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Developments in Banking Supervision

INTRODUCTION

One of the main objectives of bank nationalisation was taking banks to the masses and getting them to finance the credit needs of less well-off sections of society. These socio-political objectives were pursued vigorously in the 1970s. By the beginning of the 1980s, however, it was clear that sooner or later issues concerning the profitability and viability of banks had to be recognised.

At the global level, the focus was on safety and prudential issues. The international crisis in bank lending in the early 1980s led the Bank for International Settlements (BIS) to contemplate central bank co-operation in the matters of supervisory and prudential norms. The BIS macro-prudential approach first came to the fore in the Cross Report (1986). It defined the macro-prudential domain as “the safety and soundness of the broad financial system and payments mechanism.” These developments also engaged the attention of the Reserve Bank, which began taking steps in the field of supervision, payments and settlements, and capital adequacy norms.

The concern voiced by the Reserve Bank at various forums on the need to improve the profitability of banks and make them viable resulted in a change of mindset at all levels, including the Central Government, and contributed to some well-considered reforms in banking in the latter half of the 1980s. This gradually led to a major overhaul of policies, particularly after the balance of payments (BoP) crisis of 1991. The necessity to reform the banking system was spelt out by Dr Manmohan Singh, Governor in a speech,[1] where he identified new challenges and responsibilities that the Indian banking system was called upon to meet during the Seventh Five Year Plan. He hoped that this exercise would set in motion a process of thinking and debate about structural reforms, organisational improvements and procedural progression that were urgently needed to enable the banking system to perform successfully in the next phase of India's development.

BANKING POLICY *VERSUS* PRUDENCE

Banking policy as defined under section 5 (ca) of the Banking Regulation (BR) Act, 1949, entailed "any policy which is specified from time to time by the Reserve Bank in the interest of banking system or in the interest of monetary stability or sound economic growth, having due regard to the interest of the depositors and other resources of the bank and the need for equitable allocation and efficient use of these deposits and resources." Thus, prudence was an integral part of the banking policy. The banking policy, along with monetary and credit policies in the early 1980s, subserved the objectives of budgetary policies and the Five Year Plan priorities, irrespective of its impact on the functioning of the banks. The emphasis in the early 1980s was on growth and expansion. The banking system was getting a social orientation and hence had other goals to achieve. The Reserve Bank, as regulator and supervisor, became an intermediary in carrying out the directions of the Central Government and ensuring that banks complied with the instructions. As the majority of banks were in the public sector with little operational flexibility, they helped promote this strategy without much strain.

In this context, an observation on the Indian financial system by Robin Leigh-Pemberton, former Governor of the Bank of England in the L.K. Jha memorial lecture on Economic Liberalism, Central Banking and the Developing World delivered on October 16, 1990, is pertinent. He stated, "Clearly a system which is conducive to the mobilisation and efficient allocation of savings is important to India, but it is probably also fair to say that financial liberalisation is not the first priority of everyone in India. I would also acknowledge that the particular economic and social circumstances of India may be felt to justify a certain amount of official encouragement of the way the financial sector develops." He, however, added that a market economy needed clear property rights and benefits from a wide measure of private ownership. In the banking sector it required

1. Singh, Manmohan (1984). *Indian Banking System in the Seventh Five Year Plan*, Speech delivered at founders' day of the Bank of Maharashtra. Pune. September 16.

avoiding the moral hazard, to which bank managements could be a prey, if they were not made accountable for performance and profitability.

Deposits were mobilised as per the rates prescribed and loans were disbursed as per the directions and terms and conditions predetermined by the Reserve Bank in consultation with the Central Government. The issue of margin of profit was hardly a matter of concern. Banks were advised to spread their wings to every corner of the country and, to achieve that, the licensing policy was suitably liberalised and modified. State governments were advised to provide the logistic support in terms of adequate land and other needed infrastructure. Lending rates were prescribed with a conscious policy of cross-subsidisation, which resulted in minimum viability or profitability; loan targets were fixed without taking into account the bankability of projects; and bank funds were earmarked in the form of liquidity requirements for the Government/public sector undertakings (PSUs).

The rapid expansion and diversification of banking led to many stresses and strains. An accelerated expansion in the branch network, rapid growth in the volume of business, increased responsibilities on account of development work connected with the priority sector lending, lead bank schemes (LBS), preparation of district credit plans (DCPs) and the annual action plans (AAPs) led to relaxations in procedures and practices of lending, mounting arrears of work in housekeeping and stretching the lines of supervision and control. The persistence of these factors affected the quality of loan assets. Environmental factors like natural calamities coupled with wilful defaults and lack of appropriate supervision and follow-up on loan recovery also contributed to overdues and a rise in the level of non-performing assets (NPAs). Professionalism and commercial considerations were overlooked in view of the political and economic compulsions of using banks as agents of social change and for equitable distribution of credit.

BANKS AS AGENTS FOR EQUITABLE GROWTH

The other view of the public policy of the time was that after nationalisation of the banks in 1969, the central bank had adopted an aggressive supply-led approach to financial development, an integral part of which was to locate branches in unbanked (mainly rural and semi-urban) areas. There was a close co-relation of this policy with the Government's objectives of resource mobilisation to finance the Five Year Plans. The pattern of establishing bank branches was broadly based on the Government's scheme of development administration, so as to cover each of the community development blocks; this was also considered necessary for implementing government-sponsored rural development programmes.

In the 1970s, the branch licensing policy of opening bank branches in rural and semi-urban areas was guided by considerations of social benefit. The high fixed cost of establishing financial intermediaries coupled with a relatively low demand for banking services in rural areas made it unprofitable for private agents to open branches in these areas. The societal gains of providing banking services in such areas outweighed the private benefits. The presence of financial intermediation provided the consumers with a choice to borrow or lend some of their incomes, offered avenues for owning liquid financial assets as an alternative to holding illiquid assets, such as the real estate and gold, ensured a supply of loanable funds with investment opportunities and reduced transaction costs. It was to bridge this gap that the branch licensing policy was regulated in the period after nationalisation.

Banks emerged as effective catalytic agents of socio-economic change, gearing up their operations according to Plan priorities. The philosophy of bank credit itself underwent a change from a security-oriented to a production-oriented system of lending, bringing succour to the vast majority of needy agriculturists in rural areas.

A balanced view of the 1980s reflects that the very policies that were supposed to promote a more equal distribution of funds also led to inefficiencies in the Indian banking system. Besides the restrictions on the use of funds, the Government also had control over the price of the funds, *i.e.*, the interest rates on deposits and loans. The situation changed only at the beginning of the 1990s when a BoP crisis triggered far-reaching reforms.

By the mid-1980s, operational and allocative inefficiencies caused by the distorted market mechanism led to a serious deterioration in the profitability of public sector banks (PSBs). The Government was aware of this and in 1985, the Finance Minister,[2] while addressing at the golden jubilee celebrations of the Reserve Bank said "the time has come for the banking system to embark on a phase of consolidation in which improvement in operational efficiency must be the key concern." It became necessary to enhance the profitability of PSBs so as to ensure the stability of the financial system. The restructuring measures for PSBs included

2. Address by Shri V.P. Singh.

improving profitability, debt recovery, customer service, and streamlining the payment and settlement mechanisms, besides continuing efforts to update the legal system. The major policy changes were the introduction of Treasury Bills, the creation of money markets, and rationalisation and a partial deregulation of interest rates.

MAJOR ISSUES IDENTIFIED

CHANGES IN SUPERVISORY APPROACH

To improve the efficiency and image of the banking system, banks were advised in April 1983 to review and revamp their vigilance machinery, tone up control and supervision, strengthen the management information system (MIS), streamline their follow-up and inspection/audit arrangements, and draw a time-bound programme to clear arrears in book balancing and reconciliation of inter-branch and other accounts. In a meeting of department heads of the Bank held on April 29, 1985, the Governor, Shri R.N. Malhotra, expressed concern on issues of the declining profitability of banks, low capital-to-assets ratios and the inadequate loan-loss provisions made by banks. While advising the departments to make an introspective self-assessment of their functioning as central bank supervisors and to identify areas where there were weaknesses or deficiencies, the Governor stressed that financial viability should be one of the prime considerations for regulating the banking system. Further, that in India, as in many other countries, the role of the central bank regulators had not received enough attention, and this should be the focus as many banks were confronted with solvency and viability problems arising from a spurt in the magnitude of bad advances. He emphasised the need to review and revise the regulatory system with a view to reversing the trend of non-viability of many banking units in the country.

PROFITABILITY

On one hand, banks were facing increasing competition in mobilising resources with the emergence of new institutions and a series of new savings instruments that combined the attraction of special tax benefits with better returns. With the continuing shift of public preference towards long-term high-return deposits, the interest costs of bank deposits were rising. On the other, the pre-emption of the resources of banks for various special purposes became sizeable. While the compulsions of monetary policy took the average cash reserves maintained by banks to as high as around 15.0 per cent of banks' demand and time liabilities, the growing need to mobilise resources for development pushed up statutory liquidity ratio (SLR) to 38.5 per cent. There were further pre-emptions arising from policy prescriptions on the remaining loanable funds of the banks. Credit for food procurement and distribution accounted for between 8.0 per cent and 10.0 per cent of total credit, and fetched banks an interest rate at 12.5 per cent. Although banks were given refinance against food credit, the amount provided was regulated in accordance with overriding monetary considerations. The allocation of a larger slice of credit to the priority sector was a major thrust of banking policy since the nationalisation of banks. This shift accounted for 40.0 per cent of total credit, the greater part of which was extended at relatively low rates of interest. Thus, only about 20.0 per cent of the resources raised by banks were available for lending at what might be termed as commercial rates of interest. Export credit at subsidised rates also adversely affected the banks' lendable resources available for lending at commercial rates. Apart from these factors, banks' operating costs were rising due to compulsions of fulfilling social objectives such as geographical dispersion and increased coverage of small accounts. Inefficiency in handling the ever-increasing volume of transactions, low productivity due to lack of mechanisation coupled with high wage costs, poor recoveries and huge lock-up of funds in sick units affected the viability of banking, drawing the attention of all concerned.

In a meeting of the finance minister with the chief executives of PSBs held on May 28, 1985 at New Delhi, the Minister of State for Finance pointed out that "the banking system is converted from class banking to mass banking." Commenting on the profitability of banks, he stated "if maximum output and better service is rendered, the profitability of the bank will certainly go up and it will also demonstrate the satisfaction of the people. But it does not happen so and often excuses are given." Further, that the unions had become militant and the management was not in a position to assert itself. He laid stress on the need to enforce discipline among employees and reduce the influence of unions in the banking industry.

OVERSEAS OPERATIONS

Another issue in commercial banking related to the overseas operations of banks. Over the decade, these operations expanded in both volume and range, with the number of banks involved also rising. The overseas network of Indian banks comprised 141 branches, 5 subsidiaries and 11 representative offices. By and large, foreign operations had proved profitable; in the case of some individual banks, they accounted for a significant portion of the profits. These operations were conducted in highly competitive and volatile conditions, and the risk involved was often very high. It was, therefore, necessary to devise appropriate measures of control and regulation of these operations and implement them assiduously. There was also a need for proper country assessment and introduction of appropriate MIS to avoid or reduce, wherever necessary, unduly large risk concentration in countries and/or borrower groups.

CREDIT QUALITY

The fourth issue related to the quality of bank credit to industry and agriculture. The outstanding bank credit to sick units in the industrial sector stood at ₹ 2,793 crore or 7.9 per cent of total bank credit at the end of June 1983. As regards lending to agriculture, poor recovery position was a matter of concern. The ratio of recovery to direct agricultural advances granted by PSBs as at the end of June 1983 was only 53.3 per cent. Locking-up of funds to such an extent, in the industrial units or in agriculture, affected the capacity of banks to recycle funds in a profitable manner. An improvement in the quality of the loan portfolio of banks was imperative. A more careful appraisal of loan requests and a continuous monitoring of the use of loans were called for.

OTHER ISSUES

The other problems encountered by the system related to difficulties faced on account of the spread of branches — communication and control of operations, deteriorating customer service, poor housekeeping, reconciliation of inter-branch accounts, and inefficient payment and settlement systems. Low productivity and lack of co-operation and understanding from the employees under the influence of strong unionism also contributed to the increased cost of operations. With regard to customer service, banks were asked to pay special attention to the critical areas of banking service. The Reserve Bank's approach to address the issues relating to customer service, internal control and housekeeping is detailed in Appendix 7.1.

CHANGES IN THE SUPERVISORY APPROACH

The primary tools employed for bank supervision included statutory/statistical returns and reports, inspection, statutory audit and statutory auditor's report, feedback from the Reserve Bank's nominees/additional directors on the boards of banks, and discussions with the chairmen/top executives of banks.

The most significant supervisory function exercised by the Department of Banking Operations and Development (DBOD) continued to be the inspection of banks. The objective of these inspections was to safeguard the interests of the depositors and to ensure that the development of the banking system conformed to the banking laws and regulations *vis-à-vis* the country's socio-economic interests. In other words, inspections served as a medium for overall appraisal of the financial and managerial systems and performance of banks, their methods of operations and prevention of irregularities.

At the conference of regional heads of departments in February 1981, it was decided to discontinue with the surprise element in conducting the annual appraisal of banks and instead to inspect a representative number of branches, which were exclusively attending to development functions, and certain branches in rural and semi-urban centres, 50.0 per cent of which were located in the lead districts of the respective banks.

It was also decided to watch the time factor and to adopt the programme evaluation review technique (PERT) designed by the Management Services Department (MSD) in the conduct of inspection, initially for PSBs and subsequently for other banks. Accordingly, a PERT discipline was introduced to monitor progress and expedite inspection mechanism. It was also decided to increase the frequency of inspection of branches of Indian banks abroad.

WORKING GROUP TO REVIEW THE EXISTING SYSTEM OF INSPECTION OF BANKS

In a meeting of the Committee of the Central Board, the Governor indicated the desirability of engaging a working group to examine the Reserve Bank's system of inspection. Accordingly, a working group under the chairmanship of Shri V.G. Pendharkar[3] was appointed on December 10, 1981, to review the existing system of inspection of commercial banks, regional rural banks (RRBs) and urban co-operative banks (UCBs) with

3. Former Executive Director, Reserve Bank of India.

particular regard to the objectives of banking and credit policy of the Reserve Bank and the scope, coverage, methodology and periodicity of the inspection mechanisms. The terms of reference of the working group also included examining the question of in-class as well as on-the-job training of inspection staff and examining the machinery deployed to monitor the progress of inspections and the follow-up of their findings.

The report of the working group was submitted to the Reserve Bank on October 22, 1983. The recommendations were intended for the internal guidance of the Reserve Bank and National Bank for Agriculture and Rural Development (NABARD) in the matter of inspection of banks. A memorandum (June, 1984), examining the major recommendations relating to inspection of commercial banks was submitted to the Central Board and was approved in their meeting on July 11, 1984.

It was decided to introduce changes in the periodicity, type and time frame of inspections. The system of annual appraisal/inspection of PSBs was replaced by a system of annual financial review and the financial inspections of both PSBs and private sector banks.

(i) Annual Financial Review: The financial review exercise would be done every year after the annual audit of banks was completed on the basis of audited accounts, management information available at the head office of the bank and formats of the reporting system (including classification of advances health-wise) prescribed by the Reserve Bank. The long audit report submitted by statutory auditors and the action taken by the bank would also be looked into in preparing the review. The annual review would be completed in the head office of the banks within a fortnight and would be forwarded to the Government and the concerned bank within a period of one-and-a-half months.

(ii) Financial Inspection: The periodicity of financial inspection would be reduced from once in five years to once in four years for PSBs in general. It would be once in three years in the case of banks experiencing special problems or whose financial position or methods of operation were not satisfactory. In the case of private sector banks, the periodicity would be normally once in two years, but annual inspections, where warranted, might be taken up. The banks which were working under direction would be inspected annually.

(iii) Selection of Branches for Financial Inspection: It was decided that for the purpose of financial inspection, the coverage of branches and controlling offices would include all major branches, all controlling offices, and 5.0 per cent of rural and semi-urban branches (as decided by the central office of the DBOD). The issue of inspection of branches/controlling offices should be taken up well in advance with the head office.

The regional offices were advised in August 1983 that the features observed during inspection of each controlling office/branch of a bank should be pointed out to the respective controlling office of the concerned bank within a month of the submission of the inspection note. The controlling office of the bank had to send a compliance report in this regard within two months from the date of receipt of the features.

At a conference held on February 1 and 2, 1984, in the Reserve Bank to improve the quality of inspection reports, a decision was taken that the gamut of inspections and reporting should cover, *inter alia*, a trend analysis of factors affecting the performance of banks. Inspecting officers should adopt a positive approach and highlight favourable aspects relating to the bank's performance; they should also look into the small loans portfolio of banks and composite loans on a selective basis in order to see, among other things, whether banks complied with the Reserve Bank's instructions in regard to such advances and security norms. Feedback on the findings was to be made available to the Rural Planning and Credit Department (RPCD).

A system for monitoring inspection of controlling offices and branches of banks was also introduced. Follow-up of inspection reports on the basis of findings was to be taken after obtaining the bank's comments in discussion with their chief executive officers (CEOs)/directors and in light of other material available with the Reserve Bank. The follow-up action included calling for half-yearly progress reports and the issue of specific steps/directions and appointment/continuance of additional directors on the bank's boards, depending on the seriousness of the findings of the inspection or the extent of deterioration in their financial position.

Directions were usually issued to banks whose financial position was not satisfactory and whose methods of operation were unsatisfactory. The directions issued by the Reserve Bank required banks to take certain steps to eradicate the defects observed in their working and bring about an improvement in their financial position and mode of operation within a certain time frame.

PRUDENTIAL SUPERVISION

Action Plans

As a general principle, the framework for supervision was to evolve in such a manner that self-regulation by banks gained pre-eminence. This necessitated the establishment of efficacious internal management and control systems. As a result, a system of action plans was introduced in the banks with effect from 1986. The Reserve Bank advised PSBs to prepare a two-year action plan to bring about substantial improvement in their working during the Seventh Plan. The annual plan envisaged to cover the period from November 1985 to December 1987. The areas to be covered were organisation, structure and personnel policies; human resources development including training, credit management, productivity, financial viability and profitability; housekeeping; internal audit and inspection; customer service; deposit mobilisation and technology upgrading. These plans aimed at qualitative and quantitative advancements within a time frame and their progress was reviewed by the Reserve Bank management with banks' chairmen every three or four months. The Reserve Bank created a cell to closely monitor the implementation of the action plans and periodically assess the progress made by each bank.

As a result of these plans, banks took several steps to strengthen their structure and internal systems of supervision and control. Training capacities were improved and training courses diversified. Credit management was tightened through regular annual reviews of credit limits, health coding of accounts, ongoing supervision of large limits and detection of incipient sickness for timely remedial action. Cost control, productivity of business per bank employee and reduction of loss-making branches received added attention. There were improvements in housekeeping, internal audit and inspection, customer service, and technological upgrading of major branches, zonal offices and bank head offices. Since action plans helped to establish a strong management culture within the banks, they constituted a powerful adjunct to the supervisory role of the Reserve Bank.

The second round of action plans of commercial banks covered the period up to March 1990, and the banks took various measures to implement these detailed plans. The progress in the implementation of the plans was reviewed with the concerned chairmen and senior executives of PSBs continually by the Reserve Bank.

While continuing to use onsite inspections as a major tool to evaluate the performance of banks and strengthen the area of prudential supervision, proposals were being considered regarding the introduction of suitable capital adequacy norms in relation to risk assets, including the off-balance sheet business. Guidelines were issued regarding exposure and risk management in the domestic sector by laying down norms for individual and group exposure, covering both funded and non-funded limits in relation to owned funds. Such norms were already in vogue in the overseas operations of Indian banks. Suitable guidelines were issued regarding recognition of non-performing loans (NPLs) based on health codes and banks were advised not to take to income, the interest on loans so classified.

Safety and Prudential Norms

A beginning was made in prescribing certain prudential norms to be observed by the banks. These related to risk exposure management and non-crediting of interest on NPLs. In respect of foreign banks operating in India, the measures taken related to retention of reserve fund created out of profits, prescription of higher minimum capital for entry and stipulation of priority sector advance levels to be reached.

Risk Exposure

As a prudential measure aimed at better risk management and avoiding concentration of credit risks, it was decided to fix limits on a bank's exposure to individual borrowers and groups of borrowers. All scheduled commercial banks (SCBs) were advised that the exposure ceiling should be fixed in relation to the bank's capital funds, not exceeding 25.0 per cent in the case of individual borrowers and 50.0 per cent in the case of groups of borrowers. Credit exposure included funded and non-funded credit limits, underwriting and similar commitments. The sanctioned limits or outstandings, whichever were higher, were to be reckoned by the banks to arrive at an exposure limit. Only 50.0 per cent of limits or outstandings in respect of non-funded credit limits needed to be taken into account for the purpose. In the case of PSUs, the single borrower exposure limit was only applicable. Borrowers for whom credit limits were directly allocated by the Reserve Bank, as in the case of the Food Corporation of India (FCI), were exempted from fixation of exposure limit. In respect of existing credit facilities to borrowers, which were in excess of the prescribed credit exposure ceiling, banks were asked to take necessary action to comply with the stipulations within one year. Banks were advised to review the existing credit limits in light of the above stipulations and forward to the Reserve Bank a list of the existing borrowers/groups whose credit limits exceeded the prescribed ceiling, with an action plan to regularise the position. An annual review of the implementation of exposure management measures was required to be placed by banks before their board of directors and a copy of each review was required to be furnished to the Reserve Bank. Besides limiting credit exposures as indicated above, banks were also advised to consider fixing internal limits for aggregate commitments to specific sectors, such as textiles, jute and tea, so that the exposures were evenly spread over various sectors. The limits so fixed were proposed to be reviewed periodically and revised as necessary.

The progress by PSBs in implementing the respective action plans was reviewed twice by the Governor: in April 1989 for the quarter ended December 1988 and in August 1989 for the period ended March 1989. The performance and results of each bank were discussed in detail during the reviews. Since the increasing number of NPAs and poor recoveries had adversely affected the ability of banks to recycle funds, the Governor impressed upon the chairmen the need to improve the quality of their loan assets. Low productivity in relation to rising costs also strained banks' profitability. The banks were counselled to look into the staffing pattern of the controlling offices *vis-à-vis* their business and take steps to control expenditure. They were also advised to introduce a regular system to evaluate the performance of controlling offices and to develop certain branches into model branches. The Governor reiterated that the service area scheme had to be implemented with a constructive and flexible approach and that there should be no disruption of credit flow in any manner during the switch over to the new arrangements.

In the area of credit management, the importance of improving the standard of credit appraisal, timely review, renewal and other measures of follow-up and supervision were highlighted. In particular, it was emphasised that banks should introduce, at the operational level, a system to exercise continuous surveillance over large borrowal accounts so that warning signals were picked up early for necessary remedial action.

Discussions were also held with the chairmen of private sector banks to review progress in implementing the action plans. The banks were advised on important aspects to which they were to devote specific attention.

COMMITTEE TO CONSIDER FORMATS OF PUBLISHED ACCOUNTS OF BANKS AND FULL DISCLOSURE IN SUCH ACCOUNTS

The banks were publishing their annual accounts in formats prescribed under the BR Act, 1949. The banking commission (Chairman: Shri R.G. Saraiya) made recommendations regarding the need for full disclosure by banks of their liabilities and assets. It was suggested that these formats needed to be revised, given the large scale expansion in banking operations and the need to improve the presentation of accounts. Accordingly, in March 1982, the Reserve Bank appointed a committee under the chairmanship of Shri A. Ghosh, Deputy Governor. The committee laid the foundations for strengthening regulatory and supervisory practices in commercial banks in the early stages of their establishment. The health code system of classification of assets, provisioning and income recognition norms recommended by the Ghosh Committee paved the way for further reforms in assessing the credit risks of banks' loan portfolios. The terms of reference of the committee were:

(i) to examine the desirability of greater or full disclosure in the published accounts of banks, having regard to the need for disclosure, public accountability of banks, requirement of maintenance of confidentiality between banker and customer, and the requirement of maintaining the image, reputation and creditworthiness of banks;

(ii) to suggest, if greater or full disclosure was not considered necessary or appropriate, whether it was necessary to make any further provisions in the existing laws;

(iii) to suggest suitable changes/amendments in the formats of the balance sheet and profit and loss accounts, having regard to: (a) the need for greater or full disclosure; (b) the expansion of banking operations both area-wise and sector-wise, over the period; (c) the need for improving the presentation of accounts; and (d) the presentation of accounts of other companies;

(iv) to look into, broadly, the practices followed by banks in accounting/classifying various items of liabilities and assets as well as income and expenditure, and to suggest standard accounting concepts which would facilitate a uniform, comparable presentation of such items in the published accounts and compliance with various statutory requirements;

(v) to consider the question of evolving suitable norms for creating provisions for various purposes, particularly for income tax and other taxes, bad and doubtful debts, and depreciation in government securities on a scientific basis; and

(vi) to make any other recommendations which were incidental or related to the above terms of reference.

The committee submitted its report in April 1985.[4] The important recommendations of the committee revealed that the time was not opportune for full disclosure in respect of secret reserves and loan-loss provisioning; banks should disclose their accounting policies with respect to certain key areas; norms for making provisions for various purposes had been laid down, which included a detailed scheme of review and classification of advances based on health codes. The system would be useful for exercising proper supervision over the advances portfolio, apart from facilitating loan-loss provisioning on a rational basis; and the investment portfolio of banks should be bifurcated into permanent and current categories, the levels of securities in each category to be determined by the Reserve Bank.

Following the committee's recommendations, the SCBs were instructed in November 1985 to introduce a comprehensive and uniform grading system (called the health code system), which would indicate the quality (or health) of individual advances as also the extent of advances causing concern in relation to total advances. The grading system was envisaged for effective monitoring and follow-up of the growing volume of bank credit and also for making adequate provisions for bad and doubtful debts. This classification helped the banks to assess the actual profit earned and accrued profit included in the profit and loss account through sticky accounts. Under this system, each bank was required to classify its advances into eight categories with a health code assigned to each borrowal account, *viz.*: (1) satisfactory; (2) irregular; (3) sick-viable-under nursing; (4) sick-non-viable/sticky; (5) advances recalled; (6) suit-filed accounts; (7) decreed debts; and (8) bad and doubtful debts.

To begin with, the health code system was to be adopted for all accounts with limits/outstanding balances of ₹ 5 lakh in the case of banks with deposits of ₹ 1,000 crore and above and ₹ 2 lakh for other banks

4. The committee submitted its report on April 6, 1985, on account of a delay in finalisation of the report as the terms of reference of the committee included certain sensitive issues with far-reaching implications and needed thorough and detailed discussions at various levels and study of practices in other countries (DBOD internal note, BP Section dated December 26, 1985, Reserve Bank of India).

as on December 31, 1984. The above cut-off points were valid only for the maiden classification to be done with reference to the position as on December 31, 1985. Thereafter, the classification had to be done on the basis of the lower cut-off point of ₹ 1 lakh. The system also covered the advances of branches outside India. Information under the system was to be updated on a half-yearly basis.

TAX TREATMENT OF INTEREST ON NON-PERFORMING LOANS

The Central Board of Direct Taxes (CBDT) decided vide their circular of September 19, 1984, that interest credited to suspense accounts by banks would be subject to tax but that interest applied on an account where there had been no recovery for three consecutive accounting years would not be subjected to tax from the fourth year. However, if there was any recovery in the fourth year or later, the actual amount so recovered would be subjected to tax in the year of realisation. The Reserve Bank sent a letter to the Government indicating that the relief afforded to banks by way of exemption from income tax in respect of interest credited to interest suspense account from the fourth year onwards was not adequate. Further, any partial or nominal recoveries in the accounts during the first three years would have the effect of postponing the relief to a further period of three years. Under these circumstances, the banks had two options, *viz.:* i) to treat the interest on doubtful advances as income in the profit and loss account as tax was being paid on it, or ii) not to charge interest on such accounts. In the first instance, taking such interest to the profit and loss account would not be prudent accounting because taking credit for income which was doubtful of realisation in the profit and loss account would artificially inflate the profits of banks; further, a sizeable amount thus got locked up in the form of tax paid on such interest, even though the banks would be eligible for a rebate when the amounts were actually written off. Under the second alternative, which was followed by many banks, no interest was charged on such doubtful debts.

The question of treating the amount credited to interest suspense account as income came up in January 1986, before a three-member bench of the Supreme Court in the case of State Bank of Travancore *versus* Commissioner of Income Tax, Kerala. By a majority verdict pronounced by the bench, it was held that such income credited to an interest suspense account should be treated as income liable to tax. The main argument adduced by the judges was that banks maintained their accounts on a mercantile basis and, as such, the income and expenditure were deemed to arise as and when they accrued; as such, the interest which accrued on such accounts needed to be treated as income and could not be allowed as an outlet of income from the taxman's net for assessment, on the plea that though shown in the account book as having accrued, the same became bad debt and not earned at all. They held that where the law was clear, considerations of hardship, injustice or anomaly did not afford justification for exempting income from taxation. However, the dissenting judge disagreed with the majority view and in his separate judgement held that interest calculated on bad and doubtful debts, and taken to an interest suspense account was not chargeable to income tax as it was not real income but only hypothetical income. Crediting interest on sticky or doubtful accounts to interest suspense accounts was a well recognised and accepted practice wholly consistent with mercantile methods of accounting; it prevented wrong crediting and improper and illegal distribution or remittance of inflated and unreal profits and by making the appropriate entries, the assessees had clearly indicated that the sum in question, being interest on sticky loans, constituted hypothetical income and not real income.

In light of the majority judgement, the Reserve Bank pointed out to the Government that the banks were likely to be subjected to tax on all the interest credited to interest suspense accounts and some tax authorities might even take the line that the limited concession allowed by the CBDT did not hold good any more. There was a considerable increase in the bad and doubtful debt portfolios of banks and, hence, the quantum of interest on such amounts was also on the increase. The profits of banks were already affected by not taking this interest income to the profit and loss account. Coupled with this, if banks were required to pay income tax on this unrealised income, it would weaken the financial position of banks considerably and also lead to negative working results in the case of a few banks, which was not in the interest of the banking system. The Government advised the Reserve Bank in February 1986 to study the implications of the Supreme Court decision on the profitability of banks. The Reserve Bank accordingly requested the Government to exempt banks from paying income tax on interest credited to a suspense account till its actual realisation by making an appropriate amendment to the Income Tax Act. The chairman of the State Bank of India (SBI) and Indian Banks' Association (IBA) also took up the issue with the Government.

INTEREST ON NON-PERFORMING LOANS

The accounting practice followed by banks in classifying loans as non-performing and stopping income recognition on such loans was considered by the Reserve Bank. It was observed that the practices followed by banks in this regard were not uniform and, in some cases, were not sound. The banks were, therefore, advised in May 1989 to adopt certain minimum standards in identifying NPLs on which interest was not to be applied and not to be taken to the profit and loss account.

The minimum standards envisaged were: (i) banks should not take to their income account any interest on loans classified under health code classifications 6, 7 and 8 *(i.e.*, suit-filed accounts, decreed debts, and bad and doubtful debts) from the quarter in which the individual accounts were so classified under these categories; (ii) as regards advances classified under health codes 4 and 5 (*i.e.*, sick non-viable/sticky and advances recalled), application of interest would depend on the availability of adequate security, taking into account the prospects of realisability of the security. The banks should put in place a system by which at the time of annual review of each account under the above categories at the appropriate level, a view was taken whether interest application should continue and, in case it was decided to apply interest on such advances, the reasons were duly recorded.

Not charging interest on certain advances was a prudent internal accounting practice to avoid inflating the income by adding interest that was not likely to be realised. It did not in any way affect the right of the bank to recover the full interest due from the borrower in due course. While the foregoing parameters constituted the minimum acceptable standard, it was open to banks to follow a more prudent policy, particularly regarding advances falling under categories 4 and 5 of the health code. The intent was that these instructions should be followed by the banks from the accounting year commencing from April 1, 1989. The banks were advised to review their loan portfolio and take necessary action to comply with these stipulations. An annual review of NPLs as on March 31 was to be placed before the board of directors before June 30 of every year and a copy needed to be furnished to the DBOD of the Reserve Bank.

CAPITAL BASE OF BANKS

Since the nationalisation of banks — 14 major banks in July 1969 and 6 banks in April 1980 — there had not been any additional direct contribution to their paid-up capital until February 1982. Some of these banks had, however, raised their paid-up capital by capitalising a part of the reserves.

With the growing international exposure of the Indian banks and the need to project their image abroad, it was decided that the capital base of the banks should be increased. Towards this end, the Government subscribed ₹ 25 crore towards the additional capital of eight nationalised banks in 1981–82.

The Finance Act, 1982 amended section 36 of the Income Tax Act and enabled the Indian scheduled banks engaged in banking operations abroad, notified by the Government, to create a special reserve account by transferring thereto, from the total income each year, an amount not exceeding 40.0 per cent of the income and claim rebate for the purpose of computing tax. The question of notifying the bank for the purpose of amended section 3(i) (viiia) of the Income Tax Act was discussed with officials of the finance ministry and the CBDT. Based on the prescribed norms, the Reserve Bank recommended the names of seven PSBs to the Government; they were the SBI, Bank of Baroda (BoB), Bank of India (BoI), Indian Overseas Bank (IOB), United Commercial (UCO) Bank, Punjab National Bank (PNB) and the Central Bank of India.

The Government of India (GoI), through a notification issued in September 1984, allowed these seven PSBs to create a special reserve account by transferring thereto from their incomes each year an amount not exceeding 40.0 per cent of their incomes and claim rebate on tax from April 1983 and any subsequent year based on the criteria that the ratio of owned funds to deposits should be below 2.5 per cent and the aggregate non-bank deposits of their foreign branches should be over US$ 100.0 million. The second criterion was later revised to US$ 50.0 million and the Government allowed Syndicate Bank and Indian Bank a similar facility for the assessment year commencing from April 1, 1986.

The Government approved a scheme to augment the capital of SBI and its associates, and SBI was advised to work out the modalities for implementing the scheme. The Reserve Bank proposed to contribute to the additional share capital of SBI in a phased manner over the next three years, so that SBI would contribute to the additional share capital of its associate banks.

In 1985–86, the authorised capital of SBI was raised from ₹ 20 crore to ₹ 200 crore. Through an additional issue of 44,37,500 shares, its subscribed and paid-up capital was raised from ₹ 5.6 crore to ₹ 50 crore. During 1985, the authorised capital of the associates of the SBI was increased to ₹ 10 crore each, and their total issued and paid-up capital was increased from ₹ 5 crore to ₹ 22.45 crore each.

The Government provided ₹ 400 crore in 1985–86 to augment the capital of nationalised banks. In a letter to the finance ministry, dated August 8, 1985, the Reserve Bank indicated that the amount of ₹ 400 crore provided towards capital would have to be invested in non-negotiable government securities at a rate of interest of 7.75 per cent; thereby the Government would be paying to banks a sum of ₹ 31 crore per annum by way of interest and it should be ensured that banks took all possible measures to step up their rate of dividend to the Government on the enhanced equity base so that there was no net loss to the Government on this account. This objective had to be kept in view while working out the modalities and principles of allocating capital contribution among various banks.

With a view to achieving owned funds-to-deposit ratio of 2.5 per cent in the case of nationalised banks, it was estimated that the Government would have to contribute about ₹ 2,000 crore in five annual instalments of ₹ 400 crore over a period of five years (Seventh Plan period) beginning 1985–86. The Government provided a sum of ₹ 400 crore during the financial year 1985–86 and this was allotted among 20 more banks towards the objective of achieving an owned funds-to-deposit ratio of 2.5 per cent.

While allocating amount of ₹ 400 crore during 1986–87, the Reserve Bank made a slight departure from the criterion adopted in the previous year. In addition to the criterion of 2.5 per cent owned funds-to-deposit, it was felt that banks, which had suffered erosion in deposits as revealed in the bank's annual financial reviews, were given additional support. Accordingly, ₹ 174 crore, being 50.0 per cent of the total erosion in deposits, was to be allocated on the basis of erosion in deposits for seven banks and the balance of ₹ 226 crore on the criterion of 2.5 per cent owned funds-to-deposit ratio; two banks, *viz.*, the PNB and the United Bank of India (UBI), were not in a position to absorb the estimated allocated amount because their authorised capital was only ₹ 100 crore. With minor adjustments in the allocation, funds were distributed among banks based on these two criteria.

In a letter to the Reserve Bank, the Government indicated that the formula for allotment needed a change and the banks, which had an international presence, might need a boost. Though the Government's suggestion merited consideration, the Reserve Bank felt that it was not possible to entirely move away from the basic approach of attaining the objective of 2.5 per cent owned funds-to-deposit ratio that had been uniformly fixed for all nationalised banks. An internal note highlighted that since nationalisation, Indian banks had presented a dismal picture *vis-à-vis* western banks, where norms were to look at the net worth-to-deposits and net worth-to-assets ratios. It was, therefore, suggested that while accepting the owned funds-to-deposit ratio as the prime criterion, the Reserve Bank had to take into account the support needed for banks which had an international presence and the back-up essential for banks, which had suffered erosion in deposits on a real and exchangeable value basis. A proposal factoring in all these considerations was made to the Government but there was no response.

In 1987–88, the Government allotted ₹ 200 crore to 20 nationalised banks, but the mode of allocation engaged serious attention of the Reserve Bank. After considering several options while deliberating on the issue, the Governor indicated that the primary concern of the Reserve Bank/Government was to eliminate/reduce the erosion in deposits. In this context, the Governor observed "It will therefore be appropriate to apportion the available funds, with this end in view. By this approach, banks with weak financial position will get some relief." For this purpose, the bank-wise figures of deposit erosion on the basis of 1986 applicable federal rate (AFR) was worked out and put up. The allocation of capital funds on the basis of the percentage gap between the existing owned funds-to-deposit ratio and the envisaged 2.5 per cent was considered a lower priority. Taking into account the higher growth of deposits, the need to build up a satisfactory level of owned funds-deposit ratio and the actual figures of erosion in deposits, the Bank requested the Government to allocate additional funds towards the capital of banks.

In accordance with the scheme to augment the capital base of nationalised banks, the Government contributed ₹ 200 crore during 1988–89, bringing their aggregate contribution to ₹ 1,200 crore under the scheme since 1985–86. The SBI's paid-up capital was raised from ₹ 5.6 crore to ₹ 50 crore in October 1985 and it was further increased to ₹ 150 crore in November 1987. After this exercise, the Reserve Bank held 99.2 per cent of the paid-up capital of the SBI. Measures were introduced to strengthen the owned funds of private sector banks also, both by raising additional capital and making additions to reserves.

COSTING IN COMMERCIAL BANKS

Following the recommendations of the working group on banking costs, operational efficiency and profitability of banks, a steering group was constituted comprising representatives from PSBs and the Reserve Bank. The group took decisions on the methodology for undertaking a costing exercise in banks on the basis of a minimum programme, guidelines for the introduction of costing, formats for collection of data and identification of a common agency for clustering of branches, processing the data and providing output information on a uniform basis. Based on these decisions, detailed guidelines were issued to banks to ensure that all PSBs undertook costing on an on-going basis.

The Reserve Bank convened a meeting of the chief officers of the costing cell of commercial banks on April 19, 1984, with a view to review the progress of data collection in banks, sorting out problems that banks faced, elaborating the types of control data and methods of collecting and consolidating control data that banks had to send for computerisation. The action points emerging from the discussion were advised to PSBs, who took the necessary follow-up action in this regard.

PROFITABILITY

Improving the profitability of banks was an area of concern both for the Reserve Bank and the Government. According to Dr C. Rangarajan, Deputy Governor, the financial institutions (FIs) normally had to be judged by the twin criteria of operational efficiency and allocative efficiency. Operational efficiency referred to the difference between the rates at which funds were raised and deployed, while allocative efficiency referred to efficient allocation of funds by an institution among competing demands. The Indian banking system, it was viewed, suffered from both operational and allocative inefficiencies as it had no independence either in determining the rates on deposits and advances or in deciding how the funds should be allocated. While the interest spread as a percentage to working funds worked out to 3.23 per cent for all PSBs for 1986, the variation among banks ranged from 0.11 per cent to 4.20 per cent. The allocative mechanism was influenced not only by profitability but also by social compulsions.

It was recognised that there was a need for banks to improve the profitability of their operations. The onus of social banking on one hand and the statutory and other pre-emptions of the loanable funds of banks, on the other, undoubtedly constrained the ability of banks to earn profits.

It was therefore, important that banks stepped up their profitability by reducing their operating costs and improving the quality of lending. Some banks with foreign branches were able to show better results. Although foreign operations could improve profitability, banks had to guard against the risks inherent in the highly competitive and volatile conditions in which they operated abroad. The banks, therefore, had to devise appropriate measures of control and regulation of the operations of their foreign branches. Another area of concern under profitability related to the quality of credit to industry and agriculture. Advances to sick industrial units were high and rising and lending to agriculture was also bedevilled by the poor recovery position. It was imperative that funds were not inordinately locked-up in these sectors and remained available to banks for recycling so that better turnover of credit facilitated larger production growth and also improved the earning capacity of banks.

In the early 1980s, the profitability of banks tended to erode, even when judged in the framework of social banking. Again, this was an outward manifestation of deeper problems which emphasised the need for more efficient recycling of banks' resources, improving the productivity of the banking industry and streamlining the operations of overseas branches of the Indian banks.

For more efficient recycling of funds, two problems needed to be tackled effectively — the recovery of advances, particularly agricultural advances, and improvement in the working of sick industrial units. The recovery of agricultural advances by PSBs deteriorated from 53.2 per cent at the end of June 1983 to 51.3 per cent of the amount due at end-June 1984. The fact that such deterioration took place after two successive good agricultural years was disturbing. Another aspect of the recovery problem was the wide interstate differences. While the recovery ratio was as low as 28.3 per cent in West Bengal and 38.8 per cent each in Orissa and Bihar, the ratio was as high as 74.1 per cent in Punjab and 65.9 per cent in Kerala. These differences in the recovery performance indicated the wide scope for improvement. Turning to sick industries, the credit locked-up in these industries accounted for 7.0 to 8.0 per cent of total bank credit. Obviously, improvement in both these areas was imperative to enhance profitability of banks.

Factors, such as, the rise in interest rate on deposits with maturity of less than 3 years ranging from 0.5 per cent to 1.5 per cent, a step-up in SLR requirements by one percentage point, the rise in advances to priority sectors, which were not only risk-prone but costly in terms of supervision and follow-up, and an increase in sick accounts tended to erode the profitability of banks. However, the Reserve Bank's decision to raise the interest rate on cash reserves maintained with the Bank in excess of 3.0 per cent from 6.5 to 7.0 per cent and measures taken by banks to curb overtime payments as also the profit from foreign branches helped banks improve their overall profitability. The induction of capital, diversification of activities, mechanisation of operations, improved housekeeping and customer service, and better productivity also contributed enormously to better performance in terms of the profitability.

FINANCIAL DIVERSIFICATION BY BANKS

Banks in India were diversifying their functions by taking up activities such as merchant banking, equipment leasing, housing finance, venture capital and mutual funds. With the approval of the Reserve Bank, six equipment leasing-cum-merchant banking subsidiaries were set up — five by PSBs and one by a private sector bank. Three more subsidiaries were set up exclusively to provide housing finance. One PSB was permitted by the Reserve Bank to set up a subsidiary jointly with the Bombay Stock Exchange (BSE) to provide share clearing and stockholding services. Two PSBs had also set up mutual funds. In order to ensure orderly functioning of mutual funds set up by the banks, the Reserve Bank issued detailed guidelines on important aspects of the mutual fund business.

LEASING

Consequent to the issue of the necessary notification under the BR Act by the Government in August 1984, commercial banks were allowed to undertake the business of equipment-leasing. Commercial banks could, with the prior approval of the Reserve Bank, set up a subsidiary with not less than 51.0 per cent of shareholding to transact equipment-leasing business or to make portfolio investments in shares of a leasing company within certain specified limits. The subsidiaries promoted were, however, prohibited from transacting hire-purchase business and financing of other companies or concerns engaged in equipment-leasing. Banks were prohibited from undertaking the business of equipment-leasing or acting as promoters of companies (other than their subsidiaries) in which they had made portfolio investments. Aggregate investment of a bank in a subsidiary and/or in shares of other leasing companies was stipulated not to exceed 10.0 per cent of the paid-up capital and reserves of the bank.

Till the end of April 1986, the Reserve Bank approved proposals from six banks to make portfolio investments in equipment-leasing companies and one proposal to set up a fully-owned subsidiary to undertake merchant banking and equipment-leasing business.

PORTFOLIO MANAGEMENT: PROHIBITION OF BUY-BACK ARRANGEMENTS

The banks were prohibited from entering into buy-back arrangements in government and other approved securities with non-bank clients with effect from April 4, 1988. They were instructed to ensure that the extant arrangements were terminated on the date they expired or on July 1, 1988, whichever was earlier. While banks were permitted to undertake outright purchases/sales, such transactions were to be effected at market prices. It was further clarified that outright sale and purchase transactions with the same party and for identical or similar amounts would be construed as tacit arrangements that violated the instructions prohibiting buy-back arrangements with non-bank clients. The banks were also advised to submit a report to the boards, setting out compliance with the instructions prohibiting buy-back arrangements with non-bank investors, and report on phased unwinding of buy-back commitments to the Reserve Bank every month. A full compliance report was required to be submitted to the Bank immediately after July 1, 1988. The Reserve Bank also advised the banks that the units of the Unit Trust of India (UTI) were not approved securities for buy-back arrangements.

OVERSEAS OPERATIONS

With the increase in the presence of Indian banks abroad, growth in the volume of business and diversification of their activities, there was a need to improve the mechanism for supervising their operations. The measures included steps to improve the machinery within the banks to monitor the functioning of their overseas branches and strengthen the systems in their international divisions for better oversight of operations of their branches abroad. A more comprehensive reporting system was introduced to reflect the financial position of the overseas branches. The system was designed to be used both in the Reserve Bank and the banks. A forum under the auspices of the Reserve Bank was organised where executives in charge of the international divisions of banks with overseas operations could exchange views on country risk assessments, data on country risk exposures, international debt rescheduling and control systems. A working group was set up comprising representatives from the Reserve Bank, banking division of the finance ministry and major banks to review and recommend an appropriate control system to be adopted by banks for their overseas operations. Further, a system of functional inspection of overseas branches was instituted.

Steps taken by the Reserve Bank and the concerned banks facilitated closer supervision and control of the overseas operations. With the professional skills that the Indian banks had acquired over the years, overseas operations continued to contribute to the profitability of the Indian banking system. Thus, a lasting solution to the problem of improving the profitability of banks seemed to lie in successfully tackling these medium-term problems.

The emphasis on strengthening the working and financial position of the overseas operations of the Indian banks continued. No new branches were opened by Indian banks abroad and the overseas branches of 9 Indian banks declined from 141 as at end-June 1985 to 116 as on June 30, 1989. The number of representative offices of 4 Indian banks and overseas subsidiaries/affiliates remained unchanged at 10 and 12, respectively, as on June 30, 1989.

To improve the lines of communication between the Reserve Bank and the Indian banks that had overseas operations, the Reserve Bank advised the chairmen and managing directors of these banks in May 1989 to furnish information about their overseas operations through a monthly demi-official letter. Further, banks were advised to provide information in a specified format on a half-yearly basis on problem credits and the provisions for problem exposures in the overseas branches.

CREDIT QUALITY

MEASURES TO ENFORCE FINANCIAL DISCIPLINE ON DEFAULTING BORROWERS

The banks were advised not to consider applications for sanction of fresh term finance (including deferred payment guarantee) for new projects, or expansion of existing units of companies, which had persistently defaulted in payment of term credit granted to them by the same bank/other banks/ term-lending institutions without justifiable reasons. Regarding working capital assistance, in the case of defaulting units whose managements were suspected to be indulging in malpractices like siphoning off the company funds, banks were to withhold fresh sanctions and release of funds and even freeze operations on the accounts if such an action was necessary to make the management comply with the required financial discipline.

CO-ORDINATION BETWEEN BANKS AND FIs

The banks were not following satisfactorily the guidelines issued for effective co-ordination between commercial banks and state-level FIs (state financial corporations [SFCs], state industrial development corporations [SIDCs] and state industrial and investment corporations [SIICs]) as per the recommendations of the Bhide Committee. As a result, timely and adequate finance to industries was not ensured. To bring about greater co-ordination between commercial banks and FIs, banks were advised to not only scrupulously follow the comprehensive guidelines but also take specific measures for joint appraisal of projects, sanction and release adequate working capital finance before the borrowing units commenced production, estimate working capital requirements for appraisal of projects in accordance with banking norms and entrust bank officials with adequate discretionary powers.

RELATED ISSUES

WORKING GROUP TO REVIEW THE ACCOUNTING SYSTEM AT BANK BRANCHES

On July 11, 1981, the Reserve Bank appointed a working group under the chairmanship of Shri M.N. Goiporia, chairman and managing director (CMD), Dena Bank and comprising senior officers from banks, the Government, the Reserve Bank and the National Institute of Bank Management (NIBM) to review the accounting system at bank branches. The terms of reference included, *inter alia*: (i) to examine the existing systems of maintaining main books of accounts at the branch level, particularly at the rural and semi-urban branches, and suggest changes to facilitate generation of summary data on deployment of funds and lending to various categories of the priority sector and to compile returns required by the Reserve Bank and head/controlling offices of banks; (ii) to review the information system introduced by the Reserve Bank and examine feasibility of integrating the same with the control/statistical returns required by banks; and (iii) to suggest other measures to ensure that data was made available without delay. The working group submitted its report within nine months from its constitution.

The banks were asked to implement the recommendations of the working group relating to maintenance of separate subsidiaries for different segments of priority sector advances, separate loan ledgers for different segments of priority sector borrowers and introduction of the loose-leaf system of maintenance of loan ledgers.

GOVERNANCE STRUCTURE: CONTROL OVER MANAGEMENT

Constitution of Boards of Directors

The Banking Laws (Amendment) Act, 1983, which came into effect from February 15, 1984, restricted the tenure of a director on a bank's board to eight years at a stretch; it also empowered the Reserve Bank to appoint a chairman on the board of any bank, if considered necessary. In terms of the amended provisions of section 10 A of the BR Act, 1949, some directors with various interests vacated office, but subsequently most of them complied with the statutory provisions. Wherever banks faced problems in appointing a chairman or where there was an urgent need to appoint chairmen for smooth functioning of the banks (*e.g.*, at Lord Krishna Bank Ltd and Bari Doab Bank Ltd, the entire board was dissolved on account of the new provision), the Reserve Bank took recourse to section 10(BB) and appointed them under the powers vested with it. The erring banks were advised to achieve the objective by complying with the statutory provisions both in letter and spirit, and the position regarding compliance with the provisions by banks was under scrutiny.

Appointment of Statutory Auditors of Banks

In June 1984, all Indian private sector commercial banks and foreign banks operating in India were instructed to change their statutory auditors after a continuous association of four years instead of five years hitherto; however, branch auditors were allowed a period of five years of continuous association with any bank. This was done to bring uniformity in the principles adopted for PSBs.

The working group appointed by the Reserve Bank in May 1983 to evolve suitable norms for fixing the scales of remuneration payable to statutory auditors of PSBs (central/branch) submitted its recommendations in June 1984. These recommendations, with minor modifications, were sent to the Government for acceptance.

Appointment of Additional Directors on the Boards of Private Sector Banks

The Reserve Bank was empowered under section 36 AB of the BR Act, 1949 to appoint, wherever necessary, additional directors on the boards of private sector banks. The expertise and professional knowledge of such persons, it was felt, would help strengthen the management of the concerned banks and bring about rapid improvement in the working of these banks.

In terms of the provisions of section 36 AB of the BR Act, 1949, the number of such directors appointed by the Reserve Bank was not to exceed five or one-third of the maximum strength fixed for the board by the Articles, whichever was less. To enable the Reserve Bank to have proper control over the management of banking companies, this restriction was removed when the Banking Laws (Amendment) Act, 1983, came into force in February 15, 1984. Consequent to this enactment, 13 non-officials were appointed as additional directors and, in all, 32 banks in the private sector were working under formal observation through the appointment of additional directors, both official and non-official.

FOREIGN BANKS

Section 11(2) (b) (ii) of the BR Act, 1949 provided that a foreign bank operating in India shall, at the end of each accounting year, deposit and keep deposited with the Reserve Bank either in cash or in the form of unencumbered approved securities, or partly in cash and partly in the form of such securities, an amount calculated at 20.0 per cent of its profits for that year in respect of all business transacted through its branch/es in India, as disclosed in the profit and loss accounts prepared with reference to that year under section 29 of the Act. In March 1989, the Reserve Bank advised foreign banks operating in India that, while complying with the above requirements, they should retain the Indian books in a separate reserve account with 20.0 per cent of the profits of Indian operations as disclosed in the annual accounts every year, commencing with the accounting period ended March 31, 1989. They were also advised that the separate reserve account would be permanent and form a part of the owned funds of the bank and that any withdrawals from the same could be made only with the prior approval of the Reserve Bank.

Besides, the minimum start-up capital for a new bank seeking entry into India was raised to ₹ 15 crore. Foreign banks were also required to achieve, in respect of priority sector lending, a target of 10.0 per cent by end-March 1989, which was increased to 12.0 per cent by March 1990 and to 15.0 per cent by March 1999.

REVIEW OF THE FUNCTIONING OF PRIVATE SECTOR BANKS

The position of private sector banks (excluding foreign banks) operating in the country was reviewed to determine their place in the existing banking system and to consider the desirability of their continuance as individual units. Their financial soundness, methods of operation and contribution to economic development in their area of operations were examined and the Government was apprised of the position.

The Governor met the chairmen of all private sector banks in February 1989 to discuss the performance of the banks. In the light of the weak capital base of some banks, the unsatisfactory quality of their loan portfolios and the overall deteriorating position, it was suggested that the banks should voluntarily explore the possibility of getting together and merging to form reasonably sized and relatively strong and viable units. The attention of the chairmen was also drawn to the poor performance in lending to priority sectors, direct finance to agriculture and assistance under various poverty alleviation programmes. The banks were advised to make concerted efforts to fulfil their social obligations.

As at end-June 1989, there were 32 private sector banks including United Industrial Bank Ltd, which was placed under moratorium on June 10, 1989. Of these 32 banks, the position of 13 banks was rated as 'good', that of 8 banks as 'satisfactory', 1 bank as 'not satisfactory' and the remaining 10 banks as 'unsatisfactory'. Besides United Industrial Bank Ltd, 4 banks that were rated 'unsatisfactory' were placed under moratorium subsequent to the half-yearly review.

CUSTOMER SERVICE

The decade of the 1980s witnessed an emphasis on improving customer service in banks, which had become a casualty in the process of giving a social orientation to the functioning of banks. A small group was set up by the Government in 1982 to examine the recommendations of the working group on customer service in banks, to assess the notes prepared by the Reserve Bank on the performance of the banks in implementing the recommendations and suggest measures for further consideration by the Reserve Bank, the Government, and the IBA.

Apart from monitoring the implementation of the recommendations by the banks, steps were taken to improve the quality of customer service rendered by banks. Speaking at a conference of the chief executives of PSBs, the Union Finance Minister laid particular emphasis on improving customer service; he described the customer counter as the 'face' of the banking industry that determined the quality of its public image. A media report,[5] commenting on better customer service, observed that for a system not designed for dynamic and diversified role brought about by bank nationalisation, with a several-fold increase in the number of branches, swelling deposits and unheard of advances requiring new linkages between credit expansion and development priorities, naturally caused tremendous strain, affecting the organisational structure in a variety of ways. Perhaps the worst sufferer in the process was the customer who in the post-nationalisation euphoria was hailed as 'the most important visitor' doing the bank a 'favour' by giving it an opportunity to serve him.

An impressionistic survey was carried out during July/August 1985 to assess the quality of customer service in PSBs. Based on the findings, PSBs were advised to take measures to remove the deficiencies and submit quarterly reports indicating the follow-up action taken. Banks were also asked to consider constituting special squads in areas of frequent complaints to hold on-the-spot enquiries into such complaints and to include customer service in the curriculum in their training programmes. Another survey was conducted in May/June 1986 at the instance of the Government at selected branches of PSBs across the country to ascertain the position regarding the implementation of the measures initiated by the Government and the Reserve Bank. The Government was apprised of the findings of the survey.

The Government advised the bank officials at all levels to meet customers on specified dates each month so that they could gain insights into customers' problems. Further, customer service centres were opened at all state capitals for redressal of complaints. To improve customer service in banks in rural areas, it was decided that senior officers ranging from regional managers, managing directors and even the chairmen should visit some of the rural branches once a month and send a copy of their visit notes to the concerned branches for necessary action.

5. *The Hindu*, Editorial, July 22, 1985.

OTHER DIRECTIVES

Interest rates on a wide range of alternative savings instruments were lowered to maintain *inter se* relativity. A co-ordinated across-the-board reduction in interest rates on savings instruments was implemented in April 1987, covering bank deposits, post-office deposits, national savings certificates (NSCs), company deposits, debentures, public sector bonds and other schemes. For the first time, a conscious policy measure was taken to avoid unhealthy competition among various avenues of savings.

To develop bills finance as a payment mechanism, the following steps were initiated: (i) reduction in the effective interest rate for bills discounting on behalf of borrowers in the highest interest range; (ii) raising the ceiling on the rediscount rate from 11.5 per cent to 12.5 per cent in order to attract additional funds into the rediscounting business; and (iii) fixing a time-line for gradual substitution of cash credit limits with bills in the case of credit authorisation scheme (CAS) parties.

The CAS was substantially liberalised during 1986–87. The liberalisation reduced the number of bank borrowers coming under prior authorisation and the vesting of large discretionary powers with banks. The CAS parties, which were able to comply with the prescribed credit discipline, were exempted from such prior authorisation. There was also a commitment by the Reserve Bank for disposal of applications/references from banks under the scheme within a period of one month.

Other policy changes were in the nature of rationalisation and effective implementation of existing measures. The rationalisation of selective credit controls initiated in 1985–86 continued during 1986–87. Where the commodity balances were favourable, such controls were relaxed, and where such controls were no longer needed, they were abolished.

The new branch licensing policy emphasised consolidation while ensuring the availability of a bank branch within a distance of 10 kms in rural and semi-urban areas and a coverage of 17,000 population per bank office in rural and semi-urban areas of each block. More liberalised norms were adopted for branch expansion in hilly and tribal areas. During the period July 1986–March 1987, 300 new branches were added, of which four-fifth were in unbanked centres. Branch offices in the rural areas formed nearly 56.0 per cent of the total at the end of March 1987 as compared with only 22.0 per cent in June 1969. To improve the functional efficiency of rural branches, in August 1986 banks were advised to observe one day in a week as non-public business working day at the rural branches so that the managers could spend the day exclusively in the field to contact their present/prospective clientele for development/promotional work, for mobilisation of deposits, credit allocation, supervision over the end-use of credit, recovery of loans and for rendering appropriate guidance to the borrowers. The banks were also urged to set up satellite or mobile branches in the areas where the volume of business and other conditions did not warrant setting-up of a regular branch.

Satisfactory progress was made in implementing the action plan in 1986–87. Steps were taken, especially to revamp credit management through health coding, timely review and renewal of credit limits, time-bound action to detect sickness, determining the viability of sick units and activating nursing programmes, and/or initiating recovery procedures in respect of non-viable units. There were improvements in housekeeping and customer service. The Reserve Bank continued to hold quarterly meetings with the chairmen of PSBs to monitor the progress in implementing the action plans. All banks continued to meet the credit targets for the priority sector and sub-sectors within it. Data from 50 SCBs on sectoral deployment of credit showed that from July 1986 to April 1987, advances to the priority sector increased by ₹ 3,056 crore as compared with ₹ 2,534 crore during the corresponding period of the previous year.

The share of priority sector advances in total outstanding net bank credit formed 43.0 per cent at end-April 1987 as against 41.1 per cent the year before. The share of outstanding advances to agriculture at ₹ 10,592 crore was 41.8 per cent of total priority sector advances at end-April 1987. The outstanding loans to small scale industries (SSIs) at ₹ 9,300 crore constituted 36.7 per cent of priority sector lending. Direct credit to agriculture by PSBs constituted 16.2 per cent of the total net bank credit at end-December 1986 as against the target of 16.0 per cent set for March 1987. Advances to the weaker sections at end-December 1986 formed 10.8 per cent of net bank credit as against a target of 10.0 per cent set for March 1985. The loans outstanding under the differential rate of interest (DRI) scheme at ₹ 561 crore at end-December 1986 accounted for 1.2 per cent of the total lending portfolio and were spread over 48 lakh accounts.

During 1986–87, the sphere of social banking was further widened by introducing a lending scheme to alleviate poverty of the urban poor. Also, measures were taken to increase the flow of credit to minority communities. There was a marginal improvement in the percentage of recovery to demand in respect of direct agricultural advances, which rose to 56.2 per cent at end-June 1986 from 54.2 per cent a year earlier. However, there was considerable scope for improving the overall recovery performance of banks. Further, industrial sickness continued to affect bank profitability adversely.

Addressing the concerns that emerged about the overseas operations of PSBs in the past two/three years, the Reserve Bank, in consultation with the Government took steps to rationalise the overseas branch networks. Two approaches were adopted: banks were asked to either review and close down non-viable branches or consolidate their branches (for example, in London where there were many branches of several banks). Eleven overseas branches were closed, bringing down the number to 123 as at end-June 1987. The process of rationalisation entailed withdrawal of four PSBs from international banking, all operating in the United Kingdom (UK). The assets and liabilities of these banks were transferred to other Indian banks operating in the country from the beginning of January/February 1987. This brought down the number of Indian banks having offices abroad to nine. To strengthen the operating and monitoring systems in these banks in relation to the international banking business in their overseas branches; guidelines were issued covering exposure norms, country risk management, control of liquidity, interest rate mismatches and currency lending exposures.

The widening spectrum of banking activities gathered further momentum in 1986–87 which continued in 1987–88. The larger Indian banks and foreign banks diversified their activities into new business areas like lease financing and were also contemplating entry into mutual funds, venture capital and housing finance. Some of these activities were being undertaken through the promotion of subsidiaries or equity holding in other financial companies. The interface with the capital market also expanded, subject to directives and prudential guidelines of the Reserve Bank. The thrust was on merchant banking activities, especially on management and underwriting of new issues.

There was also a general improvement in the overall profitability of banks in 1986. Certain decisions taken by the Government and the Reserve Bank, such as, augmenting the capital base of PSBs, higher coupon rates on government securities and higher returns on cash balances maintained with the Reserve Bank, improved the profitability of banks. The hike in service charges and enhanced staff productivity were also contributory factors.

The Reserve Bank continuously monitored the situation and reiterated its guidelines to banks on safeguards to be taken on operational aspects, such as, clearing of instruments, kite-flying operations by unscrupulous clients, security arrangements and the preventive and punitive aspects of frauds. Other areas where detailed instructions were issued and compliance followed up included appraisal of advances and post-sanction follow-up to minimise the incidence of frauds and resultant heavy losses; observing safeguards while opening accounts and issuing cheques; methods of issuing opinion reports on borrowers; hiring of contract workers, such as, ex-servicemen or paramilitary personnel to work as armed guards in disturbed areas till police force became available; discontinuing extending advances to directors of other banks or firms in which the director was an interested partner or guarantor, or any company in which the director of another bank held a substantial interest, or to relatives of the bank's directors/other banks' directors; refining the existing system to strengthen the preventive measures to curb malpractices in banks and periodic review of donations by banks' boards.

The improved bank profitability achieved in 1986–87 could be attributed, to a large extent, to the policy responses of the Government and the Reserve Bank. However, for commercial banks to sustain their profitability at a reasonable level in the coming years, endogenous factors had to be effectively addressed, especially those concerning the internal structure, cost control, including special establishment costs, housekeeping, credit and funds management, and customer service. Improving the quality of loan assets and timely recovery of dues were two important areas to which increasing attention was sought to be paid. In this context, commercial banks as well as governments, especially at the state level, had to strive to create and maintain an environment conducive to financial discipline and recovery of dues. The composition of banking business was undergoing changes as banks undertook new activities. It was, however, essential for them to eschew speculative business and to ensure that their major function of providing working capital to agriculture, industry and exports was effectively performed.

The recovery performance in direct agricultural advances showed a small improvement from 56.5 per cent at end-June 1986 to 57.1 per cent at end-June 1987. The schemes for social banking also made further progress during the year. Under the self-employment scheme for educated unemployed youth (SEEUY), 1.01 lakh beneficiaries were assisted with an aggregate credit of ₹ 208 crore during the year 1987–88, against the target of 1.25 lakh beneficiaries. During the year, 3.63 lakh beneficiaries were also sanctioned loans aggregating ₹ 132 crore under the self-employment programme for urban poor (SEPUP).

CONCLUDING OBSERVATIONS

CONSOLIDATION PAID DIVIDENDS

The involvement of banks and their responses were encouraging and they were able to maintain their professional competence in a substantive manner as evidenced by their improved performance from 1985 onwards. All banks drew up a two-year comprehensive plan to improve their overall operations and efficiency. These plans included measures to: (i) strengthen the internal administration for ensuring better supervision and control; (ii) improve customer services; (iii) improve credit appraisal and the quality of loan assets; (iv) improve recovery of bank dues; (v) reduce costs; and (vi) introduce new work technologies. Effective implementation of these plans called for strenuous efforts. Their fulfilment, in turn, resulted in better customer service and improved financial viability of banks. The importance of running banking along professional lines was realised both by the authorities and the banks, which rendered it easy to introduce subsequent reforms.

Notwithstanding the perceptible progress achieved under the action plans, there still were certain areas of concern. Even though banks had health coded their borrowal accounts and improved follow-up of irregular cases, industrial sickness and defaults in repayment of bank dues continued to adversely affect the quality of their assets. While banks had to make all efforts to step up recycling of funds, it was important to improve the general climate for recovery of bank dues. The existence of a sizeable number of loss-making branches was also a drag on the profitability of banks. It was, therefore, necessary to impart financial viability to such branches through expansion of business within a reasonable time frame. The ongoing tasks of human resource development and personnel management needed focus with a view to further improving motivation, discipline, efficiency, output and work culture at various levels in the industry. Greater effort was called for in the field of technology upgrading, wherever needed, to improve customer service.

In view of the above concerns, banks were advised to draw up new action plans covering the period from April 1988 to March 1990, broadly along the lines of the previous action plans, with an added emphasis on the qualitative aspects of banking. These plans placed emphasis on various aspects of bank performance including rationalisation of systems and procedures, introduction of efficient MIS, strengthening of the organisational structure, financial viability, proper implementation of the service area approach (SAA), effective credit management, use of the health code of borrowal accounts as a management tool to enhance the quality of bank assets, faster response to signs of industrial sickness and appropriate mechanisation of operations.

Apart from responding to the immediate situation, the policy measures introduced during the year 1988–89 contained a strong thrust on structural changes so as to promote efficiency in the operations of the financial system. Some important measures in this respect were: continuing the restructuring of deposit rates; replacing the ceiling rate by a floor rate for the general category of large bank borrowers; replacing the requirement of prior authorisation by the Reserve Bank under the CAS with a post-sanction scrutiny; freedom to transfer borrowal accounts between banks; relaxations in the stipulations regarding consortium lending; freeing the entire short-term money market from interest rate regulation; introduction of new money market instruments; and steps to implement proposals regarding factoring services.

In the area of branch expansion, while the process of consolidation continued, it was necessary to allow the opening of additional branches so as to achieve appropriate coverage under the SAA — a new strategy of rural lending, which became operative from April 1, 1989.

Apart from strengthening the capital base of nationalised banks, a number of steps were taken during the late 1980s to strengthen prudential supervision, such as, issuance of guidelines on exposure risk management and recognition of NPLs. To achieve greater transparency, aspects relating to the modification of accounting policies and practices of banks also received attention.

The commercial banks diversified into services, such as merchant banking, leasing, mutual funds, venture capital and housing finance, and some banks set up specialised subsidiaries for such activities. The provision of these services was a natural affiliate of the diverse and growing needs of the economy following the economic liberalisation measures initiated in the country and reflected the adaptability of commercial banks to the changing needs of the financial system. As at end-June 1989, three banks, *viz.*, the SBI, Canara Bank and BoB were permitted to set up mutual funds. While the SBI and Canara Bank set up mutual funds and introduced several individual investment schemes immediately, BoB followed suit in due course. Six commercial banks, *viz.*, the SBI, Canara

Bank, PNB, BoB, Central Bank of India and Vysya Bank Ltd, were granted permission to set up subsidiaries, either wholly-owned or jointly with other banks/FIs. While all six banks were permitted to undertake merchant banking, equipment leasing and other financial services through their subsidiaries, four of them, *viz*., the SBI, Canara Bank, BoB and Central Bank of India, were permitted to also operate venture capital financing. Subsidiaries were set up by all six banks to undertake these activities. In addition, the SBI, Canara Bank and PNB had, with the permission of the Reserve Bank, set up separate subsidiaries, either wholly-owned or jointly with other institutions, to provide housing finance. Thus, in all, six banks established nine subsidiaries to undertake diversified activities. Besides, some banks opened specialised branches to cater to corporate customers and the investing public. It was at this point of time that the question of extending prudential supervision over the subsidiaries of banks received the attention of the Reserve Bank.

BEYOND SUPERVISION

The Governor, Shri R.N. Malhotra, in a speech[6] identified some constraints that the banking system was facing in maintaining its health and viability. These were:

- (i) Delays faced in enforcing their claims in the courts of law, thereby encouraging defiance on the part of borrowers and the need to establish special tribunals to deal with large bank claims.
- (ii) Cross-subsidisation on account of priority sector targets at highly concessional rates and with greater risk could place an undue burden on banks which should not be pushed beyond a point.
- (iii) The environment for recycling bank funds needed improvement to enable the banks to maintain financial health, and the pressures for lending to essentially non-viable units, which were counterproductive, had to be avoided.
- (iv) The autonomy, professionalism and accountability of banks, which were intimately linked, needed to be preserved while meeting the national policy objectives. Credit decisions needed to remain the sole responsibility of bank personnel in both the priority and non-priority sectors. Departures from well-recognised principles like credit evaluation and lending norms could erode accountability,

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6. Malhotra, R.N. (1989). *Changing Practices of Central Bank Supervision.* Address on the occasion of 125th anniversary of Allahabad Bank. Calcutta. December 6.

lead to deterioration in the quality of bank assets and encourage insider abuse; and

(v) To make the banking system efficient and competitive, the process of mechanisation and computerisation of its operations needed to be accelerated.

It was well recognised that regulation had to be compatible with socioeconomic objectives. Deregulation and liberalisation appropriate to Indian conditions required reinforcing the capital and prudential norms in banks and OFIs to counter enhanced risks arising from such changes. Reinforcing the legal framework, standardising the accounting practices, increasing disclosure of the state of bank operations and consolidating supervisory functions, preferably under a single agency in the context of the progressive integration of financial markets, were some of the issues under active consideration in the late 1980s.

Several steps were taken in the late 1980s to impart flexibility to the financial system and to encourage a measure of competition. The measures related to: (i) the CAS, which was first liberalised and then abolished and replaced by *ex post* monitoring; (ii) interest rate prescriptions with regard to money market instruments were abolished; (iii) a floor of 16.0 per cent was fixed without a ceiling rate for most non-priority sector borrowers, enabling banks to charge interest in the light of borrowers' track records. At the same time, parties were allowed to transfer their accounts from one bank to another, provided they cleared their liabilities to the existing banks; (iv) banks were permitted to issue certificates of deposit (CDs) for large amounts, with the interest rate determined by negotiation between the bank and the depositor; (v) commercial paper (CP) was introduced to enable highly-rated companies to raise money at rates lower than what they paid on their bank borrowings; and (vi) banks were allowed to diversify their activities in several new business areas, either directly or through specialised subsidiaries. The money and capital markets were activated by introducing several new instruments.

While continuing with onsite inspections and follow-ups as a major tool for evaluating the performance of banks, a number of steps were taken to strengthen the area of prudential supervision. Keeping in view the developments abroad, proposals were considered regarding the introduction of suitable capital adequacy norms in relation to risk assets, including off-balance sheet business. Guidelines were issued regarding exposure risk management in the domestic sector by laying down norms for individual/group exposure, covering both funded and non-funded limits in relation to owned funds. Such norms were already in vogue in respect of the overseas operations of banks. Suitable guidelines were also issued regarding recognition of NPLs based on health coding, and banks were advised not to take into account interest income arising from loans so classified. The transparency of the accounting policies and practices of banks also engaged the attention of the Reserve Bank at this juncture.

The Reserve Bank was actively involved in the establishment of BANKNET, a data communications network for the banking industry. To assess the requirements of banks as well as to co-ordinate the activities of user banks for speedy implementation of BANKNET phase I, a user group was constituted. Similarly, 37 banks in India (including the Reserve Bank) were accepted as members of the Society for Worldwide Interbank Financial Telecommunications (SWIFT), a co-operative society based in Belgium. Action was taken to install the SWIFT Regional Processor in Bombay to act as an international gateway. Message formats conforming to SWIFT specifications were standardised jointly by the Reserve Bank and the IBA.

The pressure on bank profitability was, to a large extent, attributable to the irregular accounts of sick or mismanaged industrial units and the unsatisfactory recovery of bank dues from agricultural and other priority sector advances. As regards the first category, in order to make the legal processes for enforcing banks' claims more expeditious and effective, special tribunals were established during the 1990s. With regard to the dues in agricultural and other priority sector advances, banks were required to step up efforts towards recycling their funds. Besides, it was important to ensure that the general environment for recovery of dues by commercial and co-operative banks was not vitiated. Towards this end, the Reserve Bank and NABARD undertook measures to make refinancing of state co-operative banks contingent on adherence to the prescribed interest rate and other credit disciplines.

There was increased emphasis on consolidation in the banking system. This was sought to be achieved through comprehensive action plans prepared by commercial banks. The objectives of these action plans were: improving the operational efficiency of banks by strengthening the organisational structure, upgrading internal supervision and control systems, enhancing capacity and quality of training for human resource development, improving customer service and housekeeping, reinforcing financial viability through better credit management, higher productivity, economy of expenditure and recovery of bank dues, and introducing new technology in a phased manner. These efforts yielded results but there was considerable scope for further improvement. Though customer service showed significant progress, it needed to be further reinforced.