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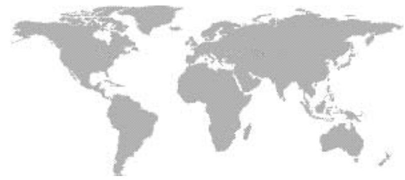

INDIA: Evaluating Bank Assistance for Financial Sector Development

A Country Assistance Evaluation

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Abbreviations

ADB	Asian Development Bank
ALM	Asset/liability management
ARC	Asset reconstruction company
BSF	Back-stop facility
CARs	Capital adequacy ratios
CAS	Country assistance strategy
CEM	Country economic memorandum
CRR	Cash credit requirements
DFIs	Term lending institutions
DRT	Debt recovery tribunal
ESIL	External sector and investment regime liberalization
ESW	Economic and sector work
FSDP	Financial sector development project
GOI	Government of India
IB	Indian Bank
ID	Institutional development
IFC	International Finance Corporation
IMF	International Monetary Fund
IOB	Indian Overseas Bank
NPAs	Nonperforming assets
PSB	Public sector bank
RBI	Reserve Bank of India
RM	World Bank’s Resident Mission
SAL/SAC	Structural adjustment loan/credit
SSN	Social safety net
USAID	United States Agency for International Development

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Preface

This paper is one of the background papers prepared as an input to the India Country Assistance Evaluation (Task Manager: Mr. Gianni Zanini) by the Operations Evaluation Department (OED) of the World Bank. Findings are based on a review of project appraisal and completion reports, sector reports, and a number of other documents produced by the Borrower, the Bank, OED, and research papers. An OED mission visited India in April/May 1999. The mission interviewed current and retired government officials and Indian experts. Bank staff were interviewed at both headquarters and in the field office. Their valuable assistance is gratefully acknowledged.

Peer reviewers were Ms. Laurie Effron (OEDCR) and Mr. Anandarup Ray (Consultant, OEDCR). An earlier version of this paper was reviewed by the Bank's India financial sector team, the Department of Economic Affairs in the Ministry of Finance, and by the Department of Economic Analysis and Policy (Division of International Economic Relations) of the Reserve Bank of India. It was discussed at a workshop in New Delhi on March 31, 2000, chaired by Dr. Omkar Goswami and with the participation of central and state government officials, academics and members of policy research institutes, and other representatives of civil society.

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Executive Summary

1. The Indian financial system has been a government instrument over the last four decades, to mobilize resources and to allocate them to the public and private sectors. Though the financial sector grew both in size and diversity, it remained highly repressed, with negative real interest rates and inefficient allocation of resources. Despite this, however, there was impressive financial deepening. In 1991, the beginning of the reform period, M3/GDP ratio was high at 49 percent; the ratio of household sector's saving in financial assets was around 9 percent and there was a wide choice of financial instruments. India's financial sector compared well with those in East Asian countries; commercial banks dominating the sector accounted for 70 percent of total financial assets. But the resources were preempted, to the extent of 80 percent, by liquidity and cash requirements, directed credit and special programs. Discretion for management was limited; bank concentration was pronounced with interest rate spread of 12 percent; most of the public sector banks (PSBs) were involved in losses; foreign banks yielded better results; capital adequacy ratios were too low at 1-5 percent of assets. The financial position of banks was fragile with NPAs ranging between 15-45 percent; legal framework was weak to recover bad loans; accounting standards were not uniform; Reserve Bank of India's (RBI) supervision was weak as the emphasis was on economic regulation rather than prudential.

2. Following sweeping financial reform policies initiated in mid-1991, the Government of India (GOI) and the RBI adopted a medium-term strategy of financial sector reform which comprised strengthening capital adequacy ratio, tightening supervisory capabilities, recapitalization of banks, enhancing flexibility in asset management (lowering liquid assets and cash ratios, removal of subsidy in directed credit, elimination of interest rates both on loans and deposits, raising of auditing standards, improvement of asset classification; etc. The impact of the reform was substantial and in a desired direction. NPAs at end 1997-98 were about 18 percent of total loans and 9.25 percent net of provision. Competition from private domestic banks and foreign banks increased to some extent. The profit/total assets of PSBs was positive even in excess of provision. Asset classification was generally below international standards, and compared favorably with the standards in East Asia, and the autonomy of PSBs still remained limited.

3. The World Bank's involvement in India's financial sector needs to be viewed not only by what it did for the financial sector but also by the extent to which it contributed to minimizing the microeconomic distortions in the Indian economy. The World Bank had a clear strategy regarding assistance to India, both relating to the overall economy and the financial sector, articulated through its economic and sector work (ESW), country assistance strategies (CAS), country economic memorandums (CEM), sector report on the financial system (in 1990) and a stream of regular informal dialogues and policy notes on specific topics. The Bank's strategy emphasized removal of macroeconomic risks that might arise from the unsound banking system and that the financial system should meet adequately and efficiently the credit needs of the deregulated private sector. The Bank's diagnosis of the financial sector rightly stressed that it was good at mobilization of resources but weak at allocation and functioned without prudential norms.

4. The Bank used three lending instruments, structural adjustment loan/credit (SAL/SAC, 1991), external sector and investment loan (ESIL, 1993), which had considerable impact on the financial system, and FSDP (1995). The first two addressed the problems of macroeconomic distortions and structural change central to the financial sector reform and the last one FSDP focused on the six PSBs in respect of recapitalization and management and institutional development. The implementation of the first two was quick and impact was immediate in creating space for the growing private sector and the congenial environment for the efficient

development of the financial sector. The FSDP objectives were achieved, partially or otherwise, but their effect on management of the concerned banks was not so far apparent nor was its components well formulated as one of its constituents was dropped at the very beginning of the program implementation.

5. Only two of the six banks were recapitalized. Two of the banks started privatization through issue of equity in the market. Five of the banks reached stipulated CARs of 8 percent of assets. All the banks reached targeted profits. The project succeeded to some extent to demonstrate the best practices to other banks in India. However, the impact of the project on the management development of the targeted banks was imperceptible. There was a doubt whether those banks would not lose capital again. The FSDP is still ongoing but on present indications based on supervision reports, the probable outcome would be moderately satisfactory; it's expected ID impact and sustainability would be at best modest and likely respectively.

6. The Bank's effectiveness in improving the aggregate performance of the financial sector is viewed in two ways—first by evaluating its ESW and second by evaluating its two major adjustment loans—SAL/SAC and ESIL and FSDP. As regards the first, the Bank's nonlending assistance played an important role in financial reform as it set out all issues involved and indicated the policy choices to the borrower. Its report on the banking system (1990), a subsequent volume on the proceedings of the banking seminar (in 1997) and the payments system (1998) contributed to a better understanding of the financial reform by the policymakers, the bankers and the public at large. On this count, the ESW is given a top billing of 1, in all categories—strategic relevance and timeliness, internal quality, presentation, and likely impact. The Bank's SAL/SAC operation among the three operations had a large impact on the development of the financial sector as it aimed at removal of the microeconomic distortions in the economy. Interest rate controls were dismantled, directed credit scaled down, new accounting standards set, competition ushered in, prudential and supervision system introduced. Despite all this, the banking system still remains massively inefficient state-controlled system. Competition is minimal, foreign and private banks have not had any significant impact; privatization is used simply as a revenue-raising device; bank supervision is still compliance-oriented; accounting system has some major flaws and the auditing standards are out of alignment, with international norms and NPAs are growing as fast as fresh lending because of poor lending practices and the flawed legal framework. For all these reasons, the Bank's aggregate sectoral assistance performance is rated as moderately satisfactory in regard to outcome, modest in regard to relevance, efficacy, institutional development impact and likely in respect of sustainability.

7. However, there is a heavy agenda of reforms of the financial system, still unfinished. The Bank's effectiveness in future will depend on how it could accelerate those reforms, both through its lending and nonlending services. NPAs problem still is serious, the operational efficiency of banks is low without the incentive structure, as in the Western countries. Privatization of banks is slow and management efficiency will not improve, unless the majority share holding and management are in the private sector. The Bank's ESW was prescient and focused on the major relevant issues for the sector and the Bank is likely to continue this work even with greater effectiveness than in the past. The Bank needs to devise a lending instrument with appropriate policy content which will give weight to sequencing of various elements of second generation financial reforms and their effective implementation.

1. Introduction

1.1 The Indian economy has been decisively in economic transition since 1991 from being pervasively controlled to being left largely to be governed by market forces. India's growth journey has never been smooth; it faced at least four major crises—the first one during the mid 1960's, two in 1970's, and the last one in mid 1991. Though the trigger points for the first three crises were provided by the internal and external shocks such as drought and oil price hike, they had their origin in the long-standing policy regime India adopted. There were sporadic attempts, however, to alter the policy frame particularly in early 1970's and mid 1980's but they were feeble, faltering and inconsistent because of the microeconomic inefficiencies endemic in the prevalent policy framework. It was during the last crisis of mid-1991 that it was realized that sound macroeconomic policies could not be formulated without eliminating the microeconomic distortions such as a repressed financial system, industrial licensing, price controls and stifling foreign exchange and trade regimes. It was such a crisis-ridden milieu of 1991 that forced a path breaking departure from the long-standing policy framework which opened the Indian economy to the influence of market forces both from within and outside.[1]

1.2 The economic reforms were undertaken admittedly on Government of India's (GOI) own initiative, but the World Bank in particular played a prominent accommodating role, firstly by preparing sustained in-depth and comprehensive analytical work in a period prior to 1991 on India's trade regime, foreign exchange regulation, industrial policy and financial sector which focused on the main issues that impeded the pace of India's growth. Also immediately after India embarked on radical economic policy, the World Bank came up with promptitude a supportive Structural Adjustment Loan/Credit (SAL/SAC)—a first ever quick disbursing policy loan for India during its over forty years long association with it and followed it up with three other adjustment loans in quick succession which all contributed to the acceleration of the Indian reform program. The Bank also gave India a Financial Sector Development Project loan (FSDP) yet another first of its kind to India which combined policy element with institutional development.

2. State of the Financial System on the Eve of Economic Reforms, 1991[2]

2.1 The Indian financial system has been a government instrument over the last four decades, to mobilize resources and to allocate them both to the private and public sectors. Despite financial repression, India could boast a striking financial deepening comparable to that in several East Asian and even some of the industrial countries. Broad money as a ratio to GDP in India was 49 percent in 1991. On the basis of a more meaningful measure as represented by the ratio of household sector's saving in financial assets to GDP, the progress was even more remarkable.

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[1] The Indian economic policy and problems in a period prior to 1991 have been extensively documented in several studies and publications such as: Joshi V. and Little I.M.D. *India: Macroeconomics and Political Economy, 1964-1991,* World Bank and Oxford University Press, 1996; Khatkhate, D., "National Economic Policies in India," in *National Economic Policies: Handbook of Comparative Economic Policies*, Vol. I, edited by D. Salvatore, Westport, C.J. Greenwood 1991; Bardhan, P ., *The Political Economy of Development in India* , 1984, Basil Blackwell, Oxford; Bhagwati, J., *India in Transition: Freeing the Economy*, 1993 (Oxford Clarendon Press); Desai, A., *My Economic Affair*, 1993, Wiley Eastern Limited, New Delhi; I. Ahluwalia and I.M.D. Little (ed), *India's Economic Reform and Development: Essays for Manmohan Singh*, 1998, Oxford University Press, New Delhi.

[2] Much of the data and the insights in this section are sourced from the following: D. Khatkhate and J. Nayak, *India: Private Capital Flows and Financial Integration,* (unpublished), World Bank, 1996; J. Nayak, *Reform of India's Financial System*, 1993 (unpublished), Asian Development Bank; World Bank (1990), *India: Financial Sector Report, Consolidation of the Financial System*, Washington, D.C.

Total household saving and gross household financial saving as ratios of GDP were at 18.4 and 8.6 percent respectively. The choice of financial instruments with differing risk and return profile available to investors was wide, varying from deposits with post-office and all financial institutions to contractual savings and bonds and shares of private companies, apart from several financial instruments issued by government and semi-government public entities. Particularly noteworthy was a large proportion of deposits raised in the rural areas, constituting as high as 17 percent of total bank deposits.

2.2 Around mid-1991, commercial banks were the primary institutions in India's financial system. They had almost 70 percent of total financial assets, the remaining claimed by the term lending institutions (DFIS) generally owned by the government. Twenty-seven nationalised banks dominated commercial banking accounting for 92 percent of commercial banks' assets. Being closely controlled by the GOI and the Reserve Bank of India (RBI), banks had little autonomy in allocation of credit. The cash and liquidity requirements took away 53 percent of bank deposits and directed credit absorbed another 20 percent; in addition special programs claimed about 10 percent, leaving barely 20 percent of bank resources to the discretion of bank management. Even that was subjected to window guidance from the RBI, even to the minutest details.

2.3 At first blush, the Indian banking system did not appear to be particularly monopolistic with concentration ratios being lower in 1991 than in many other countries. In actual practice, there was hardly any competition among banks as evidenced by the unchanging shares of ten largest banks in bank assets. The public sector banks operated in collusive manner which derived in large part from the regulatory framework. Lead development bank managed consortia for large investment loans. The RBI, until 1997, regulated lending to large borrowers, first ex-post and then ex-ante. Working capital lending was governed by a number of RBI restrictions as regards the size of loans. Large borrowers could not change banks easily under consortium arrangements; branching was controlled and the RBI's interest rates policy had the effect of stifling competitive spirit of banks.[3]

2.4 The overemphasis on banks as saving mobilizers has diverted attention away from the management of banks' assets. The Indian banks, in view of the inadequacy of their allocative—transactional policies, could not make optimal use of saving mobilized through it. The public sector banks (PSBs) had a relatively low credit/deposit ratio, a consequence, among others, of strong interventionist policies which led to a high interest rate spread of 12 percent so as to achieve adequate operating profits. Thirteen of the 27 PSBs experienced losses to the extent of 5 to 10 percent of their assets in 1991. Fourteen other PSBs earned a profit between 0-0.5 percent of their assets. Those which earned profits beyond 1 percent and up to 7 percent of assets were all foreign banks. Even the low capital adequacy ratio was overstated because of the misleading income recognition and loss provisioning practices adopted by the banks. Due to the absence of incentive system in place and lack of autonomy for the management, the financial position of banks deteriorated significantly. Seven out of 27 PSBs had a ratio of nonperforming assets (NPAs) to total loans in range of 25 to 45 percent and seventeen banks had a ratio between 15 and 25 percents. Banks could not recover NPAs through courts, because of the difficult and lengthy legal processes.[4] Since the RBI's supervisory staff was overburdened with the enforcement of numerous regulations outside of the prudential areas, bank inspections were limited to periodic on-site visits with no off-site monitoring.

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3 See D. Khatkhate and J. Nayak (1996), India: Private Capital Flows and Financial Integration, op.cit.
4 D. Khatkhate, *Indian Banking System: Restitution and Sequencing*, 1993 (unpublished), Washington, D.C.

2.5 India had been one of the few developing countries which could boast of having a vibrant and strong capital market, though the trading is most-active in shares by the corporate sector. Corporate instruments included shares, both equity and preference, bonds, including convertibles, short-term commercial paper and unit of mutual fund. Governments securities-treasury bills and long-dated securities with maturities between two and ten years dominated the fixed income securities market. The Government intervention was strong with control on issue price of equity and the market for government securities was virtually captive with banks, life insurance corporation and provident funds being obligated to hold government securities under their statutes.

2.6 The financial systems in India's neighboring countries were no different from that in India. The distortions in financial systems in Bangladesh, China, Pakistan during a comparable period were as stark as in India, without India's advantage of having a far greater degree of financial deepening as reflected in higher ratio of M2 to GDP ratio. Likewise, the degree of competition among banks in those countries was very low. The extent of fragility of the systems was as bad as that in India.[5]

2.7 The state of financial systems in the East Asian countries like Korea, Malaysia, Indonesia, and Thailand was hardly distinguishable from that in India, despite the general perception that these countries' financial sectors benefited from several bouts of financial reforms. Many of the structural weaknesses were masked by the very rapid growth of their economies over the last twenty years and once those economies went into tailspin since1997, the vulnerabilities of the financial sector surfaced. The amounts of NPAs were estimated to constitute anywhere between 18-30 percent of bank loans in all the four countries. Litany of weaknesses has been also similar: inadequacies in the regulation and supervision of financial institutions, limited experience of management of banks in the pricing and managing of risk, lack of commercial orientation, poor corporate governance and lax internal controls led to the inefficient and ineffectual banking performance.[6]

3. Financial Sector Reform and Its Impact[7]

3.1 Following sweeping economic reform policies initiated in mid 1991, the GOI and the RBI adopted a medium-term strategy for financial sector reforms which comprised strengthening capital adequacy requirements, tightening prudential norms and enhancing supervisory capabilities, restructuring the banks' operations to improve profitability, reducing NPAs, enhancing productivity, allowing flexibility in asset management together with introduction of asset/liability management system (ALM), and increasing competition in the banking sector. (For details, see Annex I, Table 1.)

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[5] World Bank (1989), *World Development Report*, Washington, D.C.

[6] For details, see, International Monetary Fund, *International Capital Markets: Developments, Prospects, and Key Policy Issues*, World Economic and Financial Surveys, 1997; International Monetary Fund, World Economic Outlook, September and December 1997, Washington, D.C.; D. Khatkhate, "East Asian Financial Crisis and the IMF: Chasing Shadows," *Economic and Political Weekly*, April 25, 1998.

[7] For a detailed mapping of reforms, see, Reserve Bank of India, 1997 and 1998, *Reports on Trends and Progress of Banking in India* and *Annual Reports, 1997 and 1998*; Jayati Sarkar, 1997, "India's Banking Sector: Current Status, Emerging Challenges, and Policy Imperatives in a Globalized Environment" paper presented at the World Bank conference on "A Financial Sector for the 21st Century" Delhi; J. R. Varma, 1998, "Banking Reform: The Unfinished Agenda," and S. K. Barua, 1998 "Financial Sector Reform: The Road Ahead," included in *Economic Reform, the Next Step*, Symposium Papers, Volume I, edited by Ashok V. Desai, Rajiv Gandhi Institute for Contemporary Studies, New Delhi; J. A. Hansen and S. Kathuria, 1997, "India's Financial System: Getting Ready for the 21st Century," an Introduction presented at the World Bank conference on "A Financial Sector for the 21st Century," Delhi. Sen K. and Vaidya R, 1997, *Th e Process of Financial Liberalization in India* , Oxford University Press, Delhi.

3.2 The impact of financial sector reform on the health of the banking system was substantial and in a desired direction. The capital adequacy ratio (CAR) which was related to risk-rated assets in 1998 rose between 1991 and 1999 (March). Except for five PSBs, all others attained the required capital adequacy ratio of 8 percent and some of them even exceeded that ratio. The banking sector's performance has shown a marked improvement since the early 1990s though it remains well short of the international best practices. NPAs at end 1998-99 were about 15 percent of loans and 9.25 percent net of provisions[8] for the PSBs which accounted for 80 percent of total commercial bank assets. For the banking system as a whole, reported gross (net) NPAs were probably less than 3 percent of GDP, a fairly low figure. (For details, see Annex Table 4). However, the extent of NPAs was not reflective of the real conditions in so far as it was, understated by the system of loan classification and provisioning which fell short of the international best practices (see Annex I, Table 2). The RBI improved the loan classification norms to some extent in March 2000.

3.3 The results of reforms are mixed. The NPA problem is still serious. To aid the loan recovery process, reform of the current legal system is critical to more clearly define the rights and liabilities of the parties to contracts and to resolve conflicts. The GOI, however has begun to address the questions of NPAs with renewed vigor as evident from the latest budget announcement of seven more debt recovery tribunals (DRTs) and amendments to the recovery of debts due to banks and financial institutions act, 1993 by the issue of ordinance. PSBs are still functioning under the directions of GOI and the RBI and their autonomy is more nominal than real. So long as the ownership remains with the government, the progress in management efficiency of banks will remain limited. Apart from this, a large internal public debt (a consequence of continual fiscal deficit) which is required to be held by banks imposed a serious constraints on any financial liberalization to make more funds available to the private sector.

4. The World Bank's Involvement in India's Financial Sector

4.1 The World Bank's operations in India, though they were of long standing and claimed a lion's share of the Bank's resources over four decades, had limited impact on India's financial sector problems and policies. Till 1990, the Bank provided project lending with conditionality related mainly to the fulfillment of the project's objectives and little policy content. For details of such projects see Annex I, Table 3. On the other hand the annual country Economic Memoranda (CEM) had analyzed some of the endemic problems of India's financial sector. The Bank's involvement in India's financial sector needs to be viewed not only by what the Bank did or did not do for the financial sector per se but also by the extent to which it contributed to the elimination of the microeconomic distortions in the Indian economy and to fostering of macroeconomic stability. This is because the financial sector is only an instrumental variable which acquires significance when the overall economy grows with speed and a competitive efficiency.

4.2 When the GOI launched a first systematically organized reform program in mid-1991, to steer the economy out of the most serious economic crisis, the Bank approved the first-ever SAL/SAC of $500 million, which became operational in December 1991. The structural reforms received further impetus from other two adjustment lending operations of the Bank, Social Safety Net Sector Adjustment Credit (SSN) in December 1993 and the External Sector and Investment

[8] Net NPAs are considered relevant for India as writeoffs of NPA are made difficult by Indian laws and public sector bank managers tend to avoid the writeoffs to ward off any possible allegation of fraud.

Loan (ESIL) in June 1993[9]. A fairly quick completion of these adjustment loans and good implementation of the policies directed at economy-wide structural reforms set the stage for a financial-sector specific loan for India approved by the Bank in 1995, which was designed to carry forward the broad financial sector reform strategy and policy implicitly or explicitly spelt out in the SAL/SAC.[10]

4.3 The Bank's overall assistance strategy until 1991 was to support institution strengthening, improvement of quality, targeting and cost effectiveness in the provision of the infrastructure and social sectoral services. Though this strategy met with a fair degree of success, it did not focus directly on the structural transformation of the economy including the financial sector. It was in 1991 that the Bank made a major change in its overall assistance strategy for India. The 1992 CEM very clearly emphasized that there should be an end to the pervasive presence of government intervention in trade, industry, and the financial sector, thereby providing an expanding space for the private sector.

4.4 Most of the analytical work as embodied in the CEMs was translated into a cohesive sector assistance strategy for India, in regard to the structural adjustment of the financial sector. For risk and exposure management, the linkage between progress and the Bank's lending levels was made stronger than a relatively modest gradation provided for in the earlier strategy papers. It was envisaged that lending in trade, industry, finance, and public enterprises would be most effective, if it was connected to broad structural reforms preferably through policy-based operations.[11] This strategy crystallised into four inter-related aspects of policies: future Bank adjustment operations in India should be based on a far greater extent than hitherto on conditionalities satisfied through policy actions, taken prior to Board presentation; adjustment operations of the Bank and its policy dialogue should be closely coordinated with the Asian Development Bank (ADB) and the International Monetary Fund (IMF) as these institutions had increased significantly their policy-based lending in support of structural reforms; the Bank's assistance strategy warranted increasing conditioning of investment lending operations on sector policy and institutional improvements; the private sector including the financial sector development should be at the centre of the structural change in the Indian economy.

4.5 Within this larger Bank strategy was a subset of strategy in regard to the financial sector. A critical component of the financial sector strategy aimed at reducing macroeconomic risks that might arise in the financial sector, improving financial sector services especially outside the main centres, and encouraging the development of capital markets and contractual savings institutions to provide resources for infrastructure support at the macro level. It also focused on non-lending services, sharing experiences on ways to improve loan collections, set incentives for sound lending, level the regulatory field, maintain prudence in international borrowing, and strengthen regulation and supervision of institutions as well as capital markets.

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[9] For details of timing, sequencing, nature, outcome and sustainability of these adjustment operations, see the author's companion background paper, "India Country Assistance Evaluation: Openness of the Indian Economy and private Sector Development, 1989-99.

[10] For strategy of reform and a full panoply of policies adopted to implement it, see M.S. Ahluwalia, 1998, *India's Economic Reforms: An Appraisal* (mimeograph).

[11] World Bank (India Department), "India: Country Strategy paper (CAS), 1991 (February), and 1998 (February).

5. The World Bank's Diagnosis of the Financial System's Fragility

5.1 The Bank's diagnosis of the financial sector problems was made from two perspectives. The first was derived from its own studies on the Indian financial system and the Indian economy, academic research in India and abroad in developing economies' problems and general perception of a complementary relationship between macroeconomic stability and soundness of the banking system. The Indian financial system operated within a regulatory thrust arguably characterizable as parametric (with RBI stipulating an array of prices and quantities which banks were required to adhere to) rather than prudential (with RBI demanding adequate capital adequacy with rigorous accounting standards, while providing greater macroeconomic freedom).

5.2 The second perspective from which the Bank diagnosed the fragility of the financial system was provided by the Bank's concern, shared by the Indian authorities, about how the financial sector should brace up to emerging demands of the transforming Indian economy. With the industrial and trade deregulatation, the entire incentive system had radically changed and unless the financial system was tuned to these changes, the reforms of the economy would not achieve a desired success. The financial sector was required to develop new skills to manage asset/liabilities, and to be well responsive to risk/reward considerations. This apart, the financial sector, already saddled with large amount of NPAs would face fresh bout of NPAs in a structurally changing economy where the viability of a large number of borrowers, public as well as private, would be adversely affected as they had to compete with new companies and imports. The reform of the financial system therefore had to tackle the hard choice of restitution of banks, enhancement of their credit management capability and modernisation of their operations so that they would have a better handle on coping with market, interest rate and credit risks emerging in a liberalized economy. Furthermore, the Bank recognised close linkages between macroeconomic policies and soundness of banks. The interest rate and exchange rate changes often have an immediate impact on the balance sheets of banks, affecting their profitability as well as stability. At the same time, the unsound banks distort signalling effects of the interest rate changes as they go for risky borrowers willing to pay higher interest rates.

5.3 The diagnostic assessment by the Bank of the Indian financial sector problems mainly based on its report on the Indian banking system in 1990 was congruent not only with that by the GOI and the IMF, but also with the general academic views particularly on the imperative of ensuring a viable financial system in a globalized context as a precondition for achieving a stable macroeconomic balance, and avoidance of financial crises. In course of implementation of SAL/SAC, the Bank consistently drew attention of the GOI, through policy dialogue, to the need for faster reform of the financial system. The GOI's commitment to financial reform was reflected in its decision to appoint two committees – first in 1991 and second in 1998 which came up with recommendations on nature and sequencing of reforms similar to those embodied in the Bank's ESW. The Bank also had a close and continuous liaison with the Asian Development Bank (ADB) which initiated, during 1992-1993, a financial sector loan, the design of which was influenced by the collaboration with the Bank.

6. Financial Sector Development Project (FSDP): Objectives and Design

6.1 The Bank approved in mid-1995 FSDP loan in the amount of $700 million. Before going into details, it is necessary to comment on why this loan partook the character of investment loan rather than an adjustment type one specifically addressing the problems of the financial sector. When the FSDP was initiated, India had a comfortable balance of payment position. The GOI was not in urgent need of foreign exchange. If the Bank were to contribute to the financial sector reform, it could do so with an investment type of loan like the FSDP, focusing on micro aspects of banks.

6.2 The FSDP was designed to change the operational orientation of the six PSBs through helping their recapitalization efforts and institutional development. PSBs were chosen on the presumption that their profit prospects would allow them to satisfy capital requirement in a defined time span. In addition, it built in a facility to provide a medium-term liquidity assurance called back-stop facility (BSF) at a market related price to banks by offering them the option to borrow funds under specified terms in the event of market disruption causing distortion in benchmark interest rate spread. The objectives of the project were fostering competition among banks and allocative efficiency, financial liberalization and gradual privatization of PSBs. Since this was also the main leitmotif of the GOI's reform program, the objectives could ensure a full ownership by the borrower of the program. In fact, the basis of the program had the imprimatur of the GOI, the IMF and the ADB and the Bank, assiduously coordinated its efforts with other multilateral institutions despite some initial hiccups in relations with the ADB.

6.3 The design of the FSDP has three pillars: recapitalization of six PSBs, thereby facilitating them to have access to the capital market, enhancing their efficiency and profitability through technological improvements and management development, and a BSF to assist eligible financial institutions in India to meet rapidly expanding demand for foreign currency term loans sourced with private funds. The relevance of the first two components was obvious for promoting the strategy and the objectives of the financial sector reforms, albeit on a limited scale. The third one, BSF, became unnecessary during the course of negotiation of the loan as India's balance of payment had improved markedly at the time of the loan, with large foreign exchange reserves to which access by banks, importers, and corporates was made easier by the GOI policy.

6.4 Originally, this program, envisaged as an adjustment operation was transformed into a sort of investment loan in view of a vast improvement in India's foreign exchange position. There was a general feeling in the Bank and outside that the design was not well thought through, project planning and preparation left a lot to be desired, the initial objectives of the project were overly vague and ambitious, the design was flawed, the project was insufficiently prepared when it went to the Board, which meant a delay of almost one year for the project to become effective. More particularly, the project's components were not well conceived. First of all, the project needlessly incorporated a BSF. By adding this component, the Bank, it seemed to many, displayed a somewhat superior wisdom, unwarranted by the objective situation. In the end, the BSF was dropped but not without costing India $10 million as a commitment fee. Even other two components of the FSDP were considered to be ill-designed. Recapitalization of six PSBs merely amounted to financing of the GOI budget, not to speak of the inappropriate choice of the banks with bad history of management. It was clear when the project was launched that one of the banks was in a far worse shape than reported. The purpose of the project was not to help failed institutions to deal with the deep-rooted problems that had led to their distress. The presumption on which the project was based was that the issue was one of stock, which could be reduced by one-time recapitalization. The idea behind the third component viz. management and institutional development was to evolve strategy and a business plan focused on automation but the way it was adopted made it a routine task of replacing manual operations with the first rudiments of automation.[12]

6.5 The project design included three sets of performance indicators to monitor progress particularly in respect of capital restructuring and modernization. They were: (a) yearly evolution of five key financial parameters, (b) PSBs' entry into the capital market at the predetermined dates for raising equity from the market, and (c) implementation of the agreed targets for the modernization of the banks' computer facilities and training and human resources development. These indicators were adequate to assess the progress of the project and to remedying any slippage in its implementation. However, the project had no mechanism to ensure the achievement of the broader goals of the program viz. accelerating the pace of financial sector reform.

7. Implementation

7.1 The implementation of the FSPD was far from smooth as the PSBs, being new to the World Bank's procedures and formalities took time. While the recapitalization of banks was implemented with some urgency, difficulties were faced in regard to two out of six PSBs, the Indian Overseas Bank (IOB) and the Indian Bank (IB). The IB was in such a dire financial situation that successive doses of injection of capital failed to restore it to solvency. The third component of the project, modernization and institutional development ran into procedural and institutional impediments such as a delay in preparation of the business plan, failure to anticipate problems in procurement and the computer equipment, complexity of the conditions of disbursement, a long learning curve of the staff of the beneficiary banks, and the inability of the banks to finance the equipment required for modernization.

7.2 The Bank however expended considerable time and effort in course of implementation of the FSDP to improve a flawed design and maximize its impact, given the serious initial problems. At the mid-term review, the objectives of the project and approaches to its implementation were revised, and the loan amounts substantially reduced. The Bank worked with the counterparts (i.e. the concerned PSBs) to ensure that the revised objectives would be met and that disbursements would occur within an acceptable time frame. As a result, the management and institutional aspects seem have been better integrated in the broader development strategies of the concerned bank.

7.3 The role of the Bank's Resident Mission (RM) could be considered to be complementary to the work of the headquarters. There has been a fairly good balance between procurement and disbursement activities of the RM and the technical support from the headquarters. The RM's frequent involvement in supervision mission has also proved to be fruitful in view of the RM's close contact with the RBI officials.

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[12] The Banking Division of the Ministry of Finance of the GOI has a more benign view of this loan, though it concedes that the design and implementation of the project could have been better.

8. Outcome and Impact

8.1 The FSDP is still ongoing with much of the disbursement on capitalization of banks and on management and institutional development. So far about 62.5 percent of the loan (which amounted originally to $700 million but was scaled down subsequently to $398.7 million) has been disbursed. The objectives of the project were inadequate or poorly specified initially. Insofar as recapitalization was concerned, two of the banks started privatization through issue of equity in the market. Five of the banks realized a stipulated capital adequacy ratio of 8 percent of assets; all the six banks reached profits targeted for them in the project, keeping pace with the progress made by other PSBs.[13] However, their management efficiency as well as modernization remained static, somewhat diluting one of the objectives of the project. Though there was progress in disbursement, its practical implications for banks' functioning remained doubtful as the powers to appoint members of the boards and top executives were still exercised by the GOI and also the shareholders rights remained ill-defined.

8.2 The relevance of the FSDP was substantial. Though its reach was limited to only six PSBs, it represented the best practices which could be adopted by the banking system in future, besides acquainting banks with instruments for measuring their performance. But the results on the ground were modest. This was evident from the crawling progress in institutional building component, which warranted slower disbursement on it. It therefore was given "moderately satisfactory" rating in respect of outcome. It could earn a slightly better grade of "likely" on its sustainability because of the fall-out from the implementation of the project. The instruments introduced by the project to monitor banks' performances have been useful for the RBI in its monitoring the universe of state-owned banks. The regular missions and exchanges in connection with the FSDP have served to enhance and improve understanding of several issues like, bank-turn-around program, asset collection, aspect of privatization, debt recovery and asset reconstruction. Likewise the PSBs concerned also benefited in grasping intricate issues like bank automation, new financial products and the payment system. The project strengthened healthy trends in recapitalization, sale of equity of PSBs to the public and a movement toward modernization (see Annex I, Table 5).[14]

8.3 A question about whether the financial sector in general and the position of the targeted PSBs would have been significantly different without FSDP can be legitimately raised. A counterfactual evidence suggests that the FSDP operations might not have been warranted. The bulk of financial sector reforms took place by 1995, when the FSDP was launched and subsequent reforms were relatively minor. As far as the targeted PSBs were concerned, their financial position or management efficiency were no different from those of other PSBs, recapitalized by the GOI. Perhaps, if the program was designed as an adjustment loan, with policies prescribed for the financial sector as a whole, it could have accelerated the operational efficiency and the development of the financial sector.

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[13] International Monetary Fund, 1998, *India's Selected issues*, Chapter IV, "Financial Performance of Public Sector Commercial Banks in India;" J. Hansen and S. Kathuria (1998), "India's Banking Sector: Current Status, emerging Challenges and Policy Imperatives in a Globalized Environment," op. cit.

[14] Since the FSDP is still ongoing, these ratings should be deemed to relate to what is expected to happen on present indications, when the project is completed.

9. The World Bank's Aggregate Sector Assistance Performance—An Assessment

9.1 Having evaluated the outcome and impact of the FSDP, it is necessary to assess whether the Bank was effective in improving the aggregate financial sector performance. The FSDP was one of the three lending operations of the Bank affecting the financial sector development; the other two were SAL/SAC and ESIL which had far more pervasive and wide-ranging impact on the financial sector than the FSDP which came on the scene after the bulk of financial reforms had taken place. Interest rates were deregulated, banks were recapitalized, NPAs were scaled down, accounting standards were set, income recognition practices were followed, a beginning was made toward divestment of public ownership of banks, competition was ushered in and attempts were made to set up a competitive money and capital market and supervision and prudential controls were tightened. As a result, the financial system could be considered by and large to have been resilient to the economic and financial shocks that swirled around the region. Despite all this, the banking system still remains massively inefficient state-controlled system. Competition is minimal, foreign and private banks have not had a significant impact. The privatization is used simply as a revenue raising device. The autonomy of banks which sold shares in the market still remains suspect as they are bereft of directors representing the stock holders of the banks. Bank supervision is still very much compliance-oriented, accounting system has some major flaws, personnel policies need to be fully overhauled to encourage personnel mobility and reward performance, auditing is out of line with international practices, and reporting is far from international norms. Also the financial liberalization process has been stymied by the swelling of internal public debt forming more that 50 percent of GDP. This constraint lying outside the banking system prevents banks from extending credit to the private sector because of their statutory obligations to hold a certain amount of public debt. Thus, a major agenda in financial sector reform lies ahead of the Indian authorities. It would remain a challenge for the Bank to engage the GOI in completing the unfinished agenda. For these reasons, the Bank's aggregate sector performance should be rated as "moderately satisfactory" for outcome, the same as given to the FSDP. Also, for the same reasons, its relevance and efficacy should be rated as substantial and modest respectively (see Annex I, Table 6).

10. Sustainability of the Aggregate Sectoral Performance

10.1 The issue of sustainability can be approached from three angles—the irreversibility of reforms already undertaken, the ownership of the program by the borrower and the momentum of the reform. The reform of the financial system in India has reached a stage from where it is well nigh impossible for it to retreat. There is now a great awareness among India's policy makers of all political persuasions, fortified by the unsavoury experiences of the East Asian countries during the recent financial crisis that an efficient and well managed financial sector was critical to the growth of the Indian economy. The globalization of finance is an irreversible process and India is left with no option other than to accelerate the reforms of the banking system. Furthermore, the banking system cannot remain isolated from the trends in the real economy, which has been structurally changing though gradually. The financial sector is required to be robust to withstand the shocks emanating from the borrowing firms undergoing restructuring and rehabilitation.

10.2 The GOI, through its actions on wide fronts, has firmly signaled its commitment that the economy would be thrown open to the market forces and competition for efficiency gains. This reflected that the country was now in a confident mood of consensual approach to the solution of economic problems and harking back to the pre-reform dirigistic policies which eventuated in a repressed financial system was no longer a feasible option for the government. It was this sensitivity to the urgency of reforms that propelled the GOI in 1999 to lay renewed emphasis on the divestiture of ownership of public sector banks and further reduction of the NPAs. The reform momentum, which slowed in the last two years would have to continue with greater vigour. The GOI has shown its commitment to continuing reforms by its decision to discontinue the appointment of government directors of the boards of the public sector banks and its public declaration of accelerated privatization of PSBs. The GOI budget of 2000-2001, proposed reduction of minimum government shareholding in PSBs to 33 percent, following the recommendation of the Second Committee on Banking Sector Reform of 1998. The RBI has shown its earnestness in reform by appointing a series of committees in 1999 to suggest amendments to the relevant banking and financial institutions acts, and measures to revive on a sustained basis the weak PSBs. However, these actions still fall short of what is required to accelerate financial sector reforms. The Bank's aggregate sectoral assistance should therefore warrant "likely" rating for sustainability (see Annex I, Table 6).

11. Institutional Development

11.1 Institutional development, directly or indirectly supported by the Bank's assistance proceeded in four distinct directions. First, the RBI has considerably strengthened supervisory and prudential control capabilities through setting up a Board of Financial Supervision. The RBI now takes an integrated view of the banks' operations and monitors them, both through off-site and on-site inspections by its staff. The complex system of reporting forms and procedures has been streamlined and simplified to enhance processing, storage and evaluation of the commercial banks' financial reporting. The RBI's supervisory personnel has been trained in new computer technologies and portfolio evaluation. All these changes, however, fall short of what is needed to completely reform the financial sector.

11.2 As a remedy to resolve the NPAs, banks have improved loan recovery by taking a number of specific measures including the designation of special loan recovery units within individual banks and the use of performance incentives. To safeguard against future recovery problems, banks have enhanced their training in credit and risk evaluation and the RBI has established a credit information system.

11.3 The GOI has announced in 1999 that bank specific Asset Reconstruction Companies (ARCs) will be introduced on a trial basis for a number of weak banks. The GOI will guarantee the bonds floated by the ARCs to securitize the NPAs. The ARCs will then concentrate on recovering the maximum value from the transferred NPAs. The effectiveness of the proposed ARCs is of course dependent on number of factors including the market pricing of problem loans, the existence of a clear and transparent rules for managing and disposing of assets, and an efficient legal system. In 1993, a legal framework was created by the legislation under which Debt Recovery Tribunals were set up to help expedite adjudication. As a result, five Tribunals have been established and a proposal for additional five Tribunals is under consideration. All these measures, however, are inadequate to resolve the risks to the financial system posed by the NPAs. The problem of NPAs is one of both stock and flow. While the measures so far taken by the GOI could alleviate the stock of NPAs, by taking them off the banks' books, to stem their flow requires a more far reaching financial sector reform. The NPAs are growing as fast as fresh lending because of the banks' poor lending practices in general and priority lending (which constitutes as much as 40 percent of credit) in particular and the flawed legal framework. Unless a more determined action is taken in this area, NPAs problem will not simply go away.

11.4 There has been an intensive effort, under the advice from the Bank to streamline the institutional basis of a payment system. The medium-term objective is to establish a robust set of modern payment and government security related systems to satisfy the evolving domestic and international payment services needs of discrete user groups, like consumers, retailers, industrial and commercial enterprises, government and financial institutions. The RBI has introduced Electronic Funds Transfer and a clearing bank for extension of delivery versus payments made of trading in government securities. The RBI also decided to move towards a Real Gross Settlement System.

11.5 The last plank of the institutional development is represented by a comprehensive plan of computerization of the operations of PSBs, a beginning for which has been already made and the progress is recorded but it is slow due to the labour opposition, institutional inertia, and lack of appropriate skills. However, the main impediment is not the lack of human resource development but the political economy of India, which bedevils every effort to liberalize the economy. All these aspects of the institutional development suggest that, the Bank's sectoral assistance performance should be ranked modest for its institutional impact (see Annex I, Table 6).

12. The World Bank's Nonlending Services

12.1 The Bank's ESW was solid, setting out all issues involved and indicated the policy choices to the borrower. Apart from the general reports on the real economy like industrial regulatory policies and the trade regime having bearing on the financial sector, the Bank made the GOI and RBI aware of the banking sector problems through its report on the Indian banking system in 1990. This was complemented by policy notes on specific technical issues, prepared at the request of the GOI. The analysis and broad thrust of the recommendations of the report on banking found echo in the policies of financial reforms adopted by the GOI and a stream of technical and policy notes on issues like asset reconstruction, payment system etc. seems to have clearly established a linkage between the Bank's advisory work and the financial sector reforms that were subsequently undertaken. The Bank-sponsored conference on the banking sector reforms in 1998, in cooperation with the RBI supported research institute and United States' Agency for International Development (USAID) was instrumental in finding a common ground among diverse view points on the financial sector problems by the academicians, the GOI, RBI and managers of financial institutions in India and outside. A volume published after the seminar highlighted the progress made by the banking system since the 1991 reforms, the remaining impediments and the unfinished agenda. The Bank also completed a payment system study, outlining a strategy for establishing a modern payment system and a comprehensive report on rural finance. In addition, the Bank is currently engaged in preparing comprehensive studies of the banking system and the pension fund, and is preparing a study on the capital market. The Bank together with the IFC are also planning jointly sponsored conference on South Asian domestic debt market. All these have enabled the Bank to continue a focused policy dialogue on the unfinished agenda of financial reforms and to prepare a road map for policy actions. The Bank's ESW justifies a top rating, i.e., 1, in all categories—strategic, relevance, internal quality, presentation, and likely impact (see Annex I, Table 6).

12.2 The Bank considered that it was necessary to work on analytical issues in close coordination with the IMF and ADB, particularly the former which provided technical assistance in the area of money market, indirect monetary policy instruments and the development of a secondary market for government debt. These studies were well harmonized with the Bank's own ESW, so as to avoid discordant notes in policy areas.

13. Lessons for the Future

13.1 A major conclusion that emerges from this evaluation of the Bank's financial sector assistance to India is that its lending program specifically designed for the sector did not match its nonlending assistance in influencing the sectoral reform. The Bank's ESW was prescient and focused on the main issues relevant for the sector. The indications are that the Bank would continue this work in future even with greater effectiveness than in the past through advice on policy and technical issues sought by the GOI and not on broad generic problems. However, the Bank was found wanting in regard to the choice of right kind of lending instrument which could address the problems identified in its ESW as critical to the acceleration of financial reform in the coming years. These are:

- Restrictions on the operation of banks, particularly through high cash credit requirement (CRR) and other directed lending continue to impede the operational efficiency of banks.
- NPAs problem is still formidable.[15] Reform of the current legal system is critical to more clearly define the rights and liabilities of parties to contracts and to provide for the rapid resolution of disputes. Also staff rationalization is overdue as without it, banks would continue to be financially fragile.
- India being a big country with varying regional needs, future banking reform should emphasize, among others the need to have regional and business specialization. In this, the Bank's advice may be crucial.
- The initiatives taken to give the stronger PSBs greater autonomy should be vigorously pursued in a wide range of areas, including asset management, the ability to hire and fire staff and branch numbers; and raising capital from the market. The public ownership in PSBs should be reduced gradually to minority holding as suggested by the Second Narasimhan Committee of 1998. It is necessary to recognize that the problem of a large number of weak banks would not be solved unless the PSBs are privatized so that they can face differential incentives. The Bank can play an important role in helping banks in their search for strategic partners.
- Though new legal framework has been in place, it has not been harnessed effectively in resolving the operational problems of banks. Thus, the legal provisions of the revamped banking laws should be applied with speed and urgency of purpose.
- Though there were some signs of competition in the banking system, the oligopolistic dominance of PSBs has persisted with denial of a level playing field to other competing banks.

13.2 The Bank needs to devise lending instrument like the financial sector adjustment loan or any variant of it with appropriate policy content which will focus on sequencing of second generation of financial reforms and their effective implementation. Should the GOI evince in future an interest in financial sector adjustment loan, the Bank should give centrality to the above issues in its policy dialogue with the GOI.

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[15] According to the recent study on Indian banking by McKinsey and co-partner, NPAs of Indian banks are still high by Western standards and they are overstaffed to the extent of 30-35 percent. News report in the *Economic Times* of May 7, 1999.

Annex I - Table 1. Banking Sector Reform: Progress to Date		
Status before July 1991	*Status in November 1999*	*Bank Assistance*
Interest Rate Controls		
Bank lending rates fixed according to loan size and sector specific categories (loans over Rs. 200,000 had an interest rate floor).	Interest rate structure simplified. Lending rates above Rs. 200,000 deregulated. Banks advised to announce maximum spread over PLR for all advances other than consumer credit.	►
Bank deposit rates fixed according to account types and maturities.	Deposit rates for term deposits above 30 days deregulated. The maximum deposit rate (up to 30 days) of scheduled commercial banks linked to the Bank rate.	►
NRE deposit rates regulated.	Deposit rates on NRE term deposits of over one year, and FCNRB deposits deregulated.	T
Government Pre-emptions		
Pre-emption of large proportion of bank reserves through CRR and SLR: CRR of 25 percent and SLR of 38.5 percent of deposits.	Pre-emptions lower due to lower CRR (10.5 percent) and lower SLR (25 percent). Rationalization of CRR and SLR requirements.	►
High monetization of government debt.	Monetization reduced. Issue of *ad hoc* Treasury bills for monetization of fiscal deficit discontinued. Scheme of *Ways and Means Advances (WMA)* put in place to take care of temporary mismatches between government receipts and payments, provided such advances outstanding at any time does not exceed the mutually agreed upon limit.	►
Priority Sector Lending		
Forty percent of bank credit channeled to priority sector at concessional rates.	Number of directed credit categories and interest rate subsidy element reduced. Weaker sections in priority sector redefined.	►
	Foreign banks advised to increase priority sector advances to 32 percent of net credit.	
Prudential Regulation and bank supervision		
Inadequate and non-uniform norms concerning income recognition, provisioning and capital adequacy. Bank profits not reflecting "true" health of banks.	Regulations on asset classification, income recognition and capital adequacy strengthened, made uniform and transparent. Banks required to attain 8 percent of capital to risk weighted ratio as per international norms. Recapitalization of banks undertaken. Board for Financial Supervision (BFS) operational to strengthen bank supervision.	►
	Reports submitted by three expert Groups constituted by Department of Supervision, viz. The Group to review the system of on-site inspection of banks (Padmanabhan Committee), the Group to review the internal control and audit system in banks (Jilani Committee) and the Group for designing supervisory framework for NBFCs (Khanna Committee) were deliberated and adopted by the BFS.	
	In response to the need for having in place an effective legislative framework in respect of NBFCs that was strongly advocated by various committees in the past, the RBI (Amendment) Act, 1997, was passed in March 1997, putting place an effective legislative framework in respect of NBFCs.	►
Private Sector Banks		
Restriction on entry and expansion of domestic private and foreign banks.	Entry and expansion of private sector banks deregulated to increase competition: 19 new private banks; 9 domestic and 10 foreign opened since 1994–95. Entry of more banks approved by RBI.	►
	Guidelines issued for setting up new private Local Area Banks (LAB) with jurisdiction over two or three contiguous districts and a minimum capital base of Rs. 5 crore. In principle approvals given to two LABs.	
Branch Licensing		

Annex I - Table 1. Banking Sector Reform: Progress to Date		
Status before July 1991	*Status in November 1999*	*Bank Assistance*
Branch expansion rigidly controlled by RBI branch licensing policy. No bank allowed to open branch without prior permission.	Branch licensing policy liberalized. Specifically, domestic banks satisfying certain performance criteria as achieving capital adequacy ratio of 8 percent, etc. need no prior permission for branch expansion. Other proposals to be considered on case-by-case basis.	►
	In line with the Bhandari Committee's recommendations, the branch licensing policy for RRBs was modified to free 70 RRBs from Service Area obligations and given freedom to relocate loss-making branches. Mergers of loss-making branches subject to certain conditions also allowed.	
	Customer Services	
	- Implementation of a number of measures to strengthen customer service as recommended by the Goiporia Committee on Customer Service in Banks.	►
	- For expeditious and inexpensive resolution of customer complaints against deficiency in banking services, the Banking Ombudsman Scheme 1995 introduced.	
	- The Electronic Clearing System (ECS) being used at four metropolitan centres by about 20 corporate customers for servicing dividend, interest, refund order, salary and pension payment transactions, extended to other metropolitan centres.	
	Technological Issues	
	Recommendations of the Saraf Committee set up study technology issues relating to payment and settlement system in the banking industry, are at various stages of implementation.	►
	The Shere Committee Report, set up to study all aspects of Electronic Funds Transfer, submitted.	
	Under the World Bank's Financial Sector Development Project, participating banks can obtain a modernization and institutional development loan of US$150 million for extending *inter alia* automation and computerization of banking operations.	►
	Other	
	- Amendment of Banking Companies (Acquisition and Transfer of Undertakings) Acts, 1970/80, permitting public sector banks to raise capital up to 49 percent from the public.	►
	- Banks permitted to trade in shares in the secondary market.	
	- A "Loan System" for Delivery of Bank Credit for working capital purpose introduced to bring greater discipline in credit utilization and better control in credit flows.	
	Legislative framework established to set up Debt Recovery Tribunals.	►

► Indicates positive support from the Bank.

Annex I – Table 2. Loan Classification: Comparative Country Information

	Period Overdue		*Period Overdue for Loan Classification as:*	
Country	*Interest*	*Substandard*	*Doubtful*	*Loss*
Korea Existing Proposed*	When past due No changes	Normally not classified 3 months	Until 6 months past due 6 months	Unless declared bankrupt 6 months
*Classification will be reviewed based on findings of diagnostic reviews to ensure a forward-looking approach.				
Indonesia Existing* Under implementation	1-12 months 3 months	1-12 months 3 months	18 months 6 months	21 months** 9 months
*Varies by type of credit and installment period. **Refers to 21 months after a credit has been classified as doubtful and there is no repayment.				
Malaysia Existing*	90 days	90 days	6 months	12 months
*Effective January 1998.				
Philippines Existing:*Unsecured Secured	3 months 3 months	3 months 6 months	**	6 months
*Since October 1997. **If classified as substandard in last examination but principal has not been reduced by at least 20 percent during the succeeding 12 months.				
Thailand Existing: Unsecured Secured Proposed	6 months* 6 months* 3 months	6 months 12 months 3-6 months	Over 6 months Over 12 months 6-12 months	Over 6 months Over 12 months Over 12 months
*Effective January 1998, irrespective of collaterals; previous limit (since July 1995) was 12 months for secured loan.				
Argentina – Existing	90 days	90-170 days	180-365 days	Over 365 days
Brazil – Existing Consumer/Commercial Res. Mortgage	 60 days 360 days	 60-180 days 60-180 days	 181-360 days 181-360 days	 Over 360 days Over 360 days
Chile – Existing Consumer Res. Mortgage Commercial	 90 days 90 days 90 days	 30-59 days Over 179 days	 60-119 days n.a. Varies in accordance with % of default	 120 days & over n.a.

Annex I – Table 2. Loan Classification: Comparative Country Information				
	Period Overdue		*Period Overdue for Loan Classification as:*	
Country	*Interest*	*Substandard*	*Doubtful*	*Loss*
Colombia – Existing				
Consumer	90 days	60-89 days	90-179 days	180-360 days
Mortgage/commercial	120 days	60-119 days	120-359 days	360 days & over
India – Existing				
All loans	180 days	6 months	25 months	Identified as lost by auditors or the Reserve Bank
Proposed changes*	90 days	6 months	18 months (effective from March 2000)	Unchanged
Peru – Existing				
Consumer	90 days	30-59 days	60-120 days	Over 120 days
Res. Mortgage	90 days	30-119 days	120-365 days	Over 365 days
Commercial	15 days	Not indicated		
Source: IMF, 1998, India: Selected Issues, Chapter IV.				
*By the Second Narasimham Committee on Financial Sector Reform, in 1998.				

Note: The Reserve Bank in March 2000, announced several changes in regard to classification of loans and provisioning norms with a view to bringing the prudential accounting systems closer to the international best practices.

(Source: The Reserve Bank's comment on the earlier versions of this paper).

Annex I - Table 3 Financial Project Lending by the World Bank During Period Before 1990					
Projects	*Amount (in millions)*	*Yr.*	*OED Rating*		
			Outcome	**Sustainability**	**Institutional Impact**
1. Industrial Credit and Investment Corporation project	$9.9	1958	N/A	N/A	N/A
2. . Industrial Credit and Investment Corporation project	9.8	1960	N/A	N/A	N/A
3. Industrial Credit and Investment Corporation project	19.3	1961	N/A	N/A	N/A
4. Industrial Credit and Investment Corporation project	19.0	1962	N/A	N/A	N/A
5. Industrial Credit and Investment Corporation project	26.9	1963	Satisfactory	Likely	Not rated
6. Industrial Credit and Investment Corporation project	47.2	1965	Satisfactory	Not rated	Not rated
7. Industrial Credit and Investment Corporation project	23.9	1968	Satisfactory	Not rated	Not rated
8. Industrial Credit and Investment Corporation project	38.8	1970	Satisfactory	Not rated	Not rated
9. Industrial Credit and Investment Corporation project	56.7	1972	Satisfactory	Not rated	Not rated
10. Industrial Credit and Investment Corporation project	62.5	1973	Satisfactory	Not rated	Not rated
11. Industrial Credit and Investment Corporation project	93.8	1975	Satisfactory	Not rated	Not rated
12. Industrial Credit and Investment Corporation project	76.0	1978	Satisfactory	Not rated	Not rated
13. Industrial Credit and Investment Corporation project	95.7	1980	Satisfactory	Likely	Substantial
14. Industrial Credit and Investment Corporation project	147.9	1982	Satisfactory	Likely	Substantial
15. First Industrial Development Bank of India project	16.6	1973	Satisfactory	Not rated	Not rated
16. Second Industrial Development Bank of India project	40.0	1973	Satisfactory	Not rated	Not rated

Annex I - Table 4. Selected Financial Indicators of Public Sector Banks, 1995/96-1996/97

	Net nonperforming loans (percent of net advances)		*Capital adequacy ratio (percent)*		*Gross profit/loss (percent of total assets)*		*Net profit/loss 1/ (percent of total assets)*	
	1995/96	*1996/97*	*1995/96*	*1996/97*	*1995/96*	*1996/97*	*1995/96*	*1996/97*
State Bank of India	6.61	7.30	11.60	12.17	2.10	2.17	0.58	0.85
State Bank of Bikaner & Jaipur	6.11	7.96	9.33	8.82	1.71	1.93	0.39	0.50
State Bank of Hyderabad	9.94	11.42	9.90	10.84	2.46	2.43	0.61	0.56
State Banko f Indore	9.62	11.29	8.80	9.31	2.01	2.23	0.39	0.49
State Bank of Mysore	8.59	10.96	8.81	10.80	1.91	2.39	0.54	0.74
State Bank of Patiala	6.60	5.88	9.51	11.25	2.23	2.26	0.63	0.68
State Bank of Saurashtra	5.70	6.47	12.38	12.14	2.00	2.43	-4.94	1.45
State Bank of Travancore	7.38	8.82	9.40	8.17	2.07	1.93	0.39	0.52
Allahabad Bank	16.00	14.84	9.68	10.57	0.83	1.40	0.05	0.49
Andhra Bank	3.29	4.10	5.07	12.05	0.89	1.06	0.16	0.43
Bank of Baroda	8.15	8.94	11.19	11.80	2.55	2.06	0.61	0.73
Bank of India	7.00	6.52	8.44	10.25	1.43	1.53	0.84	0.95
Bank of Maharastra	9.39	9.66	8.49	9.07	0.85	1.18	0.16	0.54
Canara Bank	7.45	9.32	10.38	10.17	2.09	1.83	0.81	0.41
Central Bank of India	13.49	14.40	2.63	9.41	0.91	1.14	-0.32	0.57
Corporation Bank	2.26	3.63	11.30	11.27	3.13	3.02	1.52	1.53
Dena Bank	7.30	9.40	8.27	10.81	1.76	2.00	0.63	0.75
Indian Bank	23.87	25.24	Negat ive	-18.81	-1.26	-0.81	-7.52	-2.28
Indian Overseas Bank	8.57	7.64	5.95	10.07	0.12	0.72	0.02	0.58
Oriental Bank of Commerce	3.60	5.64	16.99	17.50	2.62	2.60	1.64	1.56
Pujab & Sind Bank	10.34	12.04	3.31	9.22	0.12	0.75	-1.83	0.26
Punjab National Bank	12.70	10.38	8.23	9.15	1.22	1.77	-0.30	0.68
Syndicate Bank	8.39	7.53	8.42	8.80	0.64	0.56	0.13	0.38
UCO Bank	11.43	13.73	7.83	3.16	-0.17	-0.45	-1.53	-1.08
Union Bank of India	5.94	6.98	9.50	10.53	1.52	1.52	0.39	0.96
United Bank of India	23.28	18.70	3.50	8.20	-0.37	-0.43	-2.16	-0.89
Vijaya Bank	11.90	9.56	Negative	11.50	0.07	0.43	-3.47	0.24

Annex I - Table 5. Sectoral Assistance Evaluation Matrix, 1994-to date

Strategic objectives	*Strategic actions*	*Progress indicators*	*Bank group's assistance*	*Other assistance*
• Fostering competition among banks, improve allocative efficiency, financial liberalization, and gradual privatization of public sector banks.	• Recapitalization of six public sector banks, enhancing efficiency and profitability of these banks through technological improvements and management development.	• Two of the six public sector banks started privatization through issue of equity in the market. • Five of the banks realized capital adequacy ratio of 8 percent of assets. • All six banks reached targeted profits. • Modest progress in management efficiency.	**Non-lending** • Financial sector studies on banking and payment system. • Major seminar on banking reform and unfinished agenda. • Continuous and informal advice connected with FSDP. • Commitment to undertake studies on debt market, pension fund, and capital market jointly with IFC. **Lending** • Started FSDP in 1995. 33 percent of $500 disbursed. Possible assistance on wider financial sector reform.	• ADB assistance for financial sector reform. • DFID assistance for strengthening bank regulation and supervision. • USAID assistance for financial institutional reform and expansion.

Annex I - Table 6		
Financial Sector Development Project (FSDP)		**Aggregate Sector Performance**
	Rating	
I. Outcome	Moderately satisfactory	Moderately Satisfactory
Relevance	Substantial	Substantial
Efficacy	Modest	Modest
Efficiency	NA	NA
II. ID impact	Modest	Modest
III. Sustainability	Likely	Likely

Annex I - Table 7	
	Ratings on Economic Sector Work (ESW)
1. Strategic relevance and timeliness	1
2. Internal quality	1
3. Presentation and readability	1
4. Likely impact	1

Annex II: Summary of Discussion at CAE Workshop on Financial Sector

March 31, 2000

- Participants largely agreed with thrust and ratings of background evaluation
- Major sector challenges identified by participants: over-manning, weak DFIs, high NPAs, poor debt recovery, administrative stickiness, delay in bankruptcy procedures, restructuring process, bad corporate governance, ambivalence of both the government and industry toward reforms, slow judicial reforms, slow government response to privatization and trade union militancy.
- Remedies suggested: improved corporate governance, separation by the government of ownership from management of financial institutions, clear articulation of reforms and their sequencing, effective dealing with trade unions, extension of reforms beyond banks to non banks and capital market, and reform of the Banking Regulation Act and other related laws.

Suggestions for the future:

- World Bank's possible assistance ideas: technical advice in legal and labor market reforms and experience in other countries, organizing studies on capital markets and suggestions on ways and means to improve Bond and Derivative markets.
- The World Bank should press for reform in: bankruptcy and recovery process, treasury management, evaluation of the existing laws, institutional accountability and financial disclosure standards, modalities related to the working of the Asset Reconstruction Corporation and popularization of micro-finance.
- World Bank's increasing focus on states was appreciated.
- World Bank should advise about banking reform on lines of regional and business specialization.[16]
- World Bank should help banks in their search for strategic partners. These two suggestions are incorporated in the recommendatory part of the paper.

[16] These two suggestions are incorporated in the recommendatory part of the paper.