

Banking policy and trends

3.20 With liberalisation and growing integration of the Indian financial sector with the international market, the supervisory and regulatory role of RBI has become critical for the maintenance of financial stability. RBI has been continuously fine-tuning its regulatory and supervisory mechanism in recent years to match international standards. Migration to new capital adequacy framework (Basel II) based on a three-pillar approach, namely, minimum capital requirements, supervisory review, and market discipline, involves implementation challenges for both RBI and banks. RBI has taken a number of initiatives to make migration to Basel II smoother. Banks have been advised to undertake a self-assessment of the existing risk management systems and to simultaneously initiate suitable measures to upgrade them to match international standards. Banks have also been

asked to prepare a road map and to review the progress on a quarterly basis.

3.21 In its annual policy statement for 2004-05, the RBI has carried forward initiatives aimed at improving prudential regulation and credit delivery, particularly to agriculture and the SSI sectors. The RBI has introduced higher provisioning requirement for NPAs included under 'doubtful for more than three years' category effective March 31, 2005. In order to contain risks arising from non-SLR portfolio of banks, the RBI has prohibited banks from investing in unrated non-SLR securities. Further, the RBI has indicated that with effect from January 1, 2005, only those banks, whose investment in unlisted non-SLR securities are within the prudential limit of 10 per cent of their total investment in non-SLR securities, will be allowed to make fresh investment in such securities up to the prudential limits.

Financial Performance

3.22 During the year 2003-04, the banking sector witnessed strong growth in deposits and advances. Aggregate deposits of scheduled commercial banks (SCBs) grew by 17.5 per cent compared to 13.4 per cent in 2002-03. Credit and investments by SCBs increased by 15.3 per cent and 25.1 per cent, respectively in 2003-04 compared to 16.1 per cent and 23.3 per cent respectively in 2002-03. These developments coupled with a decline in gross NPAs enabled SCBs to improve their financial performance, despite a lower income growth consequent upon low interest rates. Ratio of net profits to total assets of SCBs improved marginally from 1.0 per cent to 1.1 per cent. Ratio of operating profits to total assets improved from 2.4 per cent in 2002-03 to 2.7 per cent in 2003-04.

3.23 Total income of SCBs increased by 6.6 per cent to Rs. 1,83,767 crore in 2003-04 as compared to an increase of 14.0 per cent in 2002-03. The lower income growth was on account of lower growth of 2.4 per cent in interest income in 2003-04. Income growth in 2003-04 came mainly from other income, which increased by 25.5 per cent. Total expenditure of SCBs grew at a lower rate of 4.0 per cent in 2003-04 compared to 11.3 per cent in 2002-03.

3.24 The lower growth of total expenditure was entirely on account of a decline in interest expenditure from Rs. 93,596 crore in 2002-03 to Rs. 87,567 crore in 2003-04. As a proportion of total assets, interest expenditure declined from 5.5 per cent to 4.4 per cent. Expenditure on provisions and contingencies witnessed an increase of 28.8 per cent in 2003-04 on top of an increase of 29.3 per cent in the previous year. The financial performance varied across bank groups. Increase in the income of the SCBs varied from 2.4 per cent for old private sector banks to 8.1 per cent for foreign banks. The income of the public sector banks (PSBs) grew by 7.1 per cent in 2003-04. Among income, the growth of interest income was the highest for new private sector banks followed by old private banks, PSBs and foreign banks. The growth of other income was in sharp contrast with the growth in interest income.

Growth of other income was the highest in case of foreign banks and the lowest for the old private sector banks. Growth of expenditure was the highest in the case of foreign banks and lowest in the case of old private sector banks. Expenditure on interest declined for all bank groups, following the reduction in deposit rates. The decline in expenditure on interest was the highest for foreign banks (15.5 per cent) and lowest for old private sector banks (5.5 per cent) and PSBs (5.9 per cent).

3.25 The ratio of net profits to total assets was the highest for foreign banks (1.7 per cent) followed by old private sector banks (1.2 per cent), PSBs (1.1 per cent), and new private sector banks (0.8 per cent). The ratio of operating profits to total assets followed more or less a similar pattern with foreign banks performing the best (3.7 per cent), followed by PSBs (2.7 per cent), old private sector banks (2.6 per cent) and new private sector banks (2.0 per cent). There has been an overall improvement in the efficiency of SCBs as evident in the declining ratios for operating expenses to net total income (total income – interest expenditure). For SCBs as a whole the ratio declined from 53.0 per cent in 2001-02 to 48.3 per cent in 2002-03 and further to 45.2 per cent in 2003-04 (Table 3.4).

3.26 The profitability of SCBs, though still high, showed a declining trend in the first half of 2004-05 on account of a fall in treasury income. The ratio of net profit to total assets (annualised) was lower at 1.1 per cent in the second quarter of 2004-05 compared to 1.3 per cent in the corresponding previous quarter.

Interest spread

3.27 Increase in the net interest income or the interest spread, defined as the difference between interest income and interest expenses, of SCBs witnessed in recent years continued in 2003-04. Mainly on account of low interest expenditure, the spread increased by 19.8 per cent in 2003-04 compared to an increase of 19.5 per cent in 2002-03. The increase in the spread of private sector and foreign banks was sharper than that of PSBs. The ratio of spread to total assets had increased for all bank groups in 2003-04. The

ratio was the highest for foreign banks (3.46 per cent) followed by PSBs (2.97 per cent), old private sector banks (2.60 per cent) and new private sector banks (1.98 per cent).

3.28 Interest spread is an important indicator of efficiency of banking operations. The growth of spread in recent years clearly establishes that banks have not fully passed on the benefit

of falling interest rates to their customers. Despite the initiatives taken by the RBI, lending rates of banks have exhibited considerable downward rigidity. Net interest income (annualised) of SCBs as a proportion of total assets improved to 3.1 per cent in the second quarter of 2004-05 compared to 2.9 per cent in the corresponding quarter of last year (Table 3.4).

Table 3.4 : Working results of scheduled commercial banks

Items	Public sector banks		Foreign banks		Old pvt. sector banks		New pvt. Sector banks		SCBs	
	2002-03	2003-04	2002-03	2003-04	2002-03	2003-04	2002-03	2003-04	2002-03	2003-04
Rs. Crore										
A. Income	128464	137602	12034.6	13012	11279	11551	20567	21602	172345	183767
I) Interest Income	107232	109496	8958	8990	8920	9120	15633	16421	140742	144028
II) Other income	21232	28106	3076.95	4022	2359	2431	4934	5180.6	31603	39739
B. Expenditure	116169	121055	10210	10769	10047	10105	18843	19567.01	155270	161496
I) Interest expended	69853	65765	5055.01	4272	6327	5982	12361	11548	93596	87567
II) Intermediation cost	28895	32363	3251	3752	2147	2374	3774	5041	38067	43530
III) Provisions and contingencies	17422	22928	1904	2744	1573	1749	2708	2978	23607	30400
C. Operating profit (A-Bi-Bii)	29716	39475	3728	4987	2805	3196	4433	5013	40682	52671
D. Net profit (A-B)	12295	16546	1824	2243	1232	1446	1725	2035	17075	22271
E. Net interest income (Spread)	37379	43732	3903	4718	2593	3139	3272	4873	47146	56462
F. Total assets	1285411	1471428	116661	136316	104956	120700	192170	246576	1699198	1975020
As per cent of total assets										
A. Income	10.0	9.4	10.3	9.5	10.7	9.6	10.7	8.8	10.1	9.3
I) Interest Income	8.3	7.4	7.7	6.6	8.5	7.6	8.1	6.7	8.3	7.3
II) Other income	1.7	1.9	2.6	3.0	2.2	2.0	2.6	2.1	1.9	2.0
B. Expenditure	9.0	8.2	8.8	7.9	9.6	8.4	9.8	7.9	9.1	8.2
I) Interest expended	5.4	4.5	4.3	3.1	6.0	5.0	6.4	4.7	5.5	4.4
II) Intermediation cost	2.2	2.2	2.8	2.8	2.0	2.0	2.0	2.0	2.2	2.2
III) Provisions and contingencies	1.4	1.6	1.6	2.0	1.5	1.4	1.4	1.2	1.4	1.5
C. Operating profit	2.3	2.7	3.2	3.7	2.7	2.6	2.3	2.0	2.4	2.7
D. Net profit (A-B)	1.0	1.1	1.6	1.6	1.2	1.2	0.9	0.8	1.0	1.1
E. Net interest income (Spread)	2.91	2.97	3.35	3.46	2.47	2.60	1.70	1.98	2.77	2.86
F. Total assets	1.0	1.1	1.6	1.6	1.2	1.2	0.9	0.8	1.0	1.1
Memo item										
1. Operating expenses as per cent of net income	49.3	45.0	46.6	42.9	43.4	42.6	46.0	50.1	48.3	45.2