Banking policy and trends

3.20 Continuing the process of financial reforms for induction of best practices and technological changes, the RBI emphasised transparency, diversification of ownership and strong corporate governance practices to mitigate the prospects of systemic risks in the banking sector. The overall improvement in the efficiency parameters of the scheduled commercial banks (SCBs) reflects the positive response to the policy initiatives and changing business environment.

3.21 In February 2005, the RBI had released a roadmap for entry of foreign banks consistent with WTO commitments. Broadly, the roadmap requires that: (i) ultimate ownership and control should be well diversified; (ii) important shareholders should be 'fit and proper' (as per the guidelines of February 3, 2004 on acknowledgment for allotment and transfer of shares); (iii) directors and CEO should be 'fit and proper' and should observe sound corporate governance principles (as contained in the June 25, 2004 circular of the RBI); (iv) private sector banks should maintain a minimum capital (initially Rs. 200 crore, with a commitment to increase it to Rs. 300 crore within three years) / net worth (Rs. 300 crore at all times) for optimal operations and for systemic stability; and (v) policy and process should be transparent and fair.

3.22 The guidelines also envisaged that aggregate foreign investment in private banks from all sources cannot exceed 74 per cent of paid-up capital of a bank. If foreign direct investment (FDI), other than by foregin banks or foreign bank groups, in private banks exceeds 5 per cent, then the entity acquiring such stake would have to meet the 'fit and proper' criteria as indicated in the share transfer guidelines and has to obtain the RBI's approval for transfer of the shares. The aggregate limit for all foreign institutional investors' (FIIs) investments are restricted to 24 per cent, which can be raised to 49 per cent with the approval of the board/ shareholders. The current aggregate limit for all non-resident Indians (NRIs) investments is 24 per cent, with the individual NRI limit being 5 per cent, subject to the approval of board/shareholders.

3.23 RBI has also continued to monitor the progress of implementation of the Basel II framework, which is to be operationalised by banks and other financial institutions by March 2007. To enable banks operating in India to acquire Basel II, the Reserve Bank of India on January 25, 2006 issued detailed guidelines, for raising capital funds to meet market as well as credit risks. The Basel II accord 1998 had specified a three-tier capital structure for banks. Tier 1 covers: permanent shareholders' equity; perpetual non-cumulative preference shares; disclosed reserves; and innovative capital instruments. Tier 2 includes: undisclosed reserves; revaluation reserves; general provisions/general loan-loss reserves; hybrid debt capital instruments (a range of instruments which combine characteristics of equity capital and debt); and subordinated term debt. Tier 3 consists of short-term subordinated debt for the sole purpose of meeting a proportion of capital requirements for market risks. The earlier guidelines on capital adequacy norms did not permit banks to raise Tier 3 capital funds and in respect of Tier 1 and Tier 2 capital funds following instruments were also debarred: (a) preference shares-both cumulative and non-cumulative; (b) innovative capital instruments for Tier 1 capital funds; and (c) hybrid debt instruments for Tier 2 capital funds. The present guidelines, subject to the extant legal framework, allow banks to augment their capital funds through the following instruments: 1) innovative perpetual debt instruments eligible for inclusion as Tier 1 capital; 2) debt capital instruments eligible for inclusion as Upper Tier 2 capital; 3) perpetual non-cumulative preference shares eligible for inclusion as Tier 1 capital; and 4) redeemable cumulative preference shares eligible for inclusion as Tier 2 capital. The RBI had also issued detailed guidelines governing the instruments at (1) and (2) above. Guidelines for Items listed at (3) and (4) would be issued shortly.

3.24 The principle governing the dividend payments was further liberalised. For the accounting year ending March 31, 2005, banks were granted general permission to declare dividend subject to the following conditions: (i) their capital to risk weighted assets ratio (CRAR) should have been at least 9 per cent for the preceding two completed years and the accounting year for which it proposes to declare dividend; and (ii) net non-performing assets (NPA) should be less than 7 per cent. If any bank did not fulfil the above CRAR norm but had a CRAR of at least 9 per cent for the accounting year for which it proposed to declare a dividend, it could do so provided its net NPA is less than 5 per cent. The bank is also required to comply with the extant provisions of the Banking Regulation Act 1949 and current regulations/guidelines issued by the RBI. The proposed dividend should be payable out of the current year's profit and the RBI should not have placed any explicit restrictions on the bank for declaration of dividend.

3.25 The RBI issued detailed guidelines for the merger/amalgamation in respect of the private sector banks on May 11, 2005. These guidelines are applicable to merger proposals between two banking entities or between a banking company and non-banking financial company (NBFC); the same governing principles would be applicable, as appropriate, to public sector banks (PSBs) also. The merger of an NBFC with a banking entity would be subject to satisfaction of the Board of the banking entity on certain safeguards such as (a) whether the NBFC has violated/ is likely to violate any of the RBI/ Securities and Exchange Board of India (SEBI) norms and if so, ensure that these norms are complied with before the scheme of amalgamation is approved; (b) the NBFC has complied with the Know Your Customer (KYC) norms for the accounts, which will become accounts of the banking entity after amalgamation; and (iii) if the NBFC has availed of credit facilities from bankers/financial institutions (FIs), then the consent of the banks/FIs concerned for the proposed merger/amalgamation would be needed.

3.26 On a recent review of the flow of bank credit to the housing sector, particularly to land developers and builders, the RBI found that the majority of banks were not complying with the prescribed control mechanism for managing the risks involved in such transactions. Hence, the RBI, on June 29, 2005, issued a set of instructions for the banks stipulating, among other things, the adoption of Board-mandated policy in respect of their real estate exposure. As per the policy, it is expected that due attention would be paid to exposure limits, collaterals to be considered, margins to be kept, sanctioning authority/level, and sector to be financed depending upon the individual bank's portfolio size, risk appetite and risk containing abilities. Banks were advised to disclose their gross exposure to the real estate sector as well as the details of the direct and indirect exposure to the real estate sector in their annual reports.

3.27 In line with the apparent risk perception in individual housing credit by banks, which are fully secured by mortgage of residential properties and investments in mortgage-backed securities (MBS) of housing finance companies (HFCs) recognised by the National Housing Bank, the RBI increased the risk weight for capital adequacy purposes from 50 per cent to 75 per cent. In the case of MBS of HFCS to be eligible for 75 per cent risk weight, only assets qualifying for 75 per cent risk weight were to back securities issued by the special purpose vehicle (SPV). With effect from July 26, 2005 the risk weight on banks' exposure to the commercial real estate was raised from 100 per cent to 125 per cent. Risk weight on consumer credit, including loans and credit cards receivables, was also increased from 100 per cent to 125 per cent.

3.28 In July 2005, the RBI issued detailed draft guidelines on the sale/purchase of non-performing assets where securitisation companies and reconstruction companies are not involved. The draft guidelines cover: (a) procedure for purchase/sale of non-performing financial assets by banks, including valuation and pricing aspects; (b) prudential norms relating to asset classification, provisioning, accounting of recoveries, capital adequacy and exposure norms and disclosure requirements. The guidelines, among other things, provide that a NPA in the books of a bank shall be eligible for sale to other banks, only if it has remained as NPA for at least two years in the books of the selling bank and such selling should be only on cash basis; a NPA should be held by the purchasing bank in its books at least for a period of 15 months before it is sold to other banks; banks should ensure that subsequent to the sale of a NPA to other banks, they should not have any involvement with reference to the assets sold and do not assume operational, legal or any other type of risks relating to the financial assets sold.

Financial performance

3.29 On the back of strong economic growth and sustained industrial recovery, bank credit off-take posted steady growth. During 2004-05, with deceleration in demand and savings deposits, deposits of SCBs grew at a lower rate of 15.4 per cent (excluding the impact of conversion of Industrial Development Bank of India into a banking entity) compared to 16.4 per cent in the previous year. However, there was a significant increase in non-deposit resources (net owned funds) and borrowings to meet the higher credit demand. Through equity issues, several banks had tapped both the international and domestic markets to augment their capital base. Capital raised through Global Depository Receipts (GDRs) in the international market during 2004-05 and domestic equity market was Rs. 1,473 crore and Rs. 7,444 crore, respectively. Borrowings increased by Rs. 22,749 crore, of which, Rs. 11,941 crore (52.5 per cent) was in foreign currency.

3.30 SCBs' total income during 2004-05 grew at a lower rate of 1.5 per cent (net of conversion) as compared to 6.7 per cent in 2003-04. Expenditure had increased by 2.7 per cent (net of conversion) compared to 4.1 per cent in the previous year. Operating expenses in 2004-05, as per cent of net income, rose to 49.1 per cent from 45.4 per cent in 2003-04 and, as a proportion of total assets, declined marginally to 2.16 per cent from 2.21 per cent in the previous year. (Table 3.4)

Interest spread

3.31 With rising interest rates, interest income of SCBs during 2004-05 increased to Rs. 1,53,128 crore from Rs. 1,44,347 crore in the previous year. But higher interest rates had an adverse effect on bond prices, which reduced the treasury profits (classified as 'other income') of SCBs. Net interest income (spread), defined as the difference between interest income and interest expenses, represents an important efficiency indicator of banks. The spread of SCBs in 2004-05 increased marginally to 2.92 per cent from 2.88 per cent in 2003-04 and continued to be high by international standards. While net interest income as per cent of total assets of the SBI group and of the new and old private sector banks increased, that of nationalised and foreign banks declined.

Table 3.4 : Working results of scheduled commercial banks

Items	Public sector banks		Foreign banks		Old pvt. sector banks		New pvt. sector banks		SCBs	
	2003-04	2004-05	2003-04	2004-05	2003-04	2004-05	2003-04	2004-05	2003-04	2004-05
					Rs. Crore					
A. Income	137587	141061	13008	13034	11555	10509	21721	22099	183872	186703
I)Interest Income	109547	117691	9137	9171	9121	9275	16542	16990	144347	153128
II) Other income	28040	23370	3871	3864	2434	1234	5180	5109.1	39525	33576
B. Expenditure	121041	125890	10765	11032	10109	10073	19686	19002	161601	165997
I) Interest expended	65765	66288	4269	4040	5982	5673	11548	10600	87563	86601
II) Intermediation cost	32533	36081	3754	4397	2381	2597	5041	6064	43709	49140
III) Provisions and contingenies	22744	23521	2742	2595	1745	1803	3098	2337	30329	30256
C. Operating profit (A-Bi-Bii)	39290	38691	4986	4597	3192	2239	5133	5435	52600	50962
D. Net profit (A-B)	16546	15170	2244	2002	1446	436	2035	3098	22271	20706
E. Net interest income (Spread)	43783	51402	4869	5131	3139	3602	4994	6390	56784	66526
F. Total assets	1471077	1692579	135640	154128	102724	133494	246576	294421	1974017	2274622
					As per cent of total assets					
A. Income	9.4	8.3	9.6	8.5	11.2	7.9	8.8	7.5	9.3	8.2
I)Interest Income	7.4	7.0	6.7	6.0	8.9	6.9	6.7	5.8	7.3	6.7
II) Other income	1.9	1.4	2.9	2.5	2.4	0.9	2.1	1.7	2.0	1.5
B. Expenditure	8.2	7.4	7.9	7.2	9.8	7.5	8.0	6.5	8.2	7.3
I) Interest expended	4.5	3.9	3.1	2.6	5.8	4.2	4.7	3.6	4.4	3.8
II) Intermediation cost	2.2	2.1	2.8	2.9	2.3	1.9	2.0	2.1	2.21	2.16
III) Provisions and contingenies	1.5	1.4	2.0	1.7	1.7	1.4	1.3	0.8	1.5	1.3
C. Operating profit	2.7	2.3	3.7	3.0	3.1	1.7	2.1	1.8	2.7	2.2
D. Net profit (A-B)	1.1	0.9	1.7	1.3	1.4	0.3	0.8	1.1	1.1	0.9
E. Net interest income (Spread)	2.98	3.04	3.59	3.33	3.06	2.70	2.03	2.17	2.88	2.92
F. Total assets	1.1	0.9	1.7	1.3	1.4	0.3	0.8	1.1	1.1	0.9
Memo item										
1. Operating expenses as per cent of net income	45.3	48.3	43.0	48.9	42.7	53.7	49.5	52.7	45.4	49.1

Table 3.5 : Non-performing assets of scheduled commercial banks									
Items	**Gross NPAs (Rs. Crore)**			**Percentage to gross advances**			**Percentage to total assets**		
	2002-03	**2003-04**	**2004-05**	**2002-03**	**2003-04**	**2004-05**	**2002-03**	**2003-04**	**2004-05**
Bank group									
1. Public Sector	54090	51538	47325	9.4	7.8	5.7	4.2	3.5	2.8
2. Private Sector	11782	10354	8782	8.1	5.8	4.4	4.0	2.8	2.1
3. Foreign	2845	2894	2192	5.3	4.6	2.8	2.4	2.1	1.4
SCBs(1+2+3)	68717	64786	58299	8.8	7.2	5.2	4.0	3.3	2.6
Items	**Net NPAs (Rs. Crore)**			**Percentage to net advances**			**Percentage to total assets**		
1. Public Sector	24867	18860	16642	4.5	3.0	2.1	1.9	1.3	1.0
2. Private Sector	6882	4857	4151	5.0	2.8	2.2	2.3	1.3	1.0
3. Foreign	921	898	648	1.8	1.5	0.9	0.8	0.7	0.4
SCBs(1+2+3)	32670	24615	21441	4.4	2.9	2.0	1.9	1.2	0.9

3.32 Declining non-interest income adversely impacted operating profits of SCBs in 2004-05, when such profits declined by 3.1 per cent compared to an increase of 29.3 per cent in 2003-04. Among bank groups, operating profits of nationalised banks, old private sector banks and foreign banks declined, while those of SBI group and new private sector banks increased.