

Financial Institutions

5.1 The role of financial institutions has been under discussion in recent years. Although setting up of the development finance institutions (DFIs) was an important feature in the overall development of the financial system; with the emergence of the capital market as an important source of finance in the late 1980s and early 1990s, and the renewed role of banks in term-financing, DFIs have been increasingly exposed to greater competition. Liberalisation of the financial sector, with its associated processes of decontrol, deregulation and globalisation, has led to increased competition for financial intermediaries across different segments. The competitive pressures have come into the business domain of FIs on account of the entry of new players. Moreover, with the initiation of financial sector reforms in the early 1990s, access of FIs to assured sources of long-duration/concessional funds from the Government, particularly 'SLR bonds' that were subscribed to by banks and insurance companies, has been gradually phased out. FIs at present are overwhelmingly dependent on market borrowings - wholesale and retail, domestic and foreign - for their resource mobilisation. As a consequence, DFIs are required to raise funds from the capital market. With the removal of administrative controls on the interest rate structure, it has become increasingly difficult for DFIs to raise long-term funds. This in turn has affected their ability to offer competitive rates to their borrowers.

5.2 Apart from the competitive pressure for raising resources, the role of DFIs as an exclusive source of development finance has diminished as other intermediaries especially banks have also entered into long-term and high risk project financing. Therefore, FIs are increasingly facing competition not only in terms of raising resources but also in the deployment of funds. In short, the change in the operating environment coupled with the legacy of high non-performing assets has led to serious financial stress on the term lending financial institutions.

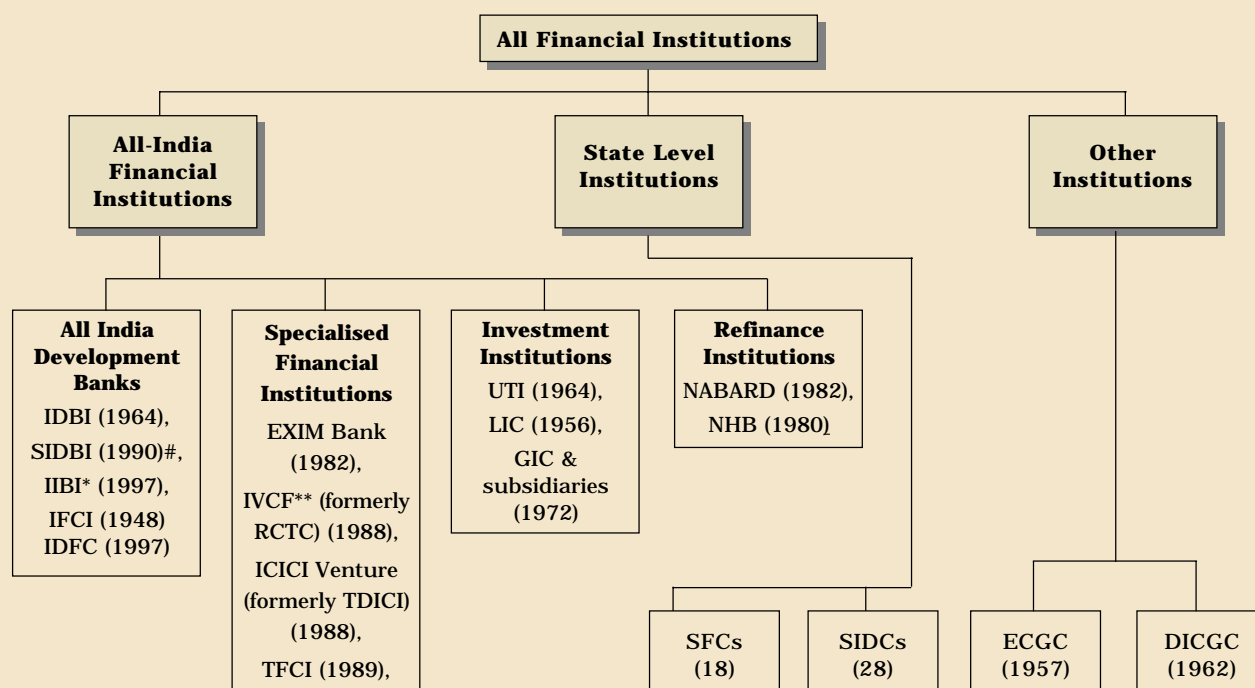
5.3 The financial institutions in India can be broadly classified into three categories, viz., All-India Financial Institutions (AIFIs), State level institutions and other institutions (Chart V.1). On the basis of functions and activities, the AIFIs have four segments; (i) all-India development banks, (ii) specialised financial institutions, (iii) investment institutions and (iv) refinance institutions. The State level institutions comprise State Financial Corporations (SFCs) and State Industrial Development Corporations (SIDCs). Other financial institutions include Export Credit Guarantee Corporation of India (ECGC) Ltd. and Deposit Insurance and Credit Guarantee Corporation (DICGC). Out of 17 AIFIs, the Reserve Bank regulates and supervises only nine. Out of these nine, six FIs, viz., Industrial Development Bank of India (IDBI), Industrial Finance Corporation of India (IFCI) Ltd., Industrial Investment Bank of India (IIBI) Ltd., Tourism Finance Corporation of India (TFCI) Ltd., Infrastructure Development Finance Company (IDFC) Ltd. and EXIM Bank are 'Term Lending Institutions', while the remaining three FIs, viz., National Bank for Agriculture and Rural Development (NABARD), National Housing Bank (NHB) and Small Industries Development Bank of India (SIDBI) are termed as 'Refinance Institutions' for regulatory and supervisory purposes.

2. Policy Initiatives for Financial Institutions

5.4 The Reserve Bank regulates and supervises nine AIFIs¹ under Section 5 of the Reserve Bank of India Act, 1934. The FIs are currently on the transition path as recommended by the Narasimham Committee II, by making endeavours, to convert themselves either into a bank or NBFC. The focus of the policy initiatives by the Reserve Bank and the Government has been on financial as well as organisational restructuring to facilitate their transition into universal banks. As a corollary, the Reserve

¹ IFCI Limited, IDBI, EXIM Bank, IIBI Limited, TFCI Limited, IDFC Limited, NABARD, NHB and SIDBI.

Chart V.1: Organisational Structure of Financial Institutions



* The erstwhile Industrial Reconstruction Bank of India (IRBI), established in 1985 under the IRBI Act, 1984, was renamed as Industrial Investment Bank of India Ltd. (IIBI) with effect from March 27, 1997.

** IVCF-IFCI Venture Capital Funds Ltd.

SIDBI is termed as the 'Refinancing institution', for regulatory and supervisory purpose.

Notes: 1. Figures in brackets under respective institutions indicate the year of incorporation.

2. Figures in the brackets under SFCs/SIDCs indicate the number of institutions in that category.

3. IDBI became IDBI Ltd. on October 1, 2004.

Bank has been harmonising its various policy measures for banks and FIs in such a manner that FIs, on becoming banks, are in a position to fully integrate themselves into the banking system. The Reserve Bank initiated various regulatory and supervisory initiatives including facilitating organisational restructuring of the FIs during 2003-04. Policy initiatives for select AIFIs laid emphasis on asset classification and provisioning, disclosures, consolidated accounting and supervision, infrastructure financing and measures to facilitate market developments.

5.5 To examine the supervisory and regulatory issues relating to term lending and refinancing institutions and improve the flow of resources to them, the Reserve Bank announced the setting up of a Working Group on Development Financial Institutions which submitted its Report in May 2004 (Box V.1).

Regulatory Initiatives

Asset Classification and Provisioning Norms: Refinement

5.6 FIs were advised that with effect from end-March 2006, an asset should be classified as a non-performing asset (NPA) if the interest and/or instalment of principal remain overdue for more than 90 days. As regards the additional provision arising as on March 31, 2006 on account of the modification in the norms, FIs would have the option to phase out the required provisioning over a period of three years beginning from the year ending March 31, 2006, subject to at least one fourth of the additional required provision being made in each year.

Prudential Norms for Classification of Doubtful Assets of FIs

5.7 With a view to moving closer to international best practices and ensuring

Box V.1: Report of the Working Group on Development Financial Institutions

In order to address the regulatory and supervisory issues and enhance the flow of credit, the Reserve Bank of India in its mid-term Review of monetary and credit policy 2003-04 announced the setting up a Working Group on Development Financial Institutions (Chairman: N. Sadasivan)². The broad objectives of the Working Group were to review the experience and prospects of DFIs for transformation into banks and to assess the financial position and recommend a regulatory framework for the existing financial institutions.

The Working Group observed that in the pre-reform period, DFIs faced little competition in the area of long-term finance as funds were available to them at cheaper rates from multilateral and bilateral agencies duly guaranteed by the Government. The reforms in the financial sector have changed the operational environment for the DFIs. Along with the changed operating environment for banks in a globalised scenario, the regulatory framework for FIs has undergone a significant change. While on the supply side, the access of DFIs to low-cost funds has been withdrawn, on the demand front, they have to compete with banks for long-term lending. Out of nine select all India financial institutions being regulated and supervised by the Reserve Bank at present, three institutions, viz., NABARD, NHB and SIDBI extend indirect financial assistance by way of refinance. The financial health of these three institutions is sound as their exposures are to other financial intermediaries, which in certain cases are also supported by State Government guarantees. Of the remaining six institutions, two niche players, viz., EXIM Bank and IDFC Ltd. are also healthy. The remaining four institutions that have been operating as providers of direct assistance, are all in poor financial health. The major recommendations by the Group are:

- The role of DFIs as exclusive providers of development finance has diminished during the 1990s with the emergence of a well-diversified banking system operating efficiently and acquiring skills in extending long-term finance. The banks should be permitted to raise long-term finance through development bonds to enable them to extend high-risk project finance.
- As a result of the exposure of DFIs to certain sectors with cyclical downturn, DFIs have accumulated large NPAs. To overcome this, Government should undertake a social cost-benefit analysis, on the basis of which Government should decide which sectors need

convergence of the norms applicable to the FIs with those of banks, the Reserve Bank in its mid-term Review of annual policy Statement for the year 2004-05 proposed that in respect of FIs, an asset would be classified as doubtful, if it remained in the sub-standard category for 12 months with effect from March 31, 2005. FIs are

development finance and which institutions can continue as DFIs. The rest of the DFIs should be converted either to a bank or a regular NBFC as recommended by the Narasimham Committee II.

- The Group identified that the main problems of SFCs were the centralised decision making, lack of corporate culture, high transaction cost and poor appraisal skills. The SFCs, according to the Group have lost their relevance. The Group is uncertain regarding the revival of financially sick SFCs and recommended phasing out of SFCs.
- Since long-term project finance is a risky proposition for any financial intermediary whose portfolio is almost exclusively comprised of project financing, the DFIs should consciously scale down the proportion of project financing by resorting to diversified products, before transformation into banks. Highly illiquid asset profile may be risky from the systemic point of view.
- DFIs seeking transformation should restructure themselves like a company with a large and diversified share holding. DFIs, converted into banks, could be accorded certain exemptions/relaxations for a period of three to five years after conversion.
- The Group also emphasised on the need for ongoing monitoring of the business and strategic plan till the DFIs are fully integrated into the banking system.
- The regulatory framework needs further strengthening and should be so designed so as to ensure financial soundness of DFIs and overall systemic stability.
- The Group recommended that risk weightage for certain categories of investments such as bonds of public financial institutions should be raised from the present level of 20 per cent to 100 per cent as such investments involve substantial credit risk.
- DFIs, viz., NABARD, NHB, EXIM Bank and SIDBI work as instruments of public policy and the Reserve Bank may continue to regulate the financial and other related aspects of these institutions.

On the basis of recommendations of the Working Group and the feedback received thereon, the Reserve Bank in its mid-term Review of annual policy Statement 2004-05 proposed: i) the Reserve Bank would continue to supervise NABARD, SIDBI, NHB and EXIM Bank, ii) the Reserve Bank would supervise DFIs accepting public deposits while DFIs and large NBFCs not accepting public deposit but having asset size of Rs.500 crore and above would be subjected to limited off-site supervision.

permitted to phase out the consequent additional provisioning over a four-year period.

Slippage of Non-performing Assets – Preventive Measures

5.8 In pursuance of the directions of the Board for Financial Supervision (BFS), the Reserve Bank

² Also see Box VI.2 of the Report.

had constituted an in-house Group to identify and recommend the measures that could be instituted by the banks to prevent the slippage of the accounts from the 'sub-standard' category to the 'doubtful' category. Based on the recommendations of the Group, the Reserve Bank issued guidelines to banks and the same guidelines were extended to FIs. Accordingly, FIs were advised to place these guidelines before their Boards and take appropriate action for implementing the recommended measures, to the extent considered necessary, in keeping with the spirit of the guidelines. The introduction of a 'Special Mention' category for asset classification is for internal control and follow-up purposes only and this, however, would not constitute an additional category under the extant asset classification norms of the Reserve Bank.

Revised Guidelines for Compromise Settlement of Chronic NPAs up to 10 crore

5.9 Under the revised guidelines for One Time Settlement (OTS) of chronic NPAs up to Rs.10 crore, the last date for receipt of applications from borrowers was extended up to July 31, 2004 from the close of business on September 30, 2003 and the date of completion of processing of applications was also extended up to October 31, 2004 from December 31, 2003 in consultation with the Government of India.

Guidelines on Investment by the FIs in Debt Securities

5.10 FIs have been investing in the debt securities issued by companies on private placement basis from time to time. In order to provide greater transparency to such issuances and to protect the interest of investors in such securities, Securities and Exchange Board of India (SEBI) guidelines state that any listed company assuring debt securities on a private placement basis shall be required to comply with certain conditions relating to full disclosures (initial and continuing), Listing agreement with the exchanges, credit rating of not less than investment grade, appointment of a debenture trustee, issuance and trading of the debt securities in demat form, trading in stock exchanges and between Qualified Institutional Investors (QIIs) and High Networth Individuals (HNIs), and standard denomination

of Rs.10 lakh. If the intermediaries registered with SEBI associate themselves with the issuance of private placement of unlisted debt securities, they will be held accountable for such issues. They will also be required to furnish periodical reports to SEBI in such format as may be decided by SEBI.

5.11 SEBI has also directed the stock exchanges to make necessary amendments to the listing agreement, bye-laws, rules and regulations for the immediate implementation, as may be applicable and also disseminate its guidelines on the website for easy access to the investors and to the listed companies/member brokers/clearing members of the Exchange.

5.12 The investment by FIs in debt instruments issued by corporate entities - in primary as well as secondary market - increased substantially in the recent past. The Reserve Bank, therefore, issued draft guidelines in November 2003 which sought to address the risks arising from investment in non-Government debt securities, particularly through private placement. On receipt of the feedback from the FIs, the final guidelines on the subject were issued in January 2004. These guidelines mainly covered various aspects relating to coverage, effective date and transition time, regulatory requirements, internal assessment systems, prudential limits, the role of Board of Directors, reporting requirements, disclosures, and trading and settlement in debt securities. These guidelines apply to the FIs' investment in debt instruments, both in the primary market (public issue as also private placement) as well as the secondary market, issued by companies, banks, FIs and State and Central Government sponsored institutions, Special Purpose Vehicles (SPVs), Central or State Public Sector Undertakings, with or without Government guarantee; units of debt-oriented schemes of Mutual Funds, i.e., the schemes where the major part of the corpus is invested in debt securities; and capital gains bonds and the bonds eligible for priority sector status. The guidelines, however, do not apply to Government securities and the units of Gilt Funds; securities which are in the nature of advance under the extant prudential norms of the Reserve Bank; units of the equity oriented schemes of Mutual Funds; units of the 'Balanced Funds', venture capital funds and the money market mutual funds; Commercial Paper (CP); and Certificates of Deposit (CDs) (Box V.2).

Box V.2: Guidelines on Investments in non-Government Debt Securities

The Reserve Bank issued guidelines to FIs on investments in non-Government debt securities both in the primary (public issue and private placements) and secondary market with a view to address risks arising from investments in non-Government debt securities especially through private placements. The guidelines have been in force since April 1, 2004.

Considering the time required by the issuers of debt securities to get their existing unlisted debt issues listed on the stock exchanges, the following transition time is being provided:

- a) Investment in units of mutual fund schemes where the entire corpus is invested in non-Government debt securities would be outside the purview of the above guidelines till December 31, 2004; thereafter, such investments would also be subject to the guidelines.
- b) Investment in units of such schemes of mutual fund as have an exposure to unlisted debt securities of less than 10 per cent of the corpus of the scheme would be treated on par with listed securities for the purpose of the prudential limits prescribed under these guidelines from January 1, 2005. Hence, till December 31, 2004, investments in such units would attract prudential limits.
- c) Investments in existing unlisted securities, issued on or before November 30, 2003, were permitted up to March 31, 2004. In case, the issuers have applied to the stock exchange(s) for listing of such unlisted securities and the security is rated as minimum investment grade, investment in such unlisted securities can be permitted till December 31, 2004.
- d) Regarding unlisted securities issued after November 30, 2003, investments are permitted up to December 31, 2004, subject to a ceiling of 10 per cent of the incremental investments in the categories covered under these guidelines over the corresponding figure of outstanding investments as on November 30, 2003.
- e) With effect from January 1, 2005 only those FIs would be eligible to make fresh investments (up to the prescribed prudential limits) in the unlisted securities whose investments in such securities are within the prudential limits prescribed.

Investment by FIs are permitted only in rated debt securities with a minimum investment grade rating from an external rating agency, operating in India, as identified by the IBA/FIMMDA. FIs cannot invest in debt securities of original maturity of less than one-year other than CPs and CDs, which are covered under the Reserve Bank guidelines. The FIs need to undertake usual due diligence in respect of investments in debt securities including the securities which do not attract these guidelines. The FIs should ensure that all fresh investments in debt securities are made only in listed debt securities of companies, which comply with the requirements of the relevant SEBI guidelines. The unlisted debt securities in which the FIs are allowed to invest up to the limits specified should be rated and issuer company should follow disclosure requirements as prescribed by the SEBI for listed companies.

The FIs should follow the same standards as for their credit appraisal before investing in debt securities, irrespective of the fact that the proposed investments may be in rated

securities. FIs should not solely depend on the ratings of external rating agencies but strengthen their internal rating systems including building up of a system of regular (quarterly or half-yearly) tracking of the financial position of the issuer.

FIs are permitted to invest in the unlisted debt securities to the limit of not exceeding 10 per cent of their total investment in debt securities, which fall within the ambit of these guidelines, as on March 31 (June 30 in case of NHB) of the previous year. However, investment in Security Receipts (SRs) issued by Securitisation/Reconstruction Companies registered with the Reserve Bank in terms of the provisions of Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002, Asset Backed Securities (ABS) and Mortgage Backed Securities (MBS) which are rated at or above the minimum investment grade will not be reckoned as 'unlisted debt securities' for the purpose of monitoring compliance. FIs, with exposure to investments in debt securities in excess of the above prudential limit as on March 31, 2003 (June 30, 2003 in case of NHB), should not make any fresh investment in such securities till the prudential limit is complied with.

The Boards of FIs would have to put in place a monitoring system to ensure that the prudential limits prescribed under these guidelines are scrupulously complied with, including the system for addressing the breaches, if any, due to rating migration. Boards of the FIs are expected to review, twice a year, total turnover (investment and divestment) during the reporting period; compliance with the Reserve Bank-mandated prudential limits as also those prescribed by the Board for such investments; rating migration of the issuers/securities held in the books of the FIs and consequent diminution in the portfolio quality; and extent of non-performing investments in the fixed income category.

In order to help in the creation of a central database on private placement of debt, the investing FIs are expected to file a copy of all offer documents with the Credit Information Bureau (India) Ltd. (CIBIL). When the FIs themselves raise debt through private placement, they need to file a copy of the offer document with CIBIL. Any default relating to payment of interest / repayment of instalment in respect of any privately placed debt needs to be reported to CIBIL by the investing FIs along with a copy of the offer document. The FIs should also report to the Reserve Bank such particulars in respect of their investments in unlisted securities as may be prescribed by the Reserve Bank from time to time.

The FIs need to disclose the details of the issuer composition of investments made through private placement and the non-performing investments in the 'Notes on Accounts' of the balance sheet, with effect from the year ending March 31, 2004 (June 30, 2004 in case of NHB) in the prescribed format.

As per the SEBI guidelines, all trades, with the exception of the spot transactions, in a listed debt security, would have to be executed only on the trading platform of a stock exchange. In addition to complying with the SEBI guidelines, the FIs would have to ensure that all spot transactions in listed and unlisted debt securities are reported on the NDS and settled through the Clearing Corporation of India Limited (CCIL) from the date to be notified by the Reserve Bank.

Guidelines Relating to Issuance of Commercial Paper (CP)

5.13 In order to provide further flexibility to both issuers and investors in the CP market, it has been decided that non-bank entities including corporates may provide unconditional and irrevocable guarantee for credit enhancement of the CP issue subject to (i) the issuer fulfilling the eligibility criteria prescribed for issuance of CP; (ii) the guarantor having a credit rating at least one notch higher than the issuer by an approved credit rating agency; and (iii) the offer document for CP disclosing the net worth of the guarantor company, the names of the companies to which the guarantor has issued similar guarantees, the extent of the guarantees offered by the guarantor company, and the conditions under which the guarantee will be invoked. Further banks are permitted to invest in CPs guaranteed by non-bank entities provided their exposure remains within the regulatory ceiling as prescribed by the Reserve Bank for unsecured exposures.

Risk Weight for Exposure to Public Financial Institutions (PFIs)

5.14 Since December 1998, FIs were advised that their investments in the bonds/debentures of certain PFIs would attract a uniform risk weight of 20 per cent. In pursuance of the annual policy Statement 2004-05, it has been decided that exposures to all PFIs will attract a risk weight of 100 per cent with effect from April 1, 2005.

3. Supervision and Audit

Consolidated Accounting and Consolidated Supervision

5.15 In the light of comments received on the draft guidelines and on the basis of a review, a set of final guidelines were issued on consolidated accounting and consolidated supervision. The guidelines which came into force on April 1, 2003 (July 1, 2003 in case of NHB), comprise three components in the supervisory framework, viz., (i) Consolidated Financial Statements (CFS); (ii) Consolidated Prudential Returns (CPR); and (iii) application of prudential regulations like capital adequacy, large exposures and liquidity gaps on group-wide basis in addition to the solo prudential norms applicable to the parent FIs/subsidiaries. The

publication of the CFS as per the Accounting Standard (AS) 21 of the Institute of Chartered Accountants of India (ICAI) is mandatory for the listed FIs in terms of the Listing agreement and the guidelines have made such publication mandatory even by the non-listed FIs since April 1, 2003.

Asset Liability Management (ALM) - Guidelines

5.16 The ALM guidelines have been in operation since April 2000, and with the stabilisation of the ALM system, the FIs have been advised to submit data to the Reserve Bank regarding the liquidity and interest rate gaps as a part of the extant off-site surveillance system at quarterly intervals, with effect from the quarter ended June 30, 2003.

On-site Inspection and Off-site Surveillance System

5.17 The Reserve Bank continued to undertake on-site inspection of nine FIs under section 45N of the Reserve Bank of India Act, 1934. The inspections are conducted annually. During the year 2003-04, the supervisory process for all nine FIs with reference to their position as on March 31, 2003, (except NHB) was initiated and completed including submission of memoranda to the BFS.

5.18 Keeping in view the regulatory changes that have taken place since the introduction of Prudential Supervisory Reporting System (PSRS) in July 1999, and also based on the suggestions received from the FIs, the FID-OSMOS was modified with effect from September 2003. The FIs now submit the off-site returns using the modified software module provided to them for this purpose. The review of the performance of the FIs based on the off-site returns submitted by them is presented to the BFS on a quarterly basis.

4. Other Policy Developments

Trading of Government of India Securities on Stock Exchanges

5.19 To encourage wider participation of all classes of investors in the secondary market for Government securities, the trading in Government of India dated securities at the stock exchanges through a nation-wide, anonymous, order-driven, screen-based system was introduced on January 16, 2003. However,

participation in this segment was negligible on account of availability of alternative investment avenues with better returns like small savings instruments and savings bonds and with more tax efficient features, like units of mutual funds. Participation of wholesale entities was also adversely affected by lack of liquidity on the exchanges. As announced in the annual policy Statement 2004-05, a Working Group on Screen Based Trading in Government Securities (Chairman: Dr.R.H. Patil) was formed to study and recommend methods to improve liquidity on the Government securities trading platform of stock exchanges, in particular to improve market access for retail and mid-segment investors. As liquidity on the exchange based trading platform improves, it will provide the market participants with another efficient trading platform. The Report of the Group has been placed in the public domain for wider dissemination.

5. Review of Operations

Financial Assistance: Sanctions and Disbursements.

5.20 The declining trend observed in financial assistance sanctioned and disbursed by AIFIs

during 2001-02 and 2002-03 was reversed during 2003-04, aided by substantial improvements recorded by investment institutions and to an extent, by specialised FIs (Table V.1 and Chart V.2). Bulk of the total sanctions and disbursements was made by Life Insurance Corporation of India (LIC) which were Rs.21,974 crore and Rs.15,782 crore, respectively, in 2003-04 as compared with Rs.4,333 crore and Rs.6,206 crore in the 2002-03. The disbursement by the LIC was higher than the combined disbursements of IDBI, IFCI, IDFC, IIBI and SIDBI. This possibly reflects its strategic shift from merely investing in bonds of public and private sector corporates into active lending. In percentage terms, LIC accounted for 46 per cent of the total sanctions and 49 per cent of the total disbursements by AIFIs during 2003-04. Another noteworthy development is the steep increase in sanctions and disbursements by the IDBI to the infrastructure sector by 288.2 per cent and 45.2 per cent respectively, during 2003-04, accounting for 43.9 per cent and 34.0 per cent of its total sanctions and disbursements respectively, during this period.

Table V.1: Financial Assistance by Financial Institutions
(Year: April-March)

Institution	(Amount in Rs. crore)					
	2002-03		2003-04		Percentage variation during 2003-04	
	S	D	S	D	S	D
1	2	3	4	5	6	7
A. All-India Development Banks (IDBI, IFCI, SIDBI, IIBI, IDFC)	22,272	17,225	23,407	14,057	5.1	-18.4
B. Specialised Financial Institutions (IVCF, ICICI Venture, TFCI)	475	490	484	441	1.8	-10.1
C. Investment Institutions (LIC, GIC#, UTI)	5,965	7,902	23,705	17,402	297.4	120.2
D. Total Assistance by All-India FIs (A+B+C)	28,713	25,618	47,597	31,900	65.8	24.5

S Sanctions. D Disbursements.

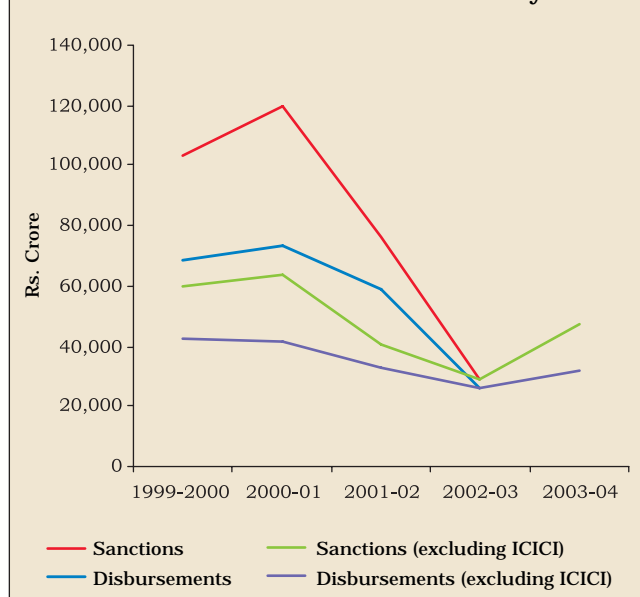
Data include GIC and its subsidiaries.

Notes : 1. Data are provisional for all institutions.

2. For IFCI, treasury operations, conversion of loans into equity/preference shares/debentures as well as differential interest on account of NPV loss consequent upon restructuring of loan accounts are not reflected in data on sanctions and disbursements, effective April 1, 2003.

3. With the repeal of UTI Act, UTI has discontinued submission of data on sanctions and disbursements since November 2002. Hence, data of UTI for 2002-03 is for seven months only, i.e., from April 2002 to October 2002.

Source : Respective FIs, IDBI for GIC and its former subsidiaries and SIDCs, and SIDBI for SFCs.

Chart V.2: Trends in Financial Assistance by AIFIs

5.21 The financial assistance consists of project finance and non-project finance. While term loans, underwriting and direct subscription, and deferred payment guarantees constitute project finance, non-project finance comprises equipment finance, corporate loans, equipment leasing, investment/direct subscription to shares and debentures/bonds. There has been a significant increase in project finance, particularly loans (rupee and foreign currency loans) from investment institutions, particularly LIC, during 2003-04 (Appendix Table V.1). Further, there was a discernible moderation in the contraction of flow of credit to commercial sector from all-India development banks during 2003-04 (Table V.2). Strengthening of industrial growth on account of a boost to a spectrum of manufacturing industries reflecting an improvement in domestic and external demand conditions and reduction in excise duties on a host of intermediate inputs may have contributed to an increase in project finance sanctioned and disbursed by the FIs.

5.22 The change in the operating environment has also necessitated realignment of FIs' asset portfolio. As the margins have become thin, it has become necessary to provide a wider range of products and services with value-added features. While project financing continues to be the main product for major FIs, various innovative products have been developed to suit the clients' varied requirements. In view of the large investment requirements of the infrastructure segment, infrastructure funding

Table V.2: Resource Flow from All-India Development Banks to Corporate Sector

(Amount in Rs. crore)

Item	2002-03		2003-04	
	1	2	3	4
Sanctions		22,272		23,407
Disbursements		17,225		14,057
Credit (1+2+3+4)		-6,021		-2,845
1. Investments in stocks / shares / bonds / debentures of industrial concerns / commercial concerns		-766		-151
2. Loans and advances to industrial/commercial concerns*		-3,804		-2,525
3. Bills of Exchange and Promissory Notes / discounted and re-discounted		-1,546		-191
4. Others (Non-Funded Assistance)		95		22

* Loans and Advances to Overseas Industrial Concerns under the Lines of Credit/Buyers' Credit Programmes have been excluded.

has become a major growth area while the share of traditional economy sectors has gone down. At the same time, FIs like IDBI have entered into funding of working capital and the short-term requirement of their existing borrowers. Although sanctions and disbursements to corporate sector by the all-India development banks recorded improvement, the net flow of resources from them to the corporate sector continued to be negative during 2003-04 possibly due to the emergence of other alternative sources of project finance and on account of higher redemption by the corporate sector.

5.23 One encouraging development in 2003-04 is a substantial increase in sanctions and disbursements to infrastructure sector by IDFC. IDFC has broadened its areas of coverage. From an initial focus on power, roads, ports and telecommunications; other sectors, such as, energy, information technology, integrated transportation, urban infrastructure, health care, food & agri-business infrastructure, education infrastructure and tourism are being increasingly catered to. Sanctions by IDFC increased by 148.5 per cent to Rs.5,727 crore in 2003-04 from Rs.2,304 crore in 2002-03 and disbursement increased by 184.7 per cent to Rs.2,704 crore in 2003-04 from Rs.950 crore in 2002-03. The infrastructure sectors that witnessed substantial growth in disbursements from the IDFC were energy (308 per cent), telecommunication (172 per cent), transportation (81 per cent) and urban infrastructure (2,260 per cent) (Appendix Table V.2).

Assets and Liability Structure of FIs

5.24 The balance sheet of select FIs, as a group, showed a growth of 7.3 per cent during 2003-04 over the previous year (Table V.3). Broad trends in liabilities remained more or less the same. Bonds/debentures continued to be the largest component due to their in-built flexibility and their tradability. The share of deposits witnessed a decline as FIs, anticipating reversal of trends in the interest rates, reduced their deposit liabilities in the shorter end of the maturity spectrum. Borrowings, however, remained at the same level.

5.25 On the assets side, there was a compositional shift away from loans and advances towards investments and holding of more liquid assets. Loans and advances, the biggest component, registered a decline in its share partly on account of a decline in disbursements, despite an increase in sanctions due to increased provisioning and higher pre/repayments by borrowers. The share of investments, on the other hand, rose significantly partly due to the strong and broad-based rally in the capital markets in 2003-04, reflecting the increase in equity prices and a rise in market capitalisation.

Sources and Uses of Funds

5.26 The total sources and deployment of funds of FIs increased substantially by 26.6 per cent during 2003-04 as against a decline of 2.1 per cent during 2002-03. Both internal and external funds registered a rise during the year under review. Reflecting the substantial improvement in the industrial climate, fresh deployments registered an increase in its share in the total. Repayment of past borrowings also rose perceptibly on account of substitution of earlier high cost debt with the cheaper debt in view of the falling interest rates. Other deployments recorded a fall due, *inter alia*, to a decrease in interest payments (Table V.4 and Appendix Table V.3).

5.27 The share of fresh deployments is more or less equal to that of internal funds, whereas the combined share of repayments of past borrowings and other deployments equaled that of external and other sources of funds. This highlights the fact that while the internal funds are being used for the purpose of fresh deployments, including fresh investment, external and other sources of funds are being utilised for repayments of past debt (Appendix Table V.3).

Table V.3: Composition of Liabilities and Assets of Financial Institutions

(Amount in Rs. crore)

Item	Outstanding as at the end-March		Distribution (per cent)	
	2002-03	2003-04	2002-03	2003-04
1	2	3	4	5
Liabilities	1,83,714	1,97,064	100.0	100.0
Capital	6,784	6,784	3.7	3.4
Reserves	18,221	20,151	9.9	10.2
Bonds and Debentures	89,640	97,512	48.8	49.5
Deposits	20,144	20,699	11.0	10.5
Borrowings	21,862	23,722	11.9	12.0
Other Liabilities	27,062	28,196	14.7	14.3
Assets	1,83,714	1,97,064	100.0	100.0
Cash	8,027	15,308	4.4	7.8
Investments	21,726	32,047	11.8	16.3
Loans and Advances	1,36,819	1,33,061	74.5	67.5
Bills Discounted/Rediscounted	1,605	1,218	0.9	0.6
Fixed Assets	2,975	1,816	1.6	0.9
Other Assets	12,562	13,614	6.8	6.9

Note: 1. Data include IDBI, IFCI, TFCI, IDFC, IIBI, Exim Bank, NABARD, NHB and SIDBI.

2. Data are provisional.

Source: Balance Sheets of respective FIs.

Table V.4: Pattern of Sources and Deployment of Funds of Financial Institutions*

(Amount in Rs. crore)

Sources/Deployment of Funds	2002-03		2003-04	
	Amount	Share (per cent)	Amount	Share (per cent)
1	2	3	4	5
Sources of Funds	95,562	100.0	1,20,936	100.0
Internal	49,048	51.3	75,537	62.5
External	32,280	33.8	41,706	34.5
Others	14,234	14.9	3,694	3.0
Deployment of Funds	95,562	100.0	1,20,936	100.0
Fresh Deployments	52,028	54.4	73,173	60.5
Repayment of Past Borrowings	17,478	18.3	26,237	21.7
Other Deployments	26,056	27.3	21,525	17.8
of which: Interest Payments	10,733	11.2	10,326	8.5

* IDBI, IFCI, IIBI, IDFC, TFCI, NABARD, NHB, SIDBI and Exim Bank.

Source: Respective FIs.

Financial Assets of All-India Financial Institutions

5.28 Greater acceleration in the accretion to financial assets of the AIFIs during 2003-04 could be attributed to the substantial recovery registered in the overall economic activity. However, growth in financial assets of AIFIs was substantially lower than that of scheduled commercial banks. The financial assets of IFCI and IIBI recorded an absolute decrease over the previous year on account of the continued losses. Maximum (absolute) increase in financial assets was observed in the case of NABARD, followed by IDBI, EXIM Bank, IDFC and NHB [Table V.5, Appendix Table V.4(A) and Appendix Table V.4(B)].

Financial Performance of Financial Institutions

5.29 AIFIs as a group continued to post poor performance during the year ended March 2004. The spread (net interest income) and the operating profits declined marginally both in absolute terms and also as a ratio to the total assets. However, in line with the trend witnessed by banks and other segments of the financial sector, non-interest income registered sharp increase. The IFCI and IIBI continued to incur operating losses indicating that these FIs are earning less than what they have to pay to their lenders. Barring these two institutions, all other institutions registered positive operating and net profits. A sharp fall in the provisions for tax boosted net profits, in spite of a decline in the operating profits (Table V.6).

Table V.5: Financial Assets* of All-India Financial Institutions and Banks
(As at end-March)

(Amount in Rs. crore)

1	2003		2004	Variation during 2003-04
	2	3	4	4
A. All-India Financial Institutions	1,80,740	1,95,247	14,507	(8.0)
B. Scheduled Commercial Banks#	14,01,682	16,39,595	2,37,913	(17.0)
C. Total (A+B)	15,82,422	18,34,842	2,52,420	(16.0)
<i>Memo:</i>				
FIs' assets as percentage of total assets	11.4	10.6		
SCBs' assets as percentage of total assets	88.6	89.4		

* Include investment, loans and advances, money market assets, deposits, cash in hand and balances with banks and other assets excluding fixed assets.

As per returns under Section 42 of the Reserve Bank of India Act, 1934 and include cash in hand and balances with the banking system, investments, bank credit and dues from banks. Hence, it does not include non-SLR investments, foreign currency assets and bank reserves.

Note : Figures in brackets are percentage changes.

5.30 The IFCI which recorded an improvement in return on assets and net profit per employee during 2002-03, suffered deterioration during the year under review (Appendix Table V.5), mainly attributable to their restructuring package. In line with the recommendations of McKinsey & Co, IFCI is moving towards segregating its non-performing

Table V.6: Financial Performance of Select All India Financial Institutions®

(Amount in Rs. crore)

Item	2002-03	2003-04	Variation during 2003-04	
			Amount	Percentage
1	2	3	4	5
1. Income (a+b)	15,763	14,783	-981	-6.6
a) Interest Income	13,169	11,314	-1,855	-16.4
b) Non-interest Income	2,595	3,469	874	25.2
2. Expenditure (a+b)	13,182	12,241	-941	-7.7
a) Interest expenditure	11,825	10,918	-907	-8.3
b) Other Expenses	1,358	1,323	-34	-2.6
<i>Of which : Wage Bill</i>	391	502	111	22.0
c) Provisions for Taxation	960	730	-230	-31.5
3. Profit				
Operating Profit (PBT)	2,581	2,542	-40	-1.6
Net Profit (PAT)	1,621	1,811	190	10.5
4. Financial Ratios*				
Operating Profit (PBT)	1.4	1.3		
Net Profit (PAT)	0.9	0.9		
Income	8.7	7.5		
Interest Income	7.2	5.7		
Other Income	1.4	1.8		
Expenditure	7.2	6.2		
Interest Expenditure	6.5	5.5		
Other Operating Expenses	0.7	0.7		
Wage Bill	0.2	0.3		
Provisions	0.5	0.4		
Spread (Net Interest Income)	0.7	0.2		

@ Includes IDBI, IFCI, TFCI, IDFC, IIBI, Exim Bank, NABARD, NHB and SIDBI.

* as percentage of Total Assets.

Notes: 1. Operating Profit refers to profit before Provisions for Taxation/Tax (PBT).

2. Net Profit refers to profits after Tax Provisions (PAT).

3. IDBI data are provisional.

Source: Annual Accounts of respective FIs.

assets with the ultimate objective of hiving these off to an asset reconstruction company and focusing on further strengthening the quality of the existing portfolio.

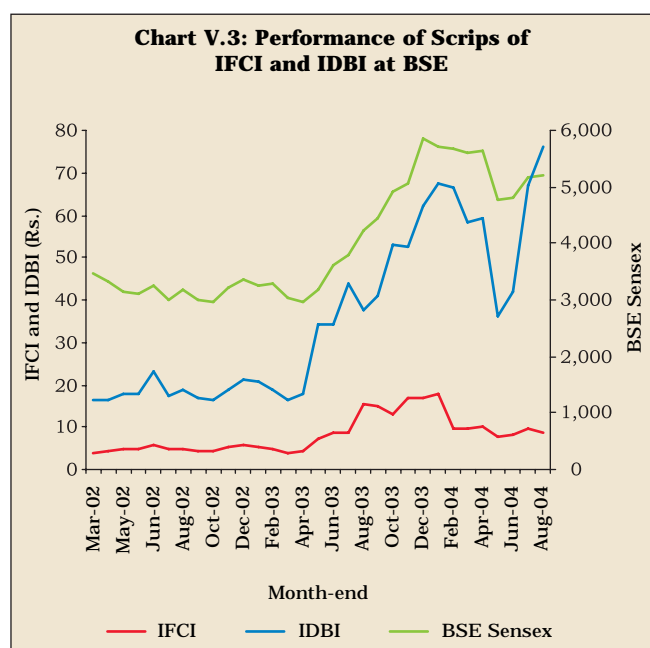
Performance of FIs' Scrips/Stocks

5.31 Out of the nine FIs under the Reserve Bank's regulatory domain, two FIs (*viz.*, IDBI and IFCI) are listed on the BSE and NSE. The performance of stocks of IDBI and IFCI reveals that both the stocks passed through a lackluster phase during 2002-03. During 2003-04, both the stocks performed well from April 2003 to January 2004 in line with the rally witnessed in the BSE Sensex. However, some corrections were witnessed in case of both the scrips after January 2004. During the current year (from May 2004 to August 2004), the IDBI scrip outperformed the BSE Sensex while the IFCI scrip witnessed a downtrend. The uptrend in the

IDBI scrip may be attributed to the restructuring proposal by the Government (Chart V.3).

Prime Lending Rate (PLR)

5.32 In line with the general softening trend of interest rates during 2003-04, the long-term PLR of IDBI declined during the year under review. Moreover, the short-term PLR was merged with the medium-term PLR. IDBI has also recently initiated a series of pro-active measures to garner new business as well as retain and win back well-performing clients to improve the quality of its asset portfolio. As part of this endeavour, the IDBI has brought down its PLR. Further, IDBI is offering a graded reduction in rupee interest rates, based on credit rating, to existing borrowers in its portfolio with a view to broadly aligning their interest rates with the prevalent interest rate regime. In the case of IFCI, there was no change in the PLR structure (Table V.7).



Capital Adequacy

5.33 The performance of the select FIs in respect of the maintenance of a minimum capital to risk weighted assets ratio (CRAR) is presented in Table V.8. It is seen that except IFCI and IIBI, all the other FIs had a CRAR much above the stipulated norm of 9 per cent as at the end-March 2004. In the case of IFCI, high NPAs - arising out of large-scale slippage from standard assets to the NPAs category, thereby negating the effect of additional provisioning led to the squeezing of cash flow. This in turn resulted in restructuring of liabilities. Further, their continued losses, *inter alia*, led to mismatches

Table V.8: Capital Adequacy Ratio* of Select Financial Institutions
(As at end-March)

Institution	(Per cent)						
	1998	1999	2000	2001	2002	2003	2004
1	2	3	4	5	6	7	8
IDBI	13.7	12.7	14.5	15.8	17.9	18.7	18.3
IFCI	11.6	8.4	8.8	6.2	3.1	0.95	-17.0
IIBI	12.8	11.7	9.7	13.9	9.2	-11.0	-20.1
IDFC	N.A.	235.5	119.7	85.5	56.7	51.3	36.9
Exim Bank	30.5	23.6	24.4	23.8	33.1	26.9	23.5
TFCI	16.4	15.4	16.2	18.6	18.5	19.8	22.8
SIDBI	30.3	26.9	27.8	28.1	45.0	44.0	51.6
NABARD	52.5	53.3	44.4	38.5	36.9	39.1	39.4
NHB	16.7	17.3	16.5	16.8	22.1	22.3	31.9

* Net of provisioning and write offs.

Source: Respective balance sheets of FIs.

Table V.7: Lending Rate Structure of Major Financial Institutions

(Per cent per annum)

Effective from	PLR	IDBI	IFCI
1	2	3	4
Mar-2002	Long-term PLR	11.5	12.5
	Medium-term PLR	12.5	—
	Short-term PLR	12.0	12.5
Jul-2002	Long-term PLR	10.7	12.5
	Medium-term PLR	12.5	—
	Short-term PLR	12.0	12.5
Mar-2003	Long-term PLR	10.2	12.5
	Medium-term PLR	12.5	—
	Short-term PLR	12.0	12.5
Jul-2003	Long-term PLR	9.6	12.5
	Medium-term PLR	12.5	—
	Short-term PLR	12.0	12.5
Mar-2004	Long-term PLR	8.9	12.5
	Medium-term PLR	10.3	—
	Short-term PLR*	—	12.5

* Merged with medium term PLR in the case of IDBI.

in assets and liabilities, resulting in erosion of IFCI's capital. Similarly, in the case of IIBI, rising NPAs and provisioning thereof, coupled with the problem of declining profitability, were some of the factors behind the negative CRAR.

Non-Performing Assets

5.34 The net NPAs of AIFIs continued to increase during 2003-04 on account of time and cost overruns in projects, slippages in the standard assets, increase in legal expenses relating to NPAs, impairment of major assets of the assisted units, contraction of credit portfolio, etc. (Table V.9 and Appendix Table V.6).

Table V.9: Net Non-Performing Assets*
(As at end-March)

(Amount in Rs. crore)

Institution	Net NPAs		Net NPAs / Net Loans (per cent)	
	2003	2004	2003	2004
1	2	3	4	5
Term Lending Institutions	12,818	13,632		
IDBI	7,157	8,693	15.8	21.1
IFCI	4,559	3,865	29.5	32.3
IIBI	915	800	34.7	38.0
IDFC	3	0	0.1	0.0
EXIM Bank	184	129	2.3	1.3
TFCI	153	145	20.4	21.1
Refinance Institutions	473	227		
SIDBI	472	226	3.8	2.4
NABARD	1	1	0.0	0.0
NHB	0	0	0.0	0.0

Source: Off-site Returns submitted by FIs.

Management of NPAs

5.35 During 2003-04, NPAs of the nine FIs grew at a lower rate than the previous year. FIs have been making concerted efforts to effectively address the problem of NPAs through various ways including recourse to compromise and negotiated settlements, rescheduling/restructuring of loans, recovery under the SARFAESI Act, 2002; implementing OTS schemes; establishing Asset Reconstruction Companies (ARCs) and recovery through Debt Recovery Tribunals (DRTs). Up to March 31, 2004, 653 cases were considered involving an amount of Rs.9,448 crore, of which an amount of Rs.844 crore was recovered under various schemes.

Mobilisation of Resources by way of Bonds/ Debentures by Select AIFIs

5.36 During the year 2003-04, total resources mobilised by way of issue of rupee bonds/debentures (including private placement and public issue) by select AIFIs aggregated Rs.23,419 crore as against Rs.14,144 crore during the previous year ended March 2003 (Table V.10). Taking advantage of the lower interest rates as in the previous year, FIs such as IDBI, NABARD, SIDBI, NHB and IDFC have raised substantial amounts during the current year. However, IFCI and IIBI (since September 18, 2003) due to their

deteriorating financial position were not permitted to raise fresh borrowings from the market. Since IFCI has been reinvesting the amounts arising out of its treasury operations and financial restructuring package with banks, FIs and provident funds; it has been able to effectively reduce its cost of borrowings. As a consequence, IFCI witnessed a decline in its outstanding borrowings at the end-March 2004 as compared to end-March 2003. IIBI and TFCI also have been able to reduce their outstanding borrowings. The total outstanding borrowings of all the FIs, however, increased to Rs.1,05,677 crore as at the end of March 2004 as against Rs.90,060 crore as at the end of March 2003 which is around 53.6 per cent of the total asset base of FIs (Table V.10 and Appendix Table V.7).

5.37 Of the total resources raised by the FIs, private placements continued to be the major mode of mobilising the resources which involved less transaction costs and also less time in terms of raising resources. Resource mobilisation by IDBI both from public issues and private placement market increased during 2003-04 as compared with the previous year. However, IDBI's reliance on the private placement market for funds requirements increased substantially as compared with the public issues during 2003-04 (Table V.11). IFCI relied solely on the private placement market for raising resources.

**Table V.10: Resources Raised by Way of Rupee Bonds/Debentures*
by Select All-India Financial Institutions**

(Amount in Rs. crore)

Institution	Resources raised		Outstandings (end-March)	
	2002-03	2003-04	2002-03	2003-04
1	2	3	4	5
IDBI	5,009	10,477	41,798	46,967
IFCI	267	-	20,203	17,564
IIBI	44	176	2,566	2,281
EXIM Bank	2,505	2,025	5,424	11,920
NABARD	2,988	5,334	8,702	11,883
NHB	1,877	2,526	4,675	6,958
SIDBI	961	1,429	4,692	5,428
TFCI	93	102	600	426
IDFC	400	1,350	1,400	2,250
Total	14,144	23,419	90,060	1,05,677

* Includes only rupee resources and does not include foreign currency borrowings.

Data are provisional.

- indicates nil.

Source: Respective FIs.

5.38 The weighted average interest rate of resources raised by the FIs eased during 2003-04 while the weighted average maturity of the instruments issued was elongated for most FIs (Table V.12 and Appendix Table V.8).

Money Market Operations of Financial Institutions

5.39 The average amount of resources raised by the FIs by way of money market instruments declined to Rs.6,035 crore (25.6 per cent of

limits) for 2003-04 from Rs.6,467 crore (25.4 per cent of limits) for 2002-03 (Table V.13). During 2003-04, term deposits were the most preferred instruments followed by commercial papers (CPs), inter-corporate deposits (ICDs), certificates of deposit (CDs) and term money.

Reserve Bank's Assistance to FIs

5.40 The practice of advancing loans by the Reserve Bank of India to industrial and agricultural financial institutions from the Long

**Table V.11: Resources Raised through Public Issues/Private Placement/Bonds/Debentures
by Major Development Finance Institutions**

(Amount in Rs.crore)

Type of Issuance	IDBI		IFCI		Total	
	2002-03	2003-04	2002-03	2003-04	2002-03	2003-04
1	2	3	4	5	6	7
Public Issue	2,216 (42.4)	2,930 (29.7)	0.0 (0.0)	0.0 (0.0)	2,216 (35.8)	2,930 (28.9)
Private Placement	3,008 (57.6)	6,942 (70.3)	965 (100.0)	267 (100.0)	3,973 (64.2)	7,209 (71.1)
Total	5,224 (100.0)	9,872 (100.0)	965 (100.0)	267 (100.0)	6,189 (100.0)	10,139 (100.0)

Note: Figures in brackets indicate percentage share in total resource mobilisation.

Table V.12: Weighted Average Cost/Maturity of Resources Raised by way of Rupee Bonds/ Debentures by Select All-India Financial Institutions

Institution	Weighted Average Cost (Per cent)		Weighted Average Maturity (Years)	
	2002-03	2003-04	2002-03	2003-04
1	2	3	4	5
IDBI	8.5	6.5	4.3	5.1
IIBI	9.6	8.7	8.7	18.0
IFCI	9.6	8.2	2.2	3.2
TFCI	8.5	8.6	10.0	10.0
EXIM Bank	8.9	5.9	6.1	6.7
IDFC	7.6	5.6	5.6	5.9
SIDBI	6.5	4.9	2.3	2.8
NABARD	6.1	5.4	5.4	5.4
NHB	6.4	5.4	4.0	3.2

Note: Data are provisional.
Source: Respective FIs.

Term Operations (LTO) funds before transferring the surplus profit of the Reserve Bank to the Government of India was discontinued subsequent to an announcement made in the Union Budget for 1992-93. Accordingly, from the year 1992-93, the Reserve Bank has been making only token contributions to these funds (Table V.14).

5.41 During 2003-04 (July-June), no long-term assistance was sanctioned by the Reserve Bank to any financial institution. While there were no outstanding long-term borrowings with any institution under the NIC (LTO) funds as at end-June 2004, the outstanding credit to NHB under the NHC (LTO) Fund stood at Rs.50 crore as at end-June 2004. Out of total Rs.175 crore, outstanding as at end June 2003, NHB

repaid Rs.125 crore to the Reserve Bank during May 2004.

5.42 The Reserve Bank sanctioned *ad hoc* borrowing limits for 12 months (July to June) aggregating Rs.180 crore to SFCs during 2003-04 at Bank Rate. These limits have been extended by a maximum period of six months. These short-term financial accommodations were backed by the pledge of *ad hoc* bonds issued by the SFCs and guaranteed by the respective State Governments/Union Territories. However, as at end-June 2004, there was no outstanding medium/short term credit to SFCs.

5.43 Major FIs, viz., IDBI, IFCI, SIDBI are engaged in venture capital funding activities to promote entrepreneurship and support them during critical phases of venture. FIs also

Table V.13: Money Market Operations of Select All-India Financial Institutions

(Amount in Rs. crore)

Instrument	2002-03	2003-04
1	2	3
Term Deposits	1,548	2,206
Term Money	373	245
Inter-corporate Deposits	3,078	1,329
Certificates of Deposit	504	408
Commercial Paper	964	1,847
Total	6,467	6,035
Percentage of limits	25.6	25.4

Table V.14: Reserve Bank's Assistance to Financial Institutions

(Amount in Rs. crore)

Type of Assistance (outstanding)	June 30, 2003	June 30, 2004
1	2	3
Long Term Credit [NHC(LTO) Fund]		
NHB	175	50
Medium / Short Term Credit		
SFCs	17	-
Total	192	50

encourage commercial applications of indigenous technologies or adaptation of imported technologies, development of innovative products and services, holding substantial potential for growth and bankable ventures but involving higher risk including those in the information technology (IT) Sector. Similarly, FIs have been assigned to provide need based assistance for technological development. Government of India introduced the Technology Upgradation Fund Scheme (TUFS) for textile and jute industries in April 1999, which is in operation up to March 2007. The Scheme is intended to provide induction of state-of-the-art or near state-of-the-art technology in textile industry. IDBI and SIDBI are nodal agencies for assistance under TUFS for textile industry (non-SSI) and textile industry (SSI), respectively while IFCI is the nodal agency for the jute industry.

6. Restructuring of Financial Institutions

Transformation into Universal Banking

5.44 With the blurring of functions between banks and FIs, the business model of a bank is being increasingly accepted for FIs also. Accordingly, there is a move to restructure FIs like IDBI and IFCI. The merger of the ICICI with ICICI Bank on March 30, 2002 was the beginning of the conversion of DFIs into universal banks as a solution to their problems. Universal banks would engage not only in traditional banking, but also investment banking and other financial activities. Since the merger of ICICI with ICICI Bank, similar moves are underway to transform the other principal DFIs in the country, viz., IFCI and IIBI. In the Union Budget 2004-05, it was indicated that IFCI will be restructured through transfer of its impaired assets to an asset reconstruction company and by effecting merger with a large public sector bank.

5.45 In view of the changing operating environment following initiation of reforms since the early 1990s, Government of India decided to transform IDBI into a commercial bank without eschewing its traditional development finance obligations. The migration to the new business model of commercial banking, with its access to low-cost current/savings bank deposits, would not only enable it to overcome most of the limitations of the current business model of development finance but also

simultaneously help in diversifying its client/asset base by offering various retail liability products. Towards this end, the IDBI (Transfer of Undertaking and Repeal) Act 2003 was enacted in December 2003 which became effective since July 2, 2004. The Act provides for repeal of IDBI Act, corporatisation of IDBI (with majority Government holding) and transformation into a commercial bank. On July 29, 2004, the proposal to merge IDBI and IDBI Bank was accorded in-principle approval. IDBI became IDBI Ltd. on October 1, 2004 and being a 'scheduled bank' under the Reserve Bank of India Act, 1934, IDBI Ltd. can formally enter the portals of banking business over and above the business currently being transacted.

5.46 In this connection, the Government of India has already approved the IDBI's proposal to set up a Stressed Asset Stabilisation Fund (SASF) wherein stressed assets of IDBI worth Rs.9,000 crore would be transferred by IDBI to SASF against transfer of equivalent amount of 20 year bonds issued by the Government of India in favour of SASF on cash/budget neutral basis. Apart from significantly improving the quality of IDBI's portfolio, the measure may facilitate recovery from the earmarked NPAs over an elongated time-frame.

5.47 The Board of Directors of IFCI has approved, in principle, its merger which is expected to facilitate progress towards universal banking. IFCI has also continued to give renewed thrust on expanding the advisory service business during the year. It may be mentioned that the Government of India has already decided to take over certain liabilities of IFCI and correspondingly, the Reserve Bank has provided certain regulatory, relaxations for restructured liabilities of IFCI.

5.48 Given the need to achieve global scales of production, funding of expansion and diversification programmes of the existing corporates have also been identified as a key business objective. As competition has created pressure on margins and disintermediation has altered the scope of term lending, FIs have accorded priority to fee-based activities like merchant banking and corporate advisory services.

5.49 The SARFAESI Act enacted in 2002 has provided an enabling legal/regulatory environment for dealing with NPAs by term-lending institutions. Under the Act, FIs can now

attach assets of defaulting borrowers without having the requirement of approaching the court for recovery of NPAs. Given the problem of NPAs faced by FIs, the role of Securitisation Companies/Asset Management Companies/Asset Reconstruction Companies which buy the assets of banks and FIs with substantial amount of NPAs, becomes important (Box V.3 and Box V.4).

7. Other Developments

5.50 The Union Budget 2004-05, presented on July 8, 2004, has spelt out a number of positive measures for financial sector participants. The focused pursuit of infrastructure development through pooled investment of Rs.40,000 crore by the proposed Inter-Institutional Group (IIG),

comprising IDBI and select FIs and banks, is expected to stimulate their business volumes.

Corporate Debt Restructuring Mechanism

5.51 Corporate Debt Restructuring (CDR) system was developed in India based on the international experience. Detailed guidelines were issued for implementation by banks and FIs in 2001. The objective of the framework has been to ensure timely and transparent mechanism for restructuring the corporate debt of viable entities, outside the purview of Board for Industrial and Financial Reconstruction (BIFR), Debt Recovery Tribunals (DRTs) and other legal proceedings. The CDR system effectively became operational from March 2002 with the execution of Inter Creditor Agreement (ICA) on February 25, 2002

Box V.3: Functioning of Asset Management Companies: International Experience

Asset management companies/asset reconstruction companies (AMCs/ARCs) have been set up in various countries to solve the problem of bad loans. AMCs take over non-performing assets (NPAs) of banks at discounted rate and manage and dispose of such assets.

The word 'asset reconstruction company' is a typical Indian word - the global equivalent of which is asset management companies and owes its origin to Narasimham Committee I which envisaged the setting up of a central Asset Reconstruction Fund. The money contributed by the Central Government to ARF was sought to be used by banks to clean up their balance sheets by writing-off the non-performing loans. This idea of ARF did not work as Government opted to recapitalise weak public sector banks to manage their own NPAs. Narasimham Committee II recommendations submitted in 1998, however, reiterated its proposal in the form of ARCs. The Union Budget 1998-99, thus encouraged a few banks with high NPAs to set up ARCs on an experimental basis and subsequently set up a task force in July 1998 to study possible modalities and prepare an operating plan for establishing ARCs in India. To provide the necessary legal backing for ARCs, the Government passed the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002. Similarly, a way out of the current dilemma, faced by the financial institutions in respect of shortage of resources, is to resort to ARCs as an asset reconstruction device to sell off the NPAs of the FIs.

Similar entities had already been successful in Malaysia, Korea and several other countries in the world. AMCs used broadly two approaches: i) restructuring of the debt/borrowing and ii) the outright sale of the loan/underlying assets. The experience of AMCs suggests that a prompt disposal of assets enables them to achieve their objective. In the aftermath of the East Asian financial crisis, Indonesia, Korea, Malaysia, and Thailand each established a centralized AMC to purchase, restructure, and dispose

of NPLs from banks and other financial institutions, and instituted informal mechanisms for corporate debt restructuring. Nearly seven years since the onset of the crisis, some of these 'crisis-created' institutions have already ceased operations. Likewise over the next two years, a couple of the AMCs will reach the end of their mandates. Major factors facilitating the successful functioning of an AMC are strong political will, supportive legal structure, efficient market environment, adequate governance, realistic asset pricing and speedy disposal of acquired assets.

In Thailand, the Government set up the Thai Asset Management Corporation (TAMC) which buys bad loans of state banks. TAMC has restructured debts worth Bt 753.33 billion in its first three years of operation which represent 96.7 per cent of its total distressed assets. China initially had four financial asset management companies (AMCs) to take over a total of 1.4 trillion Yuan (US \$168 billion) of non-performing loans. Till June 2004, these four AMCs disposed of NPAs with 45.7 per cent assets-disposal ratio and 20.7 per cent as cash-recovery ratio. In addition to this, six licenses have been issued further to other companies allowing them to be involved in asset management. In Taiwan, AMCs promoted by international investors participate in the auctions and submit bids to acquire NPAs after carrying out negotiations with financial institutions directly.

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Statistics Data, China Banking Regulatory Commission, July 2004.

Box V.4: Regulatory Environment for ARCs in India

In India, the enactment of SARFAESI Act, 2002 enabled lending agencies (banks and financial institutions) to foreclose and sell underlying assets without court intervention. The existing framework envisages non-Government supported multiple ARCs/securitisation companies, which may be set up by the lenders, NPA investors or corporates. The SARFAESI Act permits an ARC to commence operations with a minimum net-owned funds of Rs. two crore. Directions require an ARC to maintain a capital adequacy ratio of 15 per cent of its risk-weighted assets. However, financial assets held in trusts shall not be subject to capital adequacy requirements. An ARC may issue bonds and debentures for meeting its funding needs but cannot mobilise deposits. ARCs can acquire financial assets by way of simple agreement from the banks/FIs subject to some terms and conditions or by an issuance of bonds and debentures to the originating banks/FIs. All the rights of the lender vest in the ARC after acquiring the assets and become party to all the contracts/deeds/agreement etc. ARCs are also allowed to function as a manager of collateral assets taken over by the lenders under security enforcement rights available to them as a recovery agent for any bank/institution. Since the date of acquisitions of assets, ARCs are given a resolution time frame of maximum five years. As per the Act, to discharge its function of asset reconstruction, an ARC can undertake i) enforcement of security interest, ii) takeover or change the management of the borrower, iii) undertake sale or lease of the borrowers' business and iv) enter into settlements and reschedule the debt. However, as per the SARFAESI, for enforcement of security interest, at least 75 per cent of the secured creditors need to agree to exercise this right.

For speedier resolution of NPAs, financial assets due from a single debtor to various banks/ FIs may be considered for acquisition. Similarly, financial assets having linkages to the same collateral may be considered for acquisition to ensure relatively faster and easy realisation. As per the guidelines, the valuation process should be uniform for assets of same profile and a standard valuation method should be adopted to ensure that the valuation of the financial assets is done in a scientific and objective manner. Valuation may be done internally and or by engaging an independent agency, depending upon the value of the assets involved. The acquired assets may be sold by inviting quotations from persons dealing in such assets, by inviting tenders from the public, by holding public auctions or by private treaty. While there is no restriction on ARCs to acquire assets which are considered to be unrevivable, as per the guidelines to banks, ARCs will normally not takeover such assets and will act as an agent for recovery on a fee basis for these assets.

Three ARCs, viz., Asset Reconstruction Company (India) Ltd. (ARCIL), Asset Care Enterprise (ACE) Ltd. and ASERC (India) Ltd. have been registered. ACE Ltd. and ASERC Ltd. are yet to start their operations. ARCIL has bought assets

worth Rs.9,631 crore from the banks and financial institutions at a price of 2,089 crore. IDBI has transferred 11 cases with aggregate principal outstanding of Rs.239 crore to ARCIL. Up to March 31, 2004, IFCI's Board of Directors had approved the offer made by ARCIL to acquire 4 NPA accounts with an aggregate net outstanding of Rs.173 crore at a discounted value of Rs.83 crore. As on March 31, 2004, ARCIL had given further proposals for acquiring 16 more NPAs (principal amount outstanding in IFCI's portfolio of Rs.334 crore, for which offers received amounted to Rs.146 crore) which were under consideration. IIBI and SIDBI have also been exploring the option of selling their NPAs to ARCs.

One of the important issues in respect of ARCs in India is that of difference in stamp duty rates on the assignment of financial assets across the States which, in turn, impacts the transaction costs. Another issue is the appropriate number of securitisation companies/AMCs required in the present environment since too many companies can lead to the problems relating to debt aggregation and impede the process of asset reconstruction. To prevent entry of non-serious players and orderly functioning of ARCs, the registration process needs to emphasise upon ARCs promoted by reputed parties with adequate financial backing. The functioning of ARCs also depends on the willingness of lender banks and financial institutions to transfer NPAs to the ARCs. In the case of India, security enforcement seems to be a key resolution strategy for securitisation companies and ARCs because majority of the NPAs belong to doubtful and bad debts category. Therefore, to dispose of these assets and improve recovery levels, market trading of such acquired assets is essential. In order to ensure a sound capital base and a stake in the management of the NPAs acquired, the requirement of owned fund for commencement of business has been stipulated as not less than 15 per cent of the assets acquired or Rs.100 crore, whichever is less. A Report by Asian Development Bank (February 2004)³ suggested further policy changes required for the proper functioning of ARCs. The major recommendations were: i) amending SARFAESI Act to enable a single party to control an ARC, subject to safeguards to be regulated by the Reserve Bank against 'warehousing' of NPAs, ii) allowing single party including foreign entities to subscribe to entire 100 per cent of security receipts of a scheme, iii) ensuring and clarifying that asset managers are permitted to undertake all activities for asset reconstruction under SARFAESI Act.

References:

Technical Assistance (TA) No. 3943-IND, Developing the Enabling Environment for and Structuring Asset Reconstruction Companies in India, Final Report, Volume I, February 2004 available at the website of Ministry of Finance, Government of India.

³ The Asian Development Bank, in consultation with Ministry of Finance, appointed PricewaterhouseCoopers and two law firms Amarchand & Mangaldas and Blake Dawson Waldron Lawyers to carry out an engagement for 'Developing the Enabling Environment for and Structuring Asset Reconstruction Companies in India'.

by 49 FIs which includes public sector banks (34) and private sector banks (15). Over a period, the membership increased from 49 to 65 members, after Asset Reconstruction Company of India Ltd. (ARCIL) and Assets Care Enterprise (ACE) joined the CDR System.

5.52 With a view to making the operations of the CDR mechanism more efficient and in order to further simplify the mechanism, a High Level Group (Chairman: Shri Vepa Kamesam) consisting of Bankers and others was set up, pursuant to the announcement by the Finance Minister in the Union Budget 2002-03. Based on the recommendations made by Group and in consultation with the Government of India, the Reserve Bank has since revised the scheme of corporate debt restructuring. The revised guidelines were issued in February 2003 in supersession of the earlier guidelines.

5.53 The main features of the revised guidelines are the introduction of two types of restructuring under the CDR System. Accounts which are classified as 'Standard' and 'Sub-standard' would be restructured under the first category (Category-I) whereas accounts classified as 'doubtful' would be restructured under second category (Category-II). CDR will have a three-tier structure consisting of CDR Standing Forum and its Core Group (the policy-making body), CDR Empowered Group (the functional group deciding on the restructuring of cases referred to CDR mechanism) and the CDR Cell (the secretariat to the CDR system). Other notable changes in the scheme relate to broadening of eligibility criteria to include suit-filed cases provided the proposal to restructure is supported by 75 per cent of the lenders by value; eligibility of large erstwhile BIFR cases to be decided by CDR Core Group, composition and enhancement of the scope of the Core Group, additional functions to CDR Empowered Group, flexibility in sanction of additional assistance as part of restructuring package, availability of exit option out of the package, restructuring of 'Doubtful Assets' cases under category-II scheme, discretion to join CDR System on a case-by-case basis to institutions like UTI, LIC, GIC, and foreign lenders who have financed from outside the country.

5.54 As on June 30, 2004, the CDR Standing Forum has met six times, Core Group 14 times, and Empowered Group 53 times. Of the 135

applications received, CDR cell has referred all the cases to the Empowered Group within the stipulated time of 30 days. The Empowered Group approved final schemes in respect of 94 cases in which aggregate assistance by financial system amounted to Rs.64,017 crore, 30 cases were rejected/closed and remaining 11 cases with aggregate outstanding assistance of Rs.2,677 crore are under various stages of consideration.

Mutual Funds

5.55 The Resource mobilisation by mutual funds increased more than nine-fold during 2003-04 mainly due to a large increase in resource mobilisation by the private sector mutual funds and a net inflow in UTI in contrast to a net outflow during the corresponding period of the previous year (Table V.15 and Appendix Table V.9). Bulk of the resources mobilised by the mutual funds is by way of money market schemes (52.5 per cent) and debt instruments (27.3 per cent) while mobilisation in equity oriented schemes accounts for just over 15.4 per cent (Table V.16). In the secondary market, although traditionally, mutual funds were seen to be net sellers in equity and net buyers in debt, there has been a reversal of the trend in 2003-04 with the mutual funds turning out to be net buyers of equities and debt to the tune of

Table V.15: Resource Mobilisation by Mutual Funds

(Amount in Rs. crore)

Mutual Fund	2002-03	2003-04
1	2	3
I. Public Sector	1,895	3,762
II. Unit Trust of India	-9,434	1,050*
III. Private Sector	12,122	42,873
Total (I+II+III)	4,583	47,684

* Data for 2003-04 relate to UTI Mutual Fund for the period February 1, 2003 to March 31, 2004, being the first year of operation after the bifurcation of erstwhile UTI into UTI Mutual Fund and Specialised Undertaking of the Unit Trust of India.

- Notes:
1. Data are provisional and compiled on the basis of information received from respective mutual Funds.
 2. For UTI, the figures are net sales (with premium), including re-investment sales, and for other mutual funds, figures represent net sales under all schemes.
 3. Data exclude amounts mobilised by off-shore funds and through roll-over schemes.

Table V.16: Net Resource Mobilisation by Mutual Funds : By Types of Schemes

(Amount in Rs. crore)

Type of Scheme	2000-01	2001-02	2002-03*	2003-04
1	2	3	4	5
Money Market Schemes	2,564 (28.1)	3,291 (45.9)	5,005 (119.3)	24,576 (52.5)
Government Securities	-312 (-3.4)	1,563 (21.8)	-691 (-16.5)	2,232 (4.8)
Debt Instruments	4,839 (53.0)	8,210 (114.4)	1,467 (35.0)	12,795 (27.3)
Equity Oriented Schemes	-745 (-8.2)	-534 (-7.4)	43 (1.0)	7,219 (15.4)
Others	2,782 (30.5)	-5,355 (-74.6)	-1,628 (-38.8)	-13 (0.0)
Total	9,128	7,175	4,196	46,809

* Since the bifurcation of UTI into UTI Mutual Fund (registered with SEBI as UTI II) and Specialised Undertaking of the Unit Trust of India (UTI-I), data for UTI-I are only up to January 2003.

Notes : 1. Net resource mobilisation is arrived at after netting out the repurchases/redemption from the gross resource mobilisation.

2. Figures in parentheses pertain to the share of the particular scheme in the total net resource mobilisation.

Source: Securities and Exchange Board of India.

Rs.1,308 crore and Rs.22,701 crore, respectively. The debt oriented schemes accounted for the largest share of assets under management of the mutual funds (45 per cent) followed by money market schemes (30 per cent) and equity oriented schemes (18 per cent). During the year 2003-04, the Net Asset Value (NAV) of both equity and debt oriented schemes of all the mutual funds witnessed significant improvement as expected on account of bullish trends in the prices of equity as well as debt securities.

Policy Developments relating to Mutual Fund

5.56 Several measures were undertaken during 2003-04 to further improve the operations and governance of the mutual funds. These include, *inter alia*, applicability of investment

limits prescribed by SEBI (Mutual Fund) Regulations, 1996 to all debt securities, stipulating the minimum number of investors in each mutual fund, permitting mutual funds in the securities market only upon quoting the unique client code, mandatory completion of the certification process by all existing personnel of mutual funds/AMCs. Guidelines were issued for the participation of mutual funds in derivatives trading, making it mandatory for investors in mutual fund schemes to mention their bank account numbers in their applications/requests for redemptions, adopting a uniform cut-off time for applying NAVs both for subscriptions and redemptions of mutual funds, and permitting mutual funds to invest in foreign securities up to 10 per cent of their net assets, etc.