provision of new services, instruments and a greater exploration of the business needs of the clientele. Business expansion would be as much qualitative as quantitative and promotions would increasingly have to be based on expertise and special skills rather than merely on seniority or on the basis of span of control over branches.

In all this, the role of training and human resource development becomes important. One of the factors contributing to the deterioration of the quality of service is the dilution in the quality of supervisory staff and the inability of bank personnel to discharge their new roles. Training and orientation courses designed to improve professional expertise and imbue staff with motivation have become rather routine exercises. The quality of training imparted in banks has been somewhat uneven and training methodology has become stereo-typed with insufficient attention being paid to the selection and development of training faculty and periodic revision of the curricula for training in relation to emerging needs. Most importantly, corporate commitment to training and HRD has to be clear. Modern banking is getting increasingly skill intensive and employee training has, therefore, to be recognised as an important instrument to develop skills and attitudes among the staff. We would urge the Standing Coordination Committee appointed by the Reserve Bank in this regard to address itself to these areas and provide the requisite guidance to the banks.

One factor contributing to the weakening management systems in the banks has, as mentioned earlier, been the inability of banks to recruit their staff directly and the rigidities that have prevailed in the system of reward and punishment. The Committee proposes that instead of having a common recruitment system, individual banks should be free to make their own recruitment of officers. There is, thus, in the Committee's view no need for setting up a Banking Service Commission for centralised recruitment of officers nor for their recruitment as at present through the Banking Service Recruitment Boards (BSRBs). This would give individual banks scope for scouting for talent and, at the same time, training systems should be so designed that new skills are imparted to bank personnel. The Committee, however, predicates this recommendation on the assumption that banks will set up objective, fair and impartial recruitment procedures and wherever appropriate they could come together on a voluntary basis to have a joint recruitment system. As regard clerical grades, the present system of recruitment through BSRBs may continue but the Committee would urge that the responsibility for the appointment of the Chairman of these Boards should be totally left to the coordinating banks.

The other important aspect of organisation is concerned with the top management structure. All nationalised banks today, irrespective of their size, have a similar type of management structure, namely a board of directors, including two whole-time directors -- the Chairman and Managing Director and the Executive Director -- and top executive functionaries in the cadres of general managers, deputy general managers and assistant general managers. As regards the boards of banks, it should be clearly indicated that their primary function should be to lay down the broad financial policy of the bank concerned and set corporate goals and review performance. Boards should, in our view, not get involved in day to day operational decisions. These are the primary responsibility of the chief executive and his senior colleagues acting in accordance with the policies laid down by the board or of its committees. A view has been put forward to the Committee that the post of Chairman and Managing Director be separated (as is the case now with the State Bank of India) so as to relieve the Chairman from administrative responsibilities and leave him free to concentrate on policy planning and strategic management. The Committee has no strong views on the matter except to say that this would depend on the size of the bank. For the large banks there may be some advantage in following the State Bank of India model but for the medium and small banks we see no particular merit in the proposal. The role of the Executive Director in bank however needs to be clearly demarcated and not left to the perception of individual Chairmen.

In our view, the autonomy of internal decision making is critical to the functioning of a competitive and efficient banking system. Such autonomy presupposes absence of any type of external pressure or influence. Unfortunately, the experience in this regard, as mentioned in the previous Chapters, has not been happy. There have been cases of administrative and political interference in individual decision making in various aspects of business and administration which has seriously abridged operational autonomy. In our view, therefore, it is of paramount importance to depoliticise the functioning of banks and insulate them from political and administrative interference in internal management.

Consistent with the Committee's view that the integrity and internal autonomy of banks is far more important than the question of ownership, the Committee would recommend certain changes with regard to constitution of boards and appointment of chief executives of banks. As a first step it is, we believe, necessary to appoint members to the boards of directors composed of individuals of proven professional competence and expertise and with special insights into specific economic activities. In the case of nationalised banks the composition is laid down in the relative statute and seeks to provide representation for various interests. In respect of the private sector banks the legal requirements are that not less than 51 per cent of members of the board should have specialised knowledge or practical experience in the area specified in the legislation. Within the confines of these statutory provisions it should be possible to streamline the procedure for selection of persons to be appointed as directors on the boards without giving any quarter to political influence in such appointments.

At present, boards of public sector banks have nominees both of the Government and of the Reserve Bank. As long the Government owns the banks it would perhaps be necessary to have a representative of the Government to take care of what, one might term, the 'proprietary' concerns, but it would also be important to have officials of sufficient seniority on boards of banks.¹ The Committee, however, feels that there is no need for the representation of the Reserve Bank on the boards of banks so as to avoid possibility of conflict of interest. As regards the structure of the boards, we suggest that for the large banks of an all India character they could have, as the State Bank of India now does, local boards which would be familiar with operational matters with respect to regions under their jurisdiction while the central board could concentrate on broad strategic issues, covering the bank as a whole. We believe it would be a salutary principle for banks to constitute executive committees of the board which would be primarily charged with overseeing functional areas such as credit, investments, fund management, internal inspection and audit, human resource development and other operational areas, while the main board could concentrate on broader issues of policy direction and strategic management in relation to corporate goals of the bank.

¹ Two of our colleagues take the view that Government should not appoint its representative on the boards and that as a consequence the Banking Division, as at present constituted, should be abolished. Their note is appended.

The Committee is of the opinion that in the appointment of Chairman and Managing Director of the banks, professional competence and integrity should be the prime consideration in such selections on the basis of fair, objective and consistent norms. It is equally important to ensure security of tenure for the chief executive of the banks for a specified term, which could be 5 years and to stipulate that the services of a chief executive could be terminated only on the basis of proven misconduct. The Committee believes that while the formal appointments to these posts for public sector banks would have to be made by the Government, the recommendations for such appointments should be made by a group of eminent persons such as retired Governors of the Reserve Bank and other widely respected persons in the financial world, who could be invited by the Governor of the Reserve Bank to make recommendations in this regard and further that a convention should be established that such recommendations would invariably be accepted by the authorities. Similarly, the termination of services would also have to be on the basis of recommendations of this group of eminent persons. The Committee would also recommend that the appointment to banks' boards should also be made on the basis of the recommendations of this group of eminent persons. Flexibility of operations and ensuring the needed autonomy of internal functioning is, in the Committee's view, directly linked to the de-politicising the appointment of the chief executive and boards of banks. As regards the other whole-time director we believe, it would be an advantage to

appoint to this post a person from within the organisation on the basis of his service record and not necessarily on the basis of mere seniority. Undiluted application of seniority could degenerate into rewarding mediocrity.

The banking system in an increasing competitive environment would face new challenges and also new opportunities. There would be more scope for competition, both, inter se, among the banks and between the banks and other players in the system who are more conscious of costs and who place an accent on efficient service. It is, therefore, necessary that banks equip themselves with the right organisational structure, and even more importantly, the right personnel and systems to cope with these challenges. Banks have been reactive in their attitude with respect to organisational challenges so far. It is time for them now to be proactive in their approach and to anticipate the new demands on their skills that will be emerging and to prepare for the same through appropriate adjustments in their organisational structure and methods of operations and procedures in an environment of operational flexibility and internal autonomy.

Chapter VIII

DEVELOPMENT FINANCIAL INSTITUTIONS

Development Financial Institutions (DFIs) in India have, as we indicated earlier, by and large been able to fulfil the objectives for which they were set up. The institutions have been largely successful in accelerating the growth of industrial development by providing needed financial support on fairly liberal terms and stable rates of interest for setting up new projects, for expansion of existing projects and modernisation of projects by the induction of new technologies. The growth in the volume of their operations and their dominance in financing investment is testimony to their successful intermediation role. The promotional role played by these institutions has enabled the country to achieve a broadening of the entrepreneurial base which today is one of the major strengths of the industrial scene. The institutions in turn have benefited from a secure market niche, assured source of funds and relatively stable borrowing and lending rates. Many of these conditions are now undergoing a change with increasing competition from other parts of the financial sector, pressure on the availability of privileged (and concessional) funds through banks' SLR investments and the progressive deregulation of interest rates. This calls for DFIs to become more competitive, more efficient and more profitable.

As in the case of the commercial banks, the DFIs have in the course of the last several years suffered some decline in profitability and deterioration in financial health. This is

particularly so in the case of state level financial institutions. Though the all India institutions have by and large managed to retain their financial viability, there have been more recently signs of some erosion of profitability. However, unlike in the case of commercial banks, this decline in profitability is not so much because of acceptance of social obligations of lending to some sectors at concessional rates of interest but because of deterioration in the asset quality. The DFIs did have till recently schemes for provision of interest at concessional terms to projects set up in backward areas, for modernisation of technology, energy conservation and export oriented units, but these together did not form any significant part of their portfolio and were not a major factor in the decline in profitability. For a long period the DFIs enjoyed comfortable gross spreads of about 3 per cent mainly because of assured and privileged access to resources through the SLR mechanism at relatively stable and concessional rates of interest. This favourable situation started changing only during the last four to five years partly due to stepping up of the coupon rates on the bonds and with the increasing demands on them, the institutions have had to resort to borrowings at market rates of interest for a larger proportion of their resources. This has led to some narrowing of the spreads though with the lending rates of the institutions being freed the spreads have been widening again. In the last two years the spreads are around 2.5 per cent which still are well above those of the commercial banks where the gross spreads have been between 1 per cent and $1\frac{1}{2}$ per cent.

The single most important factor contributing to the deterioration of the health of the financial institutions is, as mentioned earlier, the decline in the quality of their portfolio owing to a combination of several factors.

Under a system of industrial licencing it was assumed though not explicitly stated, that once an industrial licence was granted by the Government, financing by the Government owned institutions would follow automatically. This unfortunately led to considerable but unwarranted relaxation in the appraisal standards by the institutions. Also the deficiencies in the licensing system had its effect on lending processes as well, leading to promotion and financing of several unviable projects by entrepreneurs without proven competence.

While the liberal lending norms, particularly the high leverage in the form of a debt equity of 2:1 did indeed help in attracting new entrepreneurs, it acted as a deterrent in making the projects financially viable particularly in the context of fiscal and market uncertainties. In a way this could be attributed to the fiscal system which favoured debt rather than equity as a source of investment financing as a result of which most of the projects were seriously undercapitalised thereby affecting their ability to withstand difficult times. Frequent changes in fiscal and trade policy against a background of macro-economic instability also took their toll on projects as the basic parameters forming the appraisal exercise underwent changes.

Another factor which contributed to the decline in asset quality was the policy followed in respect of nursing of sick units both in the private and public sector, owing largely to the Government's concern for employment protection. The DFIs were obliged to continue to provide -- often against their better commercial judgment -- financial support to units which had lost their viability with obvious implications for the quality of their portfolio.

DFI operations in India have been marked by the total absence of competition in the matter of provision of term finance. The system has evolved into a segmentation of business between the DFIs and the banks, the latter concentrating on working capital finance and the former on investment financing. Though commercial banks provide term loans for industry, as a matter of policy, they have been restricted to small enterprises while in the case of larger projects their share in consortium financing does not go beyond 25 per cent of the project cost. While this dichotomy may have helped some specialisation of functions, it also meant that the number of participants in the term lending business were very few. There has also been a clear demarcation of responsibility between the state level institutions and the all India institutions. Borrowers as a consequence have had no choice in the matter of selecting an institution for financing their projects. While inter-institutional consultation and coordination have undoubtedly merit, the manner in which the institutions have operated as a consortium has virtually taken the characteristic of a cartel. While

the structured consortium arrangement did indeed provide some comfort to the borrowing clientele in the sense that it saved them from the responsibility of approaching several institutions for arranging their finance, it had two principal drawbacks. When the consortium rejected an application the borrower did not have any further option. Secondly, even though the formal nature of the consortium has been diluted and is now in theory voluntary, in effect it is mandatory and militates against the participating institutions developing a sense of accountability and responsibility for a large portion of their portfolio.

The first major issue that arises for consideration in any contemplated reform package is the examination of the continued relevance of the DFIs in the contemplated scheme of things. As industrial development proceeds and the economy acquires greater sophistication the need for specialised financial institutions focussing their attention on a promotional and developmental role is likely to diminish, though it should be added that in the present stage of development of the Indian economy this situation has not arisen. There is, therefore, a significant role to be played by the DFIs in the acceleration of industrial development and hence their continuing relevance. In fact with the progressive deregulation of industry and curtailment of the area of industrial licensing, the responsibility devolving on DFIs for taking due care in their techno-economic appraisal of projects and arranging and providing financing packages would be greater and ^{would} call for increased professional skills. Over the medium term, with an increasing

number of players in the financial services industry, the roles of DFIs would perhaps undergo a change and they could become less specialist in their operations.

An important issue in this context is whether there is any need to rethink the ownership pattern of the DFIs. Given their promotional and developmental role, it was but logical that DFIs were set up in the public sector with ownership by the Government directly or indirectly. Only one of the DFIs, ICICI has evolved into a different pattern with a substantial public holding accounting for as much as 43 per cent of its capital structure. There may perhaps be a case for other DFIs following the example of ICICI over a period of time and to start with, for a dilution of holdings in equity which IDBI has in other institutions. But for the present, as in the case of the commercial banks, improvement in the efficiency and financial health of the DFIs and ensuring autonomy in decision making is, in our view, of much greater importance than the ownership pattern per se.

The real issue is, therefore, not one so much of ownership by Government but of the degree of control by Government over their operations. As with the banks, part of the problems of the financial institutions in terms of deterioration in portfolio quality has been brought about by political and administrative interference and it is, therefore, necessary to work out a scheme for autonomy of the financial institutions, enabling them in the process to distance themselves from the Government in matters of internal administration. The Committee believes it is necessary for State

level institutions to function on business principles based on prudential norms and have a management set up appropriate to this objective. We propose that an action plan on these lines be worked out to be implemented over the next three years.

As with the banks, the appointments to post of chief executive and to the Board of DFIs should be of persons with proven professional competence and, as in the case of what we have proposed for banks, be based on the recommendations of panel of eminent persons. As for the boards of DFIs we believe they should also include representation from the industrial sector. This particular proposal is even more necessary and desirable in the case of State level institutions which have been functioning more as wings of the State Governments rather than as autonomous financial institutions. The delinking of these institutions from the State Government would be a major element in bringing about an element of efficiency. In many cases State level institutions have over-extended themselves in terms of numbers of projects which has affected their follow up and recovery procedures. They also face a resource crunch with limited access to the capital markets.

The operations of the DFIs in respect of loan sanctions should be the sole responsibility of the institutions themselves based on a professional appraisal of the technical and economic aspects of the project, an evaluation of the promoters' competence and integrity and the financing and other aspects of the proposal. There should be no room for behest lending of any kind.

The supervision of the DFIs should be conducted by the same supervisory authority that we have proposed in Chapter-X and whatever policy directives the Government desires to issue should come through the Reserve Bank of India.

Given the deterioration in the health of the DFIs importance will have to be attached to its early restoration. We propose that the DFIs should also be covered by the operations of the ARF so that the contaminated portion of their portfolio is taken off the books. Once their books are cleaned up DFIs should adopt uniform accounting systems in regard to recognition of income and provisioning of doubtful debts segregation of bad and doubtful debts and adoption of prudential norms that are internationally accepted. Efforts at recapitalisation should also proceed apace so as to restore capital adequacy.

There is also need to inject an element of competition in the matter of term lending finance with a view to providing greater choice to the borrowing clientele. As a first step we recommend that the system of consortium lending be done away with. In its place, where the institutions and the borrowers agree, a system of loan syndication or participation with other DFIs and commercial banks could be considered. Though in the short run, the borrowers may miss the shelter of a structured consortium arrangement, in the long term they should welcome the progress towards a competitive environment. The present restrictions placed on commercial banks in respect of provision of term finance will as indicated earlier, have to be removed so that the number of players providing project finance could be enlarged significantly.

The progressive deregulation of interest rates from the present detailed administrative control as we have recommended earlier should also considerably facilitate this process. Market related rates based on risk perception would be an important

element in any competitive framework by introducing an element of price competition. The entry of the commercial banks into the arena of project finance will require them to raise longer term deposits to prevent an asset liability mismatch. It will also require a conscious process of provision of training facilities to the commercial bank staff and term lending institutions should help in this process.

Currently, some DFIs have representation on each other's boards. Such cross representation may have had relevance at a time of closely coordinated consortium type of lending but when the objective is, as now, to promote healthy competition between the institutions and a measure of individual autonomy we see no reason to continue with the present cross holding pattern for equity and cross representation on the boards of various DFIs.

In the context of enlarging the area of competition between the various players in the field there is also need to re-examine the sharp dichotomy that exists between working capital finance and term loans. This distinction was perhaps relevant when the responsibility between commercial banks on the one hand and the DFIs on the other were clearly demarcated. As has been mentioned earlier, as the economy acquires greater sophistication, and as the totality of the financing package assumes importance, this distinction is bound to get blurred and the roles of DFIs and commercial banks would come closer as has happened in other countries. While the entry of commercial banks into the provision of term finance is the first of necessary steps in this direction, it is also necessary to permit DFIs to enter the area of working capital finance. There are, in our view, sound logical reasons for

this. Firstly, there is always a core portion of working capital finance which can be provided by way of loan rather than cash credit which is more appropriate to meet the needs of the fluctuating portion of credit and which could vary with seasonal requirements. Receivables finance has appropriately to be provided by way of bill discounting limits. As has been postulated by several earlier committees that have examined this question, the core portion of the working capital finance will, over a period of time have to come out of the cash accruals of the company or by way of enhancing equity. It should, therefore, be possible for the term lending institution to provide this core portion by way of a term loan which could be repaid out of cash generation. This would also bring down the high leveraging which marks the financing pattern presently of the corporate sector, remove the artificial segregation of business between commercial banks and DFIs and usher in a greater measure of competition.

A precondition for bringing about competitive efficiency is the restoration of a level playing field between the different institutions. It is necessary to bring about certain changes in the role and functions of IDBI to facilitate this process. The IDBI, we believe, should separate its promotional apex and refinancing role in respect of, for instance, SFCs, SIDBI, etc., and its direct financing function. This could be brought about by setting up a financial institution which could be incorporated as a company to take over IDBI's direct lending function. The decision of the Government recently to remove the tax concessions for IDBI is a desirable step in this direction by equalising the tax treatment of various DFIs.

At present DFIs have privileged and concessional access to resources through the SLR mechanism. This will need to be phased out over the next 3 years along with a reduction, as we have proposed earlier, in the SLR requirements. The DFIs will over time have to obtain their resources from the capital market through borrowing at market related rates for the purpose of meeting their requirements. While they cannot as such be equated with banks in regard to mobilisation of deposits directly there is no reason why they should not be permitted to access the household sector directly through certain schemes which do not directly conflict with commercial banks' deposit mobilisation efforts. While competition for business should grow and the present closely interconnected operations eliminated, there will still be need for effective arrangements to be evolved by DFIs and banks for sharing credit information and ensuring financial discipline on the part of borrowers.

As stated in an earlier Chapter, with the DFIs now accounting for a major share of corporate debt and with the increasing reliance of the corporate sector on them, the DFIs now have nominees on the boards of assisted concerns and often have covenants relating to aspects of management and deployment of financial corporate resources such as in respect of dividend distribution and are involved in what should be regarded as aspects of internal management of companies. The term lending institutions, as mentioned earlier, have also invested in the equity of the private corporate sector, both through the operation of the convertibility

clause and through their underwriting commitments. Together with the investment institutions, the public financial institutions today have considerable stake in the equity of the corporate sector and in many companies their combined holding accounts for a significant portion of the total equity. This puts them in a position to influence decisions with regard to mergers and acquisitions, especially as the portion of stock changing hands in the market in a typical take-over bid rarely exceeds 15-20 per cent of the equity base of the company. Under such circumstances, it is either the passive and sometimes the active role of the financial institutions voting bloc that determines the outcome. The financial institutions can be expected to take a professional view but there have been occasions for some disquiet that in individual cases their actions have also reflected the view of Government as to who should control which unit -- an aspect of the excessive degree of Government superintendence over the activities of these institutions. Financial institutions have an awesome responsibility arising from the trust which they have to discharge, to the depositing and subscribing public on the one hand and development oriented financial markets on the other. In fact a case could be made out for the holding of the financial institutions to be used to broaden the base of share ownership by gradual sale in small lots over a broad range of investors in the market to overcome the situations where the paucity of good scrips in relation to funds seeking to invest in them could lead and has led to unhealthy speculative activity in the markets. Such sale of scrips could also help to revolve the funds of the financial

Institutions. The Committee believes that in respect of corporate take-overs DFIs should lend support to existing managements who have a record of conducting the affairs of the company in a manner beneficial to all concerned including the shareholders, unless in their opinion the prospective new management is likely to promote the interests of the company better. In doing so, we would expect the institutions to exercise their individual professional judgment free of any extraneous pressures.

The Committee believes that the proposals outlined above would provide for greater competition amongst the various sub-sectors in ^{the} financial services industry, provide for enhanced operational flexibility and most importantly for greater institutional autonomy, subject to their observance of prudential norms and proper supervision designed to improve their health. In this way the DFIs which have contributed to the national economy so much in the past should have the financial strength and organisational capabilities to operate successfully in the more challenging economic environment ahead.

Chapter IX

OTHER MONEY AND CAPITAL MARKET INSTITUTIONS

In the last twenty years there have been several developments in the money and capital markets. The volume of capital market activity has risen sharply and its functioning increasingly diversified. New financial institutions such as merchant banks, leasing companies, mutual funds and venture capital companies have come on the scene. New financial instruments such as convertible debentures, 182-day Treasury Bills, commercial paper and certificates of deposit have appeared in the money and capital markets. These reflect the growing diversification and a measure of sophistication of the financial services industry with specialised investment institutions and instruments catering to the needs of a growing market. As mentioned in an earlier Chapter there is a growing institutional continuum -- a process which has been aided by commercial banks entering into capital market activity by floating merchant banks and mutual fund subsidiaries and going into leasing and venture capital finance.

Money market activity, though still centred on the call money market, has been broadening and a beginning made to develop a secondary market. The last decade has witnessed the capital market growing in strength and diversity. New issue activity and market transactions have risen manifold. Market

capitalisation is a multiple of what it was even a few years ago and the number of shareholders runs into several millions indicating the growth in the cult of equity.

Amongst the non-bank financial intermediaries, hire purchase finance companies have been some of the oldest and most prominent institutions. They have played an important role in the finance of the road transport sector; one estimate puts about 25-30 per cent of all civilian commercial vehicles sales as having been financed by hire purchase companies. The evidence also indicates that the recovery performance in respect of those companies engaged in hire purchase finance of commercial vehicles is good. Typically, hire purchase companies have obtained their resources by seeking deposits from the public and obtaining finance from the banking system. With a view to promoting the business on prudent lines the Reserve Bank has stipulated that the overall borrowing limit (both by way of deposits and credit from banks) for hire purchase finance companies should not exceed ten times their net owned funds. The Reserve Bank also requires these companies to maintain a liquidity ratio of, presently, 15 per cent of their deposit levels.

In recent years, a large number of leasing companies have been floated, providing another flexible funding option. Experience with leasing companies, however, has been somewhat mixed. Several of them were under-capitalised and not particularly well managed and the last few years has seen a shake out in the business leaving the more efficient and better geared

companies in business today. Leasing has proved a popular financing method for acquiring plant and machinery especially for small and medium sized enterprises. Leasing companies have provided off-balance sheet financing speedily and often without the type of conditionalities which institutional lenders normally impose. The advantage of speed and informality associated with leasing as in the case of hire purchase arrangements and the flexibility with which financing can be structured to suit individual needs has been a factor in favour of the growth of leasing business though the cost to the user of hire purchase or leasing finance is more than from the more traditional institutional sources. Leasing companies, like hire purchase companies, are governed by the stipulation of their borrowings being restricted to ten times their net worth and maintenance of a minimum liquidity ratio of 15 per cent.

The Committee is of the view that having regard to the important and growing role of leasing and hire purchase institutions in the financial intermediation process and their recourse to borrowing, minimum capital requirements should be stipulated in addition to the existing requirements relating to gearing and liquidity. Prudential norms and guidelines in respect of conduct of business should also be laid down and a system of off-site supervision based on periodic returns should be instituted by the type of

unified supervisory authority which we recommend in a later Chapter.

Beginning with the Seventies, several commercial banks, both Indian and foreign, set up merchant banking divisions and in course of time some of these divisions have been hived off to separate merchant banking subsidiaries. More recently, some private financial service companies have also been set up -- some of them in association with foreign banking and money market institutions. There have also been a few merchant banks set up by firms and individuals engaged in brokerage and financial advisory business. These merchant banks perform the usual functions associated with such institutions such as the management and under-writing of new issues, syndication of credit and provision of advisory services to corporate clients on fund raising and other financial aspects. While the merchant banks which are affiliated to or are subsidiaries of commercial banks have an advantage in drawing on the resource base of the parent institution the other merchant banks lacking this particular advantage have tended to concentrate more on advisory and brokering functions. Unlike merchant banks abroad, merchant banks in India -- both the subsidiaries of banks and the individual entities -- are not authorised to undertake banking business such as deposit taking, lending and foreign exchange services. The Committee sees considerable potential for the operation of merchant

banks in the framework of a deregulated industrial economy. The Committee believes that the emergence of well capitalised, financially strong and independent merchant banks would complement the role of the merchant banks promoted by the banks and financial institutions and help to make the merchant banking sector in the country more active, diversified and competitive. The formation of joint ventures with well reputed international merchant and investment banks should also be encouraged. In course of time, merchant banks could be permitted like some other non-bank financial intermediaries to access the market for deposits and borrowed resources subject to the stipulation of minimum capital and liquidity and the observance of prudential norms specially tailored to the conduct of their business.

Merchant banking in India is now regulated by more than one authority. While SEBI seeks to authorise and regulate all merchant banks, those which are subsidiaries or are affiliates of commercial banks are additionally supervised by the Reserve Bank of India. Further, SEBI focusses on issue activity and portfolio management business of merchant banks rather than on the totality of their activity. On the other hand, if merchant banks were to raise deposits as suggested above, they would be subject to the guidelines issued in this regard by the Reserve Bank.

Amongst the newer capital market institutions, the most prominent are the mutual funds. In the last 4 to 5 years, several public sector banks and financial institutions have been permitted

to set up mutual funds on a tax-exempt basis virtually on the same footing as the Unit Trust of India. These mutual funds have attracted strong investor support and have shown significant progress. More recently, Government have announced their decision to promote the further development of mutual funds by throwing the field open to the private sector and joint sector mutual funds.

The Committee believes that it is important and necessary that an appropriate regulatory framework be created for the sound, orderly and competitive growth of mutual fund business, whether they be in the public, joint or private sector. The Committee is of the view that to start with a proper legal framework would be necessary to govern the establishment and operation of mutual funds. While the UTI was set up under a special statute, there is no dedicated legislation in respect of other mutual funds. The Committee, therefore, recommends that special legislation be enacted ^{soon} which would provide, inter alia, for arms length relationships, prevention of conflict of interest and indication of the role of fund managers and other related matters. In enacting legislation and instituting regulation the Committee would expect that there be equality of treatment between various mutual funds, including the Unit Trust and especially in the area of tax concessions. We would expect SEBI to lay down prudential guidelines for the conduct of their business by mutual funds and supervise the effective implementation of the guidelines.

One of the more recent entrants into the capital market has been venture capital financing. With increasing deregulation and the emergence of technocrat entrepreneurs and with the insistence by financial institutions of greater promoter contribution to investment financing, the scope for venture capital business in the country is considerable now and will be more so in the future. While Government has recognised the potential of venture capital companies to give commercial support to new ideas and introduction and adaptation of new technologies, the guidelines issued by Government in this regard laying down eligibility criteria with regard to the size of the investment, technology and the background of the entrepreneurs are so restrictive and indeed unrealistic that they have come in the way of the growth of this business. The Committee believes that to create conditions for the sound and orderly growth of venture capital business the present guidelines need to be reviewed and amended to widen the scope of eligibility criteria and impart a measure of flexibility to the operations of venture capital companies. An important aspect of venture capital business is connected with the divestiture of their investment. A reduction in the tax on long term capital gains made by venture capital companies also needs to be considered in view of the high degree of risk inherent in the business. The Committee also suggests that there should be equality of tax treatment irrespective of the form of organisation and between venture capital institutions and mutual funds.

The Committee is of the view that these various institutions have helped to broaden the market and provided the saver and investor with a variety of options. This is a welcome development and needs to be encouraged further.

The growth of the newer forms of financial institutions is an indication of the growing volume and diversification of the capital market. For the business to grow on sound lines a framework of regulation is however necessary as a measure of investor protection. The Committee believes, however, that the present measure of control on the capital market requires urgent review. The controls at present are exercised by the Office of the Controller of Capital Issues (CCI). One aspect of this control is that the prior approval of the CCI is necessary for ^{new} any issue in the market. In the scenario that we envisage it would be for the merchant bankers and the underwriters who should offer professional advice on a particular issue, on the nature of the instrument, its terms and pricing and for the issuer to decide on these matters. The Committee does not believe that either the CCI or, for that matter, SEBI should be involved in prior sanction of new capital issues in respect of companies whose scrips are listed on the stock exchanges. In respect of unlisted shares however, where investor awareness of the prospects and background of the promoters may not be high and with a view to prevent any misuse by promoters, it may be stipulated that the Stock Exchanges should approve the prospectus in terms of the guidelines issued by SEBI as an aspect of self-regulation rather than that SEBI should be directly involved even at the pre-issue stage.

The regulation of the capital market should aim at protecting the investor interest against possible risks and

fraud. For this purpose, the Committee proposes that SEBI should formulate a set of prudential guidelines to protect the interests of the investor. This should replace the extant restrictive guidelines of the Controller of Capital Issues. With the establishment of SEBI, the Committee sees no reason for the continuance of the Office of the CCI. Its market regulatory functions should be transferred to the SEBI. Though SEBI has been set up and has begun functioning, the process is not complete as its powers for overseeing operations in the market still require enactment of legislation for this purpose and the Committee would urge speedy action in this behalf. However, the Committee believes that there is no point in SEBI merely replacing the restrictive controls now exercised by the Office of the CCI. The role of SEBI, as we envisage it, should be that of a market regulator to see that the market is operated on the basis of well laid down principles and guidelines and not get involved in detailed day to day functioning of the market. As in the case of other segments of the financial system, the role of regulation should be one of ensuring compliance with such prudential norms rather than excessive discretionary control of the type now being practised by the CCI. The Committee would also suggest that the capital market should be gradually opened up to foreign portfolio investments and simultaneously efforts should be initiated to improve the depth of the market by facilitating issue of new types of equities and innovative debt instruments.

As regards the money market, as mentioned earlier, the last few years have witnessed efforts at broadening activity and creation of a secondary market. While inter-bank call money transactions still form the major part of money market activity, new instruments such as 182-day Treasury bills, certificates of deposits and commercial paper have been introduced. A major problem in the call money market is its high degree of volatility. The quantum of call money transactions has been increasing and reflecting credit conditions average call money rates have been rising. While the 182-day Treasury Bills and certificates of deposits have established themselves in reasonable fashion, transactions in commercial paper have not picked up perhaps as a result of high money market rates. With regard to the money market the objective has been to broaden its base by permitting more participants and to build up an active secondary market -- aspects which are inter-related. The Reserve Bank has recently indicated that it would permit banks and their subsidiaries to set up Money Market Mutual Funds. The establishment of these Funds would add to the supply of funds to the money markets. We would also propose that well managed non-bank financial intermediaries like hire purchases and leasing companies as well as merchant banks be permitted to operate in the market. Even venture capital companies could be allowed, within limits, to place their short term surplus funds in the market. Market activity would also expand if greater scope were given for bill discounting business and for the Reserve Bank

In this connection to use its commercial bill rediscounting function in larger measure as a method of refinance, so as to popularise the bill as an instrument of finance. Broadening the base of the money market by induction of more participants especially of market makers and enlarging the variety of instruments would also help to develop and activate a secondary market. The setting up of the Discount and Finance House of India (DFHI) is an important step in this direction and apart from helping to even out fluctuations in the market, the Committee would expect the DFHI to actively encourage the creation of a secondary market.

In this connection, the Committee believes that efforts should be made towards expanding the area of debt securitisation which would help to increase the flow of instruments. This would imply that retail loans would need to be securitised so that they could be funded through issues of collateralised debt instruments. However, certain fiscal impediments have come in the way of more progress towards debt securitisation mainly in the form of high stamp duties which vary in different States. Securitisation could only proceed if the cost of assignment arising from these stamp duties were to be lessened and the Committee commends for consideration of all State Governments the adoption of the practice of some states where the stamp duty is a fixed sum and not calculated on an ad valorem basis

Reference has been made in earlier parts of this Chapter to the regulatory framework to govern different institutions.

Though the precise content of such a regulatory framework would depend on the particular type of institution, the general principles governing such a regulatory framework should relate, among other things, to capital adequacy, debt equity ratio, credit concentration ratio, income recognition, provision against doubtful debts, adherence to sound accounting practices, uniform disclosure requirements and assets valuation. The eligibility criteria for entry, growth and exit should also be laid down. The Committee believes that a regulatory framework is necessary for the orderly growth of the money and capital market institutions.

On the question of supervision, consistent with the Committee's approach that there should not be a multiplicity of institutions supervising financial institutions, the Committee recommends that the supervision of those institutions as form an integral part of the financial system should encourage self-regulation and be generally confined to off-site supervision to ensure compliance with guidelines with on-site inspections being resorted to only where necessary. SEBI should have supervisory jurisdiction over those institutions whose primary activities are related to the capital market and which directly impinge on market operations.

CHAPTER X
REGULATION AND SUPERVISION OF
THE FINANCIAL SECTOR

The financial sector, the most important constituent of which is the banking system, has traditionally been an area of regulatory interest the world over. The case for regulation of the financial system rests on the obvious ground that its solvency, safety and soundness is of paramount importance for stability and orderly growth of the economy. The institutional development of the financial sector can only take place if the depositing and investing public have confidence in the system. Instilling such confidence is thus a major promotional objective of regulation. Regulation is, therefore, designed to ensure efficiency of the system, prevent concentration of business in it and protect depositors and investors from the vulnerability of financial institutions to market failure, mismanagement and fraud.

The regulation of the banking system therefore has sought to ensure that the funds placed with financial intermediaries, viz., banks, near banks and capital market institutions and the rest are deployed by them in prudent fashion without jeopardising their safety, liquidity and solvency. The enhancement of the strength of the financial system and building up its ability to withstand shocks induced as a result of its constituents failing to service in full or on time their obligations to the system has led regulatory authorities in many countries

keeping a watchful eye on balance sheet and off-balance sheet aggregates of the concerned institutions and prescribing prudent checks on them. As, in the ultimate analysis, it is the quality of the assets portfolio of the system that determines the safety of the depositors' or investors' funds, regulatory activity has sought to concern itself with ensuring minimum standards for asset portfolio quality. In respect of banks it has taken the form of prescribing minimum liquidity ratios, qualitative and quantitative checks on asset portfolios by limiting certain types of transactions, eg., share and corporate security business, stipulation of risk asset limits and individual credit exposure limits and establishing a system of health coding of assets, to mention the more important aspects of regulation. The same principles have also been applied to other constituents of the financial system. Equally, as a prudential safeguard, the regulatory authorities have sought to ensure an adequate measure of owned funds of banks and financial institutions to enable them to withstand any adverse developments in their business. Hence, capital adequacy norms in relation to risk assets and asset gearing ratios figure prominently among regulatory measures. Sometimes the types of resources which institutions should be permitted to raise and even the terms and conditions on which they could be raised have figured in regulatory prescriptions. In this sense, regulation far from being contrary to the concept of competition could be regarded as helping to enhance competition by ensuring that there are enough players in the market and that they are all subject to the same prudential requirements designed for depositor and investor protection and prevention of restrictive practices.

Given this broad framework of regulation and allowing for country specific adaptation the function of supervision has been to ensure compliance with the prudential regulations and has been vested either in the central banks or special agencies set up for this purpose. The regulatory system in India also accords primacy to the protection of the depositors' and investors' interest and, for this purpose, the Reserve Bank of India has been statutorily vested with the extensive powers of regulation and supervision over banks and non-bank financial intermediaries to ensure adherence to the various legal provisions and administrative directions or guidelines prescribed from time to time with regard to the asset portfolio and other aspects of business. It should be added that there are no similar comprehensive provisions for the regulation and supervision of the DFIs or for that matter in respect of some of the new institutions entering the money and capital markets.

Apart from the traditional areas of regulatory interest supervisory control over the banking system in India has over the years extended to a point where it now covers virtually every aspect of banks' functioning and especially so in the period following nationalisation. With nationalisation, the public sector banks were also brought directly under the administrative and regulatory review of the Government, leading in the process to a measure of duality of supervisory control over them.

While regulation in terms of satisfying certain rules and norms of operation and supervision to ensure compliance with such rules and norms is necessary and justified, the situation in India as far as the banks are concerned is that regulation and supervision have extended to aspects not directly connected with the safety of depositors' funds. Detailed branch licensing is a case in point. Various aspects of management of banks including matters of internal organisation, operational procedures and administrative matters have come within the purview of regulation and supervisory control. There is hardly any aspect of operations and management which is not covered. The system in consequence has become over-regulated and over-administered and has placed an undue burden on the supervisory authority. Detailed and wide-ranging regulations have led to delays and rigidities and have led to insufficient operational flexibility, segmentation of markets, loss of initiative and autonomy in decision making and lower efficiency. This degree of regulation and supervision has still not been able to prevent a deterioration in the health of the system and in assets quality. In fact, as discussed earlier, part of the reason for such deterioration is the measure of administrative direction in the matter of assets deployment, the prescription of targets for lending and the detailed administration of interest rates which has led to banks receiving less than market related rates on their investments and on a significant portion of their credit.

The Committee believes that it is essential for the financial system to be regulated and that the regulation should cover essential aspects of protecting the quality of assets. With deregulation of industry, trade and, as proposed by us, of several aspects of the financial sector, and, consequently, an increasing measure of competition, the risks of business could be expected to increase and there would be even greater need than now for prudential regulation of the financial sector. The task of supervision is to ensure compliance with such prudential regulations, which should be directly concerned with the protection of depositors' or investors' interests and with ensuring adequate balance sheet quality. Our recommendations in earlier parts of the Report regarding abolition of branch licensing and a review of directed investment and directed credit programmes must be seen in this context. There is need to examine closely, with a view to their elimination, of regulations, administrative directions and supervisory controls over aspects of internal organisation and administration which are not directly concerned with protecting the depositors' interests, such as managerial functions, manpower recruitment, remuneration of staff, location of offices, hiring of premises and advertisement expenditure.

The approach the Committee has taken is that emphasis should be placed on prescription of prudential norms and statutory requirements relating to asset quality such as minimum liquidity ratios, qualitative and quantitative checks on credit portfolios, stipulation of risk asset limits, checks on individual

credit exposure, prescription of well accepted and transparent accounting practices, provisioning and disclosure statements as well as with respect to capital adequacy. We believe the system should be impersonal and objective and be based on self-regulation which would call for strengthening the management quality and the internal inspection and internal audit systems of banks. The main responsibility for ensuring compliance with the prudential norms and safeguards would thus be with the banks themselves who should send periodic returns to the supervising authorities on these aspects. Due submission of such returns should promote both adequate supervision by the supervisory authority while providing for healthy internal autonomy. Our preference, accordingly, is for ensuring off-site enforcement of rules with on-site inspection being occasional and designed to assure the supervisory authority that internal audit and inspection procedures and aspects such as credit appraisal systems are in proper place and adequate and conform to well laid down norms and that the regulations are being properly complied with.

The Committee is firmly of the opinion that the duality of control over the banking system between the Reserve Bank and the Banking Division of the Ministry of Finance should end and that the Reserve Bank should be the primary agency for the regulation of the banking system.

At present, the supervisory function over banks is being exercised by a department of the Reserve Bank of India.

We have given due consideration to this aspect and believe that the present system has over-burdened the Reserve Bank and has not allowed undivided attention to be paid to this aspect and to develop the necessary skill and expertise.

While the Reserve Bank would normally be the appropriate agency for regulation, we however, propose that the supervisory function be separated from the more traditional central banking functions of the Reserve Bank and that a separate agency which could be a quasi-autonomous Banking Supervisory Board under the aegis of the Reserve Bank be set up. In view of the widening and deepening of the financial sector and the emergence of many new types of functional institutions, the Committee proposes that the Board should have supervisory jurisdiction not merely over the banking system but also over the development finance institutions, non-bank financial intermediaries and other para banking financial institutions, such as those which accept deposits or float bonds from the public. With the financial sector getting both diversified and more closely interdependent, there is great advantage in having a single integrated system of supervision so as to avoid segmentation of the market for supervisory purposes and the associated problem of inadequate coordination between different supervisory authorities covering the financial system. As regards the stock exchanges and other institutions more directly forming part of the capital market the Securities Exchange Board of

India would be the appropriate regulatory and supervisory authority and we would expect coordination between the Banking Supervisory Board and the SEBI to prevent any avoidable duplication and overlap of functions. The Banking Supervisory Board that we contemplate could have a membership of five and be composed of professionals from areas such as banking, development finance, accountancy, law, management and have a representative of the Government at a senior level. The Governor of the Reserve Bank, we propose, should be the ex-officio Chairman of the Board while the three other members could be full-time, holding office for a minimum period of 3 years, with the full-time chief executive of the Board being an official with the status of the Deputy Governor of the Reserve Bank.

We recommend that the Reserve Bank review the extant directions and guidelines issued by the Government and by itself to banks and DFIs with a view to deciding on their continuing relevance in the context of the need to ensure the independence and autonomy of banks. Such guidelines or directions which relate to matters of internal administration such as creation and categorisation of posts, promotion procedures and similar matters should, as mentioned earlier, be rescinded. The Board's supervisory functions should ensure compliance with the prudential guidelines that may be issued by the Reserve Bank and be appropriately adapted to the different parts of the system. These guidelines should cover assets quality, capital adequacy, credit concentration ratios, accounting practices and disclosure

policies. The Board would devise its own control returns to enable it to undertake effective off-site supervision and, as mentioned earlier, in exceptional cases, undertake on-site inspection and to see how the system of self-regulation by banks and financial institution is operating. The Board, in our scheme, would also have the power to enforce implementation of its prudential norms by recommending any remedial action in case of infringement to the Reserve Bank.

With the presence of a Government official on the Board, there would be no further need for Government to be involved in direct control over banks and financial institutions. However, as long as the Government has proprietary interest in banks and financial institutions, it would be appropriate for the Ministry of Finance to deal with other Government departments and Parliament and discharge its statutory obligations but not to engage in direct regulatory ^{or supervisory} functions. The Committee would suggest to Government that other Government departments should not deal directly with the banks and financial institutions but do so only through the Ministry of Finance which in turn would do so through the Reserve Bank.

Chapter XI

LEGISLATIVE MEASURES

Implementation of the recommendations of the Committee would require some amendments to the statutes presently governing the operations of banks and financial institutions. Special legislation may also be necessary to put into effect the arrangement suggested by us to improve the functioning of the financial system. Legislative measures broadly identified by us as being needed are indicated in the following paragraphs:

We have suggested progress towards capital adequacy norms based on BIS standards. The provisions in the Banking Companies (Acquisition and Transfer of Undertakings) Acts, 1970/1980 -- Section 3(2A) and Section 9(2)(a) -- prescribing the maximum paid up capital of Rs 500 crores would require amendments as the capital needs of some banks, based on risk weighted assets, may necessitate paid up capital beyond this ceiling. Amendments may also be required in the Nationalised Banks (Management and Miscellaneous Provisions) Schemes, 1970/1980 to modify suitably the upper ceiling for issued capital.

We have recommended access to the capital market where appropriate by some public sector banks for enhancement of capital. Section 3 of the Banking Companies (Acquisition and Transfer of Undertakings) Acts, 1970/1980 stipulates that the entire capital of nationalised banks shall vest with Central Government.

Amendments, to enable issue of fresh capital to the public would, therefore, need to be incorporated. Corresponding amendments would be needed in the Nationalised Banks (Management and Miscellaneous Provisions) Schemes, 1970/1980 -- Clause 19 and 20 respectively -- to allow increase of capital through public issue. We do not perceive any difficulty in the SBI approaching the capital market as Section 10 of the State Bank of India Act, 1955, lays down only that not less than 55 per cent of the issued capital of SBI would be with RBI. Similarly, the SBI (Subsidiary Banks) Act, 1959, allows increase in capital of the Associate Banks provided SBI holds not less than 55 per cent of the issued capital.

Consequent to our recommendations in regard to the constitution of Board of Directors and Management of Banks, the relevant provisions in the statutes may need to be suitably amended. We would also like it to be examined whether a comprehensive legislation to replace existing Acts may be brought in to achieve the objective of public shareholding, flexibility of operations and autonomy of management and internal functioning.

We would suggest that Government expeditiously issue notifications in terms of Section 29(4) of the Banking Regulation Act to amend the forms set out in the Third Schedule to the Banking Regulation Act to ensure transparency and full disclosure in balance sheet and profit and loss account.

Our recommendations for the structure of rural credit envisage setting up of rural banking subsidiaries by public sector banks. In order to implement our suggestion that such subsidiaries may be on par with regional rural banks, in respect of CRR/SLR requirements, amendments would be necessary to various provisions of Banking Regulations Act and RBI Act pertaining to laying down of these ratios and matters incidental thereto. Further, our recommendation that RRBs' balances held with NABARD or by a Special Federal Agency that might be set up may count as SLR assets may require amendment of Sections 5 and 24 of the Banking Regulation Act. Amendments may also be required in the National Bank for Agriculture and Rural Development Act, 1981, for specific inclusion of rural banking subsidiaries within the purview of the credit functions of NABARD.

We have proposed that regional rural banks be allowed to engage in all types of banking business. The statutory emphasis on target groups under Section 18(2) of the RRB Act, 1976, would, therefore, ^{need} to be amended. The option for the sponsor banks to take over the RRBs as 100 per cent subsidiaries may also require a change in Section 6 of the RRB Act, 1976, prescribing proportions of issued capital of the RRBs between the Central Government, State Government and the sponsor banks.

Sections 11(3) and 11(2) of the Banking Regulation Act prescribe minimum capital requirements for the banking companies incorporated in India and outside India respectively. In line

with the broad pattern of structure indicated by us comprising international banks, national banks, local banks and rural banks, and a more liberal approach to foreign banks, different start-up capital requirements would need to be prescribed by the Reserve Bank and the stipulations of minimum paid up capital would accordingly need modification.

We have recommended abolition of branch licensing as we are of the view that the matter of opening of branches or closing of branches (other than rural branches for the present) be left to the commercial judgment of the individual banks. Section 23 of the Banking Regulation Act stipulating the statutory requirement for obtaining the prior permission of RBI for opening a new place of business would, therefore, need to be recast. The definition of 'rural centre' will also need incorporation in the Section itself.

We are not in favour of a Banking Service Commission for centralised recruitment of officers and hence recommend repeal of Banking Service Commission Act, 1984. We have also suggested that the centralised recruitment of officers through Banking Service Recruitment Boards (BSRBs) may be discontinued. The administrative orders of the Government regarding the jurisdiction of BSRBs would, consequently, need amendments. The administrative orders regarding BSRBs may also be amended to distance the Government from the appointment of the Chairmen of these Boards which should be totally left to the coordinating banks.

Amendments would be required in the SBI Act, SBI Subsidiaries Act and Nationalised Banks (Management and Miscellaneous Provisions) Schemes, 1970/1980, IDBI Act and the IFCI Act for removal of RBI nominees from the Boards of these organisations.

In the light of the recommendations of the Committee regarding security of tenure of the chief executives the provisions introduced in various relevant statutes through the Act No. 73 of 1976 would have to be deleted.

In addition to the various amendments detailed in the foregoing paragraphs to the existing statutes, special statutes may be required for setting up of Asset Reconstruction Fund, Special Recovery Tribunals and for creating a Supervisory Board under the aegis of Reserve Bank of India. The special statute for Asset Reconstruction Fund will, inter alia, need to provide for speedy recovery on lines broader than Sections 29-32 of the SFCs Act. The legislation may also incorporate provisions to facilitate transfer of debts and securities and all the rights pertaining to such assets to the ARF. Consequential amendments to the Urban Land Ceiling legislation may also be necessary where sale of real estate in urban areas is involved. Waiver of stamp duty attracted on such transfers will also require legislative formulations. The Special Recovery Tribunals may also be constituted as statutory bodies with special powers of summary trial and speedy recovery.

The statute for creation of ^{the} Supervisory Board should ensure transfer of powers of supervision vested with RBI under the RBI Act and the B.R. Act to this Board. This Board may also need to be vested with some additional powers for implementing integrated supervision over the entire financial sector.

New legislation is also necessary for providing legal framework for mutual funds and for conferring statutory powers on SEBI.

Statutes governing the DFIs, viz., IDBI Act, IFCI Act and IRBI Act may have to be amended to do away with the present system of cross holding of equity and cross representation on the Boards of the DFIs. The SFC Acts would also require amendments to give effect to the recommendations relating to these State level institutions. Legislation will also need to be enacted for transferring IDBI's commercial functions to a new institution which could be incorporated as a company.

Our recommendations also impinge upon some of the provisions of the statutes not exclusively dealing with the banks or the financial institutions. Our recommendations for the purpose of provisioning cover the issue of deductions under the Income Tax Act. Section 36 of the Income Tax Act, would require amendment to implement these recommendations. Amendments would also be required in the Income Tax Act to

comply with the recommendations regarding equality of tax treatment as between various mutual funds and the recommendation regarding venture capital institutions regarding concession on capital gains and equality of tax treatment as between different forms of organisation of venture capital institutions. Amendments to the Capital Issues Control Act, 1947 and the notifications issued under the Act would be necessary for liberalisation of the capital market and the recommendation regarding abolishing the Office of the Controller of Capital Issues. Amendments would also be needed to be initiated in the Stamp Acts to facilitate securitisation of debt.

These suggestions for legislative measures are not exhaustive. We would recommend that the legal implications with reference to each of our recommendations will need to be examined and detailed legislative steps identified by the Government in consultation with the Law Ministry.

CHAPTER XII

CONCLUDING OBSERVATIONS

As the foregoing chapters have indicated, the Indian financial system has made impressive gains in the last two decades in resource mobilisation and in extending its geographical and functional reach, but these achievements have taken their toll in terms of a serious deterioration in the quality of services and in the health of the system.

The demands on the financial system in the years ahead would be greater and more diversified. New skills need to be fashioned and new areas of expertise developed. The financial system is getting more complex and sophisticated, which calls for new concepts of management, more professional decision making and modernisation of work systems. Our review and recommendations seek to build on the quantitative gains made by the system while improving the quality of services, and restoring the health, productivity and competitive efficiency of the system and thus enhance its capabilities to meet the challenges of the future.

Our recommendations and the measures of reform which we have indicated covering aspects of the functioning of the system, its organisation and structure and the regulatory framework should be seen as an integrated package aimed at improving portfolio quality, providing greater operational flexibility and ensuring compliance with prudential norms, while, at the same time,

improving the financial strength of the system through measures aimed at enhancing productivity, efficiency and profitability.

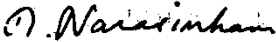
Central to this approach and indeed underlying it is the issue of full autonomy with respect to internal operations of banks and financial institutions. Management of banks and the institutions must be given freedom to manage their institutions subject to their accountability for performance and compliance with well laid down prudential norms and guidelines and macro credit policies which would be rule-bound and not discretionary and be equally applicable to all the constituents of the particular financial sector. Autonomy in decision making and operational flexibility can only be ensured if there are no extraneous administrative and political pressures, which, as the Committee has pointed out earlier, has been responsible to a great extent for the problems now facing the financial services industry. It is for this reason that the Committee has stressed the importance of de-politicising appointments of chief executives and boards of the institutions and restoring to management of institutions rights over recruitment, rewards and punishment. This would imply a measure of self-denial by Government of its perceived right as an owner to intervene in what should be the internal decision making of the institutions and distancing itself from aspects of internal management and credit allocations.

A proper sequencing of the reforms is essential to its success. The liberalisation of the system can only succeed in an

atmosphere of broad macro economic stability. The Committee, therefore, attaches the greatest importance to the early restoration of a measure of fiscal balance and continued progress towards further liberalisation of the real economy if the financial system is to play its expected part in promoting competitive efficiency in the economy. Interest rate deregulation is a specific case in point where it can only proceed with a reduction in the fiscal deficit and correspondingly a slowing of the pace of growth of internal debt. Steps towards assets reconstruction, capital adequacy, institution of uniformly accepted transparent accounting practices and stipulation and compliance with prudential norms have to be phased over a period of 3 to 5 years so as to avoid dislocation and difficulties in complying with the requirements through the insistence of immediate conformity with the desired norms and practices. While phasing is important, the process must begin immediately in many of these areas to give the right signal regarding the earnestness of the intentions. Financial sector reform should thus be an essential element of macro economic adjustment based on increasing reliance on the market mechanism.

Domestic financial liberalisation and greater internal competition should form the basis for greater contacts of the Indian financial sector with the global financial markets. This would help to upgrade our financial technology and give us greater access to the new and emerging modes of financial engineering. India cannot afford financial autarky any more than industrial or trade autarky.

The institution in a sequenced manner of a more open financial system would thus be entirely consistent with the steps being taken now to open up the Indian economy and should enhance India's ability to take competitive advantage of the increasing international opportunities for Indian trade, industry and finance.



M Narasimham



A Ghosh



M N Goiporia



S S Nadkarni



N Vaghul



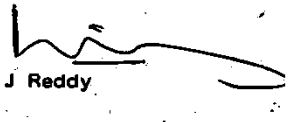
M R Shroff



Y H Malegam



M Datta-Chaudhuri



K J Reddy

HYDERABAD

NOVEMBER 16, 1991

Note by Prof M Datta Chaudhuri and Shri M R Shroff

The Summary Report starts with the following statements:

"The Committee's approach to the issue of financial sector reform is to ensure that the financial services industry operates on the basis of operational flexibility and functional autonomy with a view to enhancing efficiency, productivity and profitability. A vibrant and competitive financial system is also necessary to sustain the ongoing reform in the structural aspects of the real economy. We believe that ensuring the integrity and autonomy of operations of banks and DFIs is by far the more relevant issue at present than the question of their ownership."

The Committee has thus rightly identified the question of "ensuring the integrity and autonomy of operations of banks and DFIs" as the principal concern of the Report. The Committee predicated its various recommendations on the belief that it is possible to achieve these objectives without bringing in the question of ownership. These recommendations go a long way in creating conditions whereby market disciplines can be brought into the functioning of the public sector banks and financial institutions. But we believe that in the prevailing political culture of the country, it is important to move further to make the autonomy of these institutions credible.

In line with the above and the concept of self-denial by the Government of its ownership rights, which the Committee has rightly advocated, we think that the Government should not

appoint its officials on the boards of public sector banks and financial institutions. The Banking Division of the Ministry of Finance, as at present constituted, should consequently be abolished.

We are conscious of the Government's accountability to Parliament and the public as owner of these institutions. But accountability need not mean involvement in functions which are the responsibility of boards and managements and can be ensured by an adequate system of reporting through the Reserve Bank which, the Committee has rightly stressed, should be the prime agency for the regulation of the banking system. The continuance of Government directors on the boards of the banks and financial institutions will come in the way of ending the duality of control between the Reserve Bank and the Banking Division as recommended by the Committee.

We think that a decision by the Government not to have its representatives on the boards of public sector banks and financial institutions will serve as a strong message of autonomy to the system and will create a climate conducive to the successful implementation of the other recommendations of the Committee.

ANNEXURE - I

To be published in Part II Section 3(11) of the Gazette of India -
Extraordinary)

No.F.15(5)/91-BO.I
Government of India/Bharat Sarkar
Ministry of Finance/Vitta Mantraleya
Department of Economic Affairs/Arthik Karya Vibhag
(Banking Division/Banking Prabhag)

New Delhi-110001

Dated: August 14, 1991
Sravana 23, 1913 (SAKA)

MEMORANDUM

COMMITTEE ON THE FINANCIAL SYSTEM

3.0. The last two decades have seen a phenomenal expansion in the geographical coverage and financial spread of our financial system. The development of the financial sector is a major achievement and it has contributed significantly to the increase in our savings rate, especially of the household sector. In recent years, however, certain rigidities and weaknesses have developed in the system and these have to be addressed to enable the financial system to play its role in ushering in a more efficient and competitive economy.

2. It has, therefore, been decided by the Government of India to set up a High Level Committee to examine all aspects relating to the structure, organisation, functions and procedures of the financial system. The Committee will consist of the following:

- | | |
|---|------------------|
| 1. Shri M. Narasimham | Chairman |
| 2. Deputy Governor, RBI (Banking Operations) | Member |
| 3. Chairman, State Bank of India | Member |
| 4. Chairman, IDBI | Member |
| 5. Chairman, ICICI | Member |
| 6. Shri Manu Shroff | Member |
| 7. Shri Y.H. Malegam | Member |
| 8. Shri Mrinal Datta-Chaudhuri | Member |
| 9. Additional Secretary (Banking) | Member-Secretary |

3. The terms of reference of the Committee will be as follows:

- (i) To examine the existing structure of the financial system and its various components and to make recommendations for improving the efficiency and effectiveness of the system with particular reference to the economy of operations, accountability and profitability of the commercial banks and financial institutions.
- (ii) To make recommendations for improving and modernising the organisational systems and procedures as well as managerial policies;
- (iii) To make recommendations for infusing greater competitive vitality into the system so as to enable the banks and financial institutions to respond more effectively to the emerging credit needs of the economy;
- (iv) To examine the cost, composition and adequacy of the capital structure of the various financial institutions and to make suitable recommendations in this regard.
- (v) To review the relative roles of the different types of financial institutions in the financial system and to make recommendations for their balanced growth;
- (vi) To review the existing supervisory arrangements relating to the various entities in the financial sector, in particular the commercial banks and the term lending institutions and to make recommendations for ensuring appropriate and effective supervision;
- (vii) To review the existing legislative framework and to suggest necessary amendments for implementing the recommendations that may require legislative change;

(viii) To make recommendations on any other subject matter as the Committee may consider germane to the subject of enquiry or any related matter which may be specifically referred to the Committee by the Government of India.

4. The Committee will submit its report by 15th November, 1991. The Committee may, however, submit an interim report on any specific matter.



(K.J. REDDY)

ADDITIONAL SECRETARY TO THE GOVT. OF INDIA

The Manager,
Govt. of India Press,
Ring Road, Mayapuri Industrial Area,
New Delhi.

(TO BE PUBLISHED IN PART II SECTION 3(11) OF THE GAZETTE OF INDIA - EXTRAORDINARY)

No. F.16(5)/91-B.O.I
Government of India/Bharat Sarkar
Ministry of Finance/Vitta Mantralaya
Department of Economic Affairs/Arthik Karya Vibhag
(Banking Division)/(Banking Prabhag)
.....

New Delhi, dated 14th November, 1991
Kartika 23, 1913(SAKA)

MEMORANDUM

S.O. A High Level Committee to examine all aspects relating to the structure, organisation, functions and procedures of the financial system was set up vide Memorandum No. F.16(5)/91-B.O.I dated August 14, 1991. The Committee was required to submit its report by 15th November, 1991.

2. The Committee has submitted the summary of the report and is engaged in finalising the main report. The term of the Committee is hereby extended till 30th November, 1991 for submitting its main report.



(K.J. Reddy)

Additional Secretary to the Government of India.

To,
The Manager,
Government of India Press,
Mayapuri Industrial Area,
Ring Road,
New Delhi.

**Organisations/Individuals who submitted Memoranda for
consideration of the Committee**

1. Indian Banks Association, Bombay
2. Federation of Indian Chambers of Commerce and Industry (FICCI), New Delhi
3. Associated Chambers of Commerce (ASSOCHAM), New Delhi
4. Confederation of Engineering Industry (CEI), New Delhi
5. National Confederation of Bank Employees, Hyderabad
6. All India Bank Officers Association (AIBOA)
7. All India Bank Officers Confederation (AIBOC)
8. Indian National Bank Employees Federation
9. Indian National Bank Officers Congress
10. Institute of Chartered Financial Analysts of India, Hyderabad
11. Secretary, Ministry of Commerce
12. Shri R K Talwar, Pondicherry
13. Shri Bhabatosh Datta, Calcutta
14. Bank Employees Federation of India, Calcutta.
15. All India Bank Employees Association, Calcutta
16. All India Bank Depositors Association, Bombay
17. PHD Chamber of Commerce and Industry, New Delhi
18. Institute of Chartered Accountants of India, New Delhi
19. All India RRB Employees Association
20. Agricultural Finance Corporation Ltd Officers Association
21. Agricultural Finance Corporation Ltd Employees Association
22. Punjab State Electronics Development and Production Corporation, Chandigarh
23. Indian Merchant Chambers, Bombay
24. IRBI Officers Association, Calcutta
25. Bankers Training College, Bombay
26. Sundaram Finance Ltd, Madras
27. Bengal National Chamber of Commerce and Industry
28. Associate Bank Officers Association, Bangalore
29. All India Reserve Bank Employees Association
30. Indian National Bank Employees Congress

31. Federation of Indian Export Organisation
32. Shri Kiran S Naniwadekar, Kolahpur
33. Shri C P Shah, Bombay
34. Shri R S Bhatt, Bombay
35. Dr A C Shah, Bombay
36. Shri S D Nayar and Shri T.C Mitla
37. Shri Ramesh Gelli, Vysya Bank
38. Shri S R Prabhu, General Manager (Retd), Canara Bank
39. National Confederation of RRB's Employees, Hyderabad
40. Shri O P Dhanuka, Riga Sugar Co Ltd, Calcutta
41. Shri B K Dutt, Calcutta
42. Shri M. J Pherwani, Chairman, National Housing Bank
43. I N B E C
44. Bombay Chamber of Commerce and Industry
45. The South Indian Bank Limited

ANNEXURE - III

**Organisations which tendered oral evidence
before the Committee**

1. All India Bank Officers' Association
2. Forum of All India Private Sector Banks
3. Indian Banks' Association
4. Federation of Indian Chambers of Commerce and Industry (FICCI)
5. National Confederation of Bank Employees
6. Associate Banks' Association
7. All India Bank Employees Association
8. All India Bank Officers Confederation
9. PHD Chamber of Commerce and Industry
10. Associated Chambers of Commerce and Industry (ASSOCHAM)