Banking policy and trends

3.16 During the current financial year, the focus of on-going reforms in the banking sector was on soft interest rate regime, increasing operational efficiency of banks, strengthening regulatory mechanisms and on technological up-gradation. As a step towards a softer interest rate regime, RBI in its Annual Policy Statement had advised banks to introduce flexible interest rate system for new deposits, announce a maximum spread over PLR for all advances other than consumer credit and to review the present maximum spread over PLR and reduce them wherever they are unreasonably high.

3.17 The Union Budget for 2002-03 proposed setting up of a pilot asset reconstruction company to conduct auctions of non-performing assets (NPAs) in the banking sector, and also to develop a market for securitised loans. Accordingly, a pilot asset reconstruction company was set up by ICICI. The enactment of "Securitisation, Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002" marks a watershed in the process of on-going economic reforms. This Act enables the setting up of asset management companies for addressing the problems of non-performing assets of banks and financial institutions. The important provisions of the Act, are set out in Box 3.2. Under the Act, an

Box 3.2 : Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002

- A securitisation company or reconstruction company having own funds of not less than Rs. 2 crore or such other amount not exceeding 15 per cent of total financial assets acquired or to be acquired as specified by the RBI can commence business after obtaining a certificate of registration, subject to fulfilling certain conditions and complying with the prudential norms set by the Reserve Bank.
- The securitisation or reconstruction company may acquire assets of any bank or financial institution by issuing a debenture or bond or any other security for consideration agreed upon between such company and the bank or the financial institution.
- Notice of acquisition of a financial asset may be sent by bank or financial institution to an obligor. The obligor on receipt of such notice will make payment to the securitisation company concerned.
- A securitisation company may raise funds from qualified institutional buyers by formulating schemes for acquiring financial assets.
- In the event of non-realisation of financial assets, qualified institutional buyers of a securitisation company holding not less than 75 per cent of the total value of securities issued by such company are entitled to call for a meeting of all institutional buyers and the resolution passed in such a meeting is binding on the company.
- A securitisation or a reconstruction company may provide for the proper management of the business of the borrower, sale or lease of a part or whole of the business of borrower, settlement of dues payable by the borrower and taking possession of secured assets within the framework of guidelines framed by the Reserve Bank.
- Other functions of the securitisation company include acting as an agent for any bank or financial institution for the purpose of recovery of their dues.
- Secured creditor is entitled to enforce any security interest created in its favour without the intervention of the court or tribunal.
- In case of non-performing debts, the secured creditor is entitled to serve a notice to the borrower to discharge his liabilities within 60 days.
- In case of failure to discharge the liabilities in the stipulated period, the secured creditor is entitled to take possession of secured assets, take over the management of secured assets and to appoint any person to manage the same.
- Borrowers are entitled to prefer an appeal with the Debts Recovery Tribunal after depositing 75 per cent of the amo unt claimed by the secured creditor. Borrowers aggrieved by the order of the Debts Recovery Tribunal may prefer an appeal to an Appellate Tribunal within 30 days from the date of receipt of the order of Debts Recovery Tribunal.

asset management company is authorised to acquire assets of any bank or financial institution by issuing a debenture or bond or any other security for consideration agreed upon with such company and the bank or the financial institution. In case of non-performing debts, a secured creditor is entitled to serve a notice to the borrower to discharge his liabilities within 60 days. Failing to discharge the liabilities in the stipulated time will entitle the secured creditor to take possession of secured assets, take over the management of the assets and to appoint any person to manage the secured assets. Borrowers can prefer an appeal with the Debts Recovery Tribunal after depositing 75 percent of the amount claimed by the secured creditor. The secured creditor is entitled to enforce any security interest created in its favour without the intervention of Courts or Tribunals. The legislation puts in place a long overdue legal framework without attendant delays for the recovery of NPAs in case of secured credit. However, for realising the benefits of this legislation, banks and financial institutions have to build up expertise and put in place systems to ensure that assets taken over are kept in running condition till they fetch a good price. RBI is considering broad guidelines to be adopted by banks and financial institutions for framing a "fair practices code" for lenders' liability with the approval of their Boards. The RBI guidelines are based on the recommendations of the Working Group on Lenders' Liability Laws constituted by the Government of India. The main features of these guidelines are listed below :

- Loan application forms should be comprehensive to include information about processing fees, other charges, etc.
- A system should be devised for acknowledging the receipt of all applications and verifying them within a reasonable period of time.
- In case of rejection of any loan application, reasons for such rejection should be conveyed in writing.
- Lenders should ensure that there is proper assessment of credit requirement of borrowers.Terms and conditions governing credit facilities should be arrived at after negotiation by the lending institution and the borrower and these should be recorded in writing.
- The loan agreement should clearly specify the liability of lenders to borrowers in regard to allowing drawings beyond the sanctioned limits.
- Lenders should give reasonable notice to borrowers before taking decision to recall/accelerate payment or performance under the agreement.

3.18 As a step towards strengthening the supervisory mechanism, RBI would be switching over to risk based supervision of banks by 2003 on a pilot basis. Banks have already taken steps required to switch over to risk based supervision. An important step taken by the RBI to strengthen the regulatory mechanism in the current year relates to the introduction of the scheme of prompt corrective action (PCA), with various trigger points for prompt responses by the supervisor. In accordance with this scheme notified on December 21, 2002, the RBI will initiate certain structured and discretionary actions in respect of the banks which have hit trigger points in terms of capital to risk weighted assets ratio (CRAR), net NPA and return on assets (ROA). In case of CRAR less than 9 percent, but equal or more than 6 percent, banks are required to submit and implement capital restoration plans. In addition, the RBI at its discretion may order recapitalisation. In case of net NPAs of over 10 percent but less than 15 percent, banks are required to take special drives to reduce the stock of NPAs and contain generation of fresh NPAs. Discretionary action in this regard includes debarring the banks from entering into new lines of business. Where the ROA is less than 0.25 percent, banks will not access or renew costly deposits. Discretionary action in this regard includes debarring the banks from incurring any capital expenditure other than for technological upgradation. Notwithstanding anything contained in the PCA framework, the RBI retains the right to take any other action in the interest of bank concerned and its depositors.

3.19 The banking industry has been witnessing great strides in technology upgradation. Electronic funds transfer facility (EFT) is currently available in 13 major cities in the country. Transfer of funds on "the same day basis" is available at 4 metro centres with three settlements per day from January 2002. This has been extended to multiple settlements. With a view to extending benefits of EFT to all locations in the country and to provide for transfer of messages relating to funds transfer in a safe and secured manner, RBI is considering a proposal to commence national electronic funds transfer. With the operalisation of this facility, it would be possible to make the facility of EFT available from any branch of a bank which has connectivity to the Indian financial network (INFINET).

Financial performance

3.20 There was an improvement in the performance of the SCBs during the year 2001-02. The operating profits of SCBs increased by over 50 percent from Rs.19,755 crore in 2000-01 to Rs.29,814 crore in 2001-02.The ratio of operating profits to total assets increased from 1.5 percent to 1.9 percent in the same period. The operating profits of public sector banks (PSBs) increased by 57 percent in 2001-02 which was higher than the increase recorded by the foreign banks (13 percent) and new private sector banks (54.3 percent). Old private sector banks recorded a higher growth of 70.5 percent in their operating profits in 2001-02.The significant increase in the profits of SCBs in 2001-02 was mainly on account of increase in other income, particularly income from securities trading. Yield to maturity (YTM) on government and other approved securities declined by more than 300 basis points during 2001-02. This has resulted in higher income for SCBs. Higher income came from sale of existing securities by SCBs as well as increased turnover of trading in such securities. Higher profits were also partly on account of lower growth of expenditure on interest payments.

3.21 While the income of SCBs increased by 14.3 percent in 2001-02, expenditure increased by 11.0 percent. Within income, interest income increased by 10.3 percent and other income by 41.6 percent. The significant increase in other income was mainly because of diversification in the operations of commercial banks and higher income from fee-based activities. Despite the higher income growth of SCBs, the ratio of income to total assets had declined from 10.2 percent in 2000-01 to 9.8 percent in 2001-02 mainly on account of the growth of total assets by 18.5 percent in 2001-02. The lower growth of expenditure in 2001-02 was mainly because of cost of intermediation which declined by 1.4 percent. There was also reduction in staff costs in respect of PSBs. Interest expenditure increased by 12.0 percent despite decline in deposit rates because of growth in deposits.

3.22 There was an improvement in the net profit of SCBs in the year 2001-02 by over 80 percent. Higher growth of net profits resulted in an improvement in the ratio of net profits to total assets from 0.5 percent in 2000-01 to 0.8 percent in 2001-02.

3.23 Provisions and contingencies of SCBs registered an increase of 36.6 percent in 2001-02. This increase reflects provisioning for NPAs by banks to meet prudential requirements. The increase in provisions and contingencies was the highest in case of new private banks (83.3 percent) followed by old private sector banks (55.3 percent) and public sector banks (41.0 percent). There was a decline in the provisions and contingencies of foreign banks by 6.7 percent. (Table 3.4)

Table 3.4 : Working results of scheduled commercial banks for 2000-01 and 2001-02														
Items	**SBI Group Banks**		**Nationalised Banks**		**Public Sector Banks**		**Foreign Banks**		**Old Pvt Sector Banks**		**New Pvt. Sector Banks**		**All SCBs**	
	2000-01	**2001-02**	**2000-01**	**2001-02**	**2000-01**	**2001-02**	**2000-01**	**2001-02**	**2000-01**	**2001-02**	**2000-01**	**2 001-02**	**2000-01**	**2001-02**
							Rs. crore							
A. Income	39373	44763	64126	72486	103499	117249	11987	12960	9092	10946	7499	9871	132077	151026
I) Interest Income	34152	38746	56977	61976	91129	100722	9470	9700	8055	8725	6438	7823	115092	126970
II) Other income	5221	6017	7149	10510	12370	16527	2517	3260	1037	2221	1061	2048	16985	24056
B. Expenditure	37152	41313	62032	67635	99184	108948	11042	11468	8590	9942	6860	9096	125672	139454
I) Interest expended	22904	26556	38790	42598	61694	69154	5763	6054	5932	6495	4753	5813	78141	87516
II) Intermediation cost	10730	9487	17275	16935	28005	26422	3114	3393	1684	1935	1377	1946	34178	33696
III) Provisions and contigenies	3518	5270	5967	8102	9485	13372	2165	2021	974	1512	730	1337	13353	18242
C. Operating profit (A-Bi-Bii)	5740	8720	8062	12953	13802	21673	3110	3513	1476	2516	1369	2112	19756	29814
D. Net profit (A-B)	2221	3450	2094	4851	4315	8301	945	1492	502	1004	639	775	6403	11572
E. Total assets	402984	449509	626988	706228	1029972	1155737	102108	112096	84529	93226	78796	174454	1295405	1535513
							As per cent of total assets							
A. Income	9.8	10.0	10.2	10.3	10.0	10.1	11.7	11.6	10.8	11.7	9.5	5.7	10.2	9.8
I) Interest Income	8.5	8.6	9.1	8.8	8.8	8.7	9.3	8.7	9.5	9.4	8.2	4.5	8.9	8.3
II) Other income	1.3	1.3	1.1	1.5	1.2	1.4	2.5	2.9	1.2	2.4	1.3	1.2	1.3	1.6
B. Expenditure	9.2	9.2	9.9	9.6	9.6	9.4	10.8	10.2	10.2	10.7	8.7	5.2	9.7	9.1
I) Interest expended	5.7	5.9	6.2	6.0	6.0	6.0	5.6	5.4	7.0	7.0	6.0	3.3	6.0	5.7
II) Intermediation cost	2.7	2.1	2.8	2.4	2.7	2.3	3.0	3.0	2.0	2.1	1.7	1.1	2.6	2.2
III) Provisions and contigenies	0.9	1.2	1.0	1.1	0.9	1.2	2.1	1.8	1.2	1.6	0.9	0.8	1.0	1.2
C. Operating profit	1.4	1.9	1.3	1.8	1.3	1.9	3.0	3.1	1.7	2.7	1.7	1.2	1.5	1.9
D. Net profit	0.6	0.8	0.3	0.7	0.4	0.7	0.9	1.3	0.6	1.1	0.8	0.4	0.5	0.8

Interest spread

3.24 The interest spread, the difference between interest charged to borrowers and interest paid to depositors is an important indicator of efficiency of banks. A higher interest spread means higher cost of intermediation. With the interest income higher than interest expenditure, interest spread increased by 6.8 percent in 2001-02. Table 3.5 presents the interest spread by bank groups.

Table 3.5 : Ratio of spread to total assets						
Banks	**Spread (Rs. crore)**			**Percent to total assets**		
	1999-2000	**2000-01**	**2001-02**	**1999-2000**	**2000-01**	**2001-02**
1. Public Sector	24040	29436	31568	2.7	2.9	2.7
(a) SBI & Associates	9283	11249	12190	2.8	2.8	2.7
(b) Nationalised	14757	18187	19378	2.7	2.9	2.7
2. Private Sector	2853	3808	4241	2.2	2.3	1.6
(a) Old	1702	2123	2231	2.3	2.5	2.4
(b) New	1151	1685	2010	1.9	2.1	1.2
3. Foreign	3250	3707	3646	3.9	3.6	3.3
4. SCBs(1+2+3)	30143	36951	39455	2.7	2.9	2.6

3.25 The ratio of interest spread to total assets of SCBs declined from 2.9 percent in 2000-01 to 2.6 percent in 2001-02. The decline was seen across all bank groups.While there was a marginal decline in the ratio in the case of public sector and foreign banks, the decline in the ratio was significant in the case of private sector banks from 2.3 percent in 2000-01 to 1.6 percent in 2001-02.Ratio of interest spread to assets was the highest for foreign banks followed by public sector banks and private banks.

Non-performing assets

3.26 The gross non-performing assets of SCBs increased by Rs. 7,164 crore to Rs. 70,905 crore in 2001-02.Net NPAs increased by Rs. 3,084 crore to Rs. 35,546 crore (Table 3.6). The incremental gross NPAs at Rs. 7,164 crore in 2001-02 is more than double the amount in 2000-01. This increase is mainly on account of the inclusion of an amount of Rs. 4,512 crore in the gross NPAs consequent on the merger of ICICI with ICICI Bank. While the incremental NPAs of the public sector banks increased from Rs. 1,639 crore in 2000-01 to Rs. 1,835 crore in 2001-02, foreign banks registered a decline in their incremental NPAs from Rs. 492 crore to Rs. (–) 380 crore during the same period. The increase in the incremental NPAs of private sector banks by Rs. 5,709 crore can be attributed to the effect of ICICI merger. There was an increase in the NPAs of public sector banks. In the case of foreign banks, recoveries exceeded net accretion to NPAs.The ratios of gross and net NPAs of commercial banks to advances and total assets have been declining across all bank groups. Gross NPAs of public sector banks at 11.1 percent of gross advances and 4.9 percent of total assets are higher than those of private sector banks and foreign banks in India. Advances to non-priority sectors accounted for the bulk of the outstanding NPAs in the case of both public sector banks (53.5 percent) and private sector banks (77.9 percent).

Capital adequacy ratio

3.27 As at the end of March, 2002, 25 out of 27 public sector banks (PSBs) had CRAR above the prescribed minimum level of 9 percent. Of these, as many as 23 banks had CRAR exceeding 10 percent. The two PSBs which did not fulfil the minimum CRAR were

Table 3.6 : Non-performing assets of SCBs

	Gross NPAs (Rs. crore)			Percentage to gross advances			Percentage to total assets		
	1999-2000	2000-01	2001-02	1999-2000	2000-01	2001-02	1999-2000	2000-01	2001-02
Bank Group									
1. Public sector	53033	54672	56507	14.0	12.4	11.1	6.0	5.3	4.9
2. Private sector	4761	5963	11672	8.2	8.4	9.6	3.6	3.7	4.4
3. Foreign	2614	3106	2726	7.0	6.8	5.4	3.2	3.0	2.4
4. SCBs(1+2+3)	60408	63741	70905	12.7	11.4	10.4	5.5	4.9	4.6
Bank Group	Net NPAs (Rs. crore)			Percentage to net advances			Percentage to total assets		
1. Public sector	26187	27977	27958	7.4	6.7	5.8	2.9	2.7	2.4
2. Private sector	3031	3700	6668	5.4	5.4	5.7	2.3	2.3	2.5
3. Foreign	855	785	920	2.4	1.8	1.9	1.0	0.8	0.8
4. SCBs(1+2+3)	30073	32462	35546	6.8	6.2	5.5	2.7	2.5	2.3

Indian Bank and Dena Bank. Of the 30 private sector banks, Centurian Bank Ltd. and Nedungadi Bank Ltd. could not attain the minimum CRAR level. Out of the 40 foreign banks operating in the country, only 1 bank, viz., the Siam Commercial Bank had a negative CRAR of 13.3 percent. The CRAR of SCBs as a whole increased from 11.2 percent as at the end of March, 2001 to 11.8 percent as at the end of March, 2002.