Chapter III

Policy Environment

Global financial conditions deteriorated further during 2011-12. Amidst the subdued global growth and its increasing spillover risks, the Indian economy witnessed weakening domestic macroeconomic fundamentals. While the Western world continues to contend with dampening growth, a worsening sovereign debt crisis and repairing its financial regulatory architecture, the emerging lesson undeniably remains that financial/ banking regulations have to keep pace with the emerging market dynamics, while ensuring that such regulations do not throttle entrepreneurship and innovation. In this milieu, the Reserve Bank focused on enhancing the resilience of the banking sector. Several policy measures were initiated during 2011-12 with a greater focus on regulatory and supervisory apparatus, in line with the ongoing global initiatives such as migration to Basel II advanced approaches, setting the roadmap for Basel III implementation, efforts to move for a dynamic provisioning framework/ countercyclical capital buffers, securitisation norms, sound compensation practices and adoption of a risk-based supervisory approach for banks. Steps were also initiated to check the menace of money laundering/ terrorism financing, combating frauds, widening access to payment and settlement systems and improving customer service in banks. The Reserve Bank continued to spearhead the agenda of financial inclusion through policy initiatives combined with its outreach visits programme.

1. Introduction

3.1 Amidst an adverse external environment, the Indian economy during 2011-12 traversed a difficult terrain characterised by inflationary pressures, growth slowdown and deteriorating fiscal and external sector balances. Against the backdrop of a difficult macroeconomic setting, monetary policy had the difficult task of reining in inflation, arresting the growth slowdown, providing adequate liquidity in the system to ensure non-disruptive functioning of the financial markets and containing volatility in the forex market. The Reserve Bank continued to maintain an anti-inflationary stance up till mid-December 2011. With the emerging evidence on growth slowdown, the Reserve Bank front-loaded its action and cut the policy rates in April 2012, before reverting to pause mode in the wake of persisting inflationary pressures.

3.2 The Indian banking industry has largely remained insulated from the global financial turbulence. The global crisis brought to the fore the flaws in the Basel II prudential regulatory framework, micro-supervisory approach and its procyclical nature. Though the need for reorienting prudential policies to have a macro dimension was recognised the world over after the crisis of 2008, India was well ahead in adopting macro-prudential policies even before the crisis. Nonetheless, in the light of lessons from the global financial crisis, the Reserve Bank has been constantly reviewing and refining its regulatory and supervisory policies to ensure a strong capital base, effective risk management and best corporate governance standards in the banking sector. In recent years, the focus has also been on improving credit delivery, customer service and promoting financial inclusion.

3.3 The Reserve Bank continued to undertake several policy initiatives during the year to make the Indian banking system sound, resilient and inclusive, consistent with the developments in global regulatory reforms. This chapter traces the major developments in various areas of banking

sector policy, with greater focus on regulatory and supervisory initiatives undertaken during 2011-12.

2. Monetary Policy

Monetary policy attuned to containing inflation and mitigating the risks to growth slowdown

3.4 The monetary policy stance during 2011-12 was shaped by the overarching priorities of controlling inflation and arresting the growth slowdown. While in the first half, monetary policy had to address the risk of entrenchment of inflationary pressures and elevated inflation expectations, during the second half, with signs of marked deceleration of domestic growth, monetary policy sought to strike a balance between the objectives of growth stabilisation and low and stable inflation. Concomitantly, with liquidity deficit breaching the indicative comfort zone for an extended period due to both frictional and structural factors, the Reserve Bank had to embark on an active liquidity management with a slew of measures including OMOs to inject durable liquidity, so as to ensure non-disruptive functioning of the domestic financial markets. This also posed a challenge for monetary policy in effectively communicating the intent of liquidity-easing steps as distinct from its monetary policy stance.

3.5 The headline WPI inflation during April-November 2011 remained stubbornly high, averaging at 9.7 per cent. Treading the path of an anti-inflationary stance, the Reserve Bank raised its key policy repo rate five times by 175 basis points during April-November 2011. From the beginning of the fourth quarter of 2011-12, while there were growing indications of a moderating inflation on account of deceleration in food inflation, the downside risks to growth were clearly on the rise. In addition, the deficit liquidity conditions persisted way beyond the comfort zone of the Reserve Bank. Considering that such structural liquidity constraints in the economy, if not addressed, could lead to disruption in credit flow and exacerbate growth risks, the Reserve Bank reduced the CRR by 125 basis points effective January 28, 2012 and March 10, 2012. Keeping in view the growth slowdown, the Reserve Bank front loaded the policy rate reduction by bringing down the key policy repo rate by 50 basis points to 8 per cent on April 17, 2012. Further, based on an assessment of the prevailing macroeconomic situation, the Reserve Bank cut the CRR by 50 basis points to 4.25 per cent effective September 22, 2012 and November 3, 2012. Taking its cue from the Reserve Bank's change in the policy rate, banks have responded by attuning their deposit and lending interest rates.

3.6 Even as core inflation moderated, it continued to be well above the historical trend. Headline inflation continued to remain sticky, even as growth moderated. Monetary policy, in such a scenario had to maintain a fine balance, such that, while addressing short-term growth concerns, price stability is maintained to ensure sustainable growth over the medium-term.

Deregulation of savings bank deposit rate to bring finer pricing in savings deposits

3.7 The continued regulation of savings deposit rate hampered competition with both banks and depositors acting passively, which reduced its relative attractiveness and inhibited product innovation. Moreover, in recognition of the fact that deregulation of interest rate on savings deposits would make the rate flexible and facilitate monetary transmission, the Reserve Bank during 2011-12 initiated two major changes on the liability side of banks' balance sheet, *viz.,* (a) deregulation of savings bank deposit interest rate effective October 25, 2011 and (b) deregulation of interest rates on both savings deposits and term deposits of maturity of one year and above under Non-Resident External (NRE) accounts, and savings deposits under Non-Resident Ordinary (NRO) accounts effective December 16, 2011. The transition phase in the post-deregulated period for

each of these items has been smooth so far. With these reforms, on the liability side, current account deposits, Foreign Currency Non-Resident (Banks) [FCNRB] deposits and borrowings under overseas line of credit continue to remain regulated by the Reserve Bank. On the assets side, buyers credit to importers continues to be regulated.

Hike in interest ceiling on FCNR (B) deposits to attract foreign currency inflows

3.8 With a view to augmenting foreign currency inflows into the economy, the interest rate ceiling on FCNR(B) deposits was raised to LIBOR/ Swap rates *plus* 200 basis points for 1-3 year maturity and LIBOR/ Swap rates *plus* 300 bps for 3-5 year maturity, effective May 5, 2012 from LIBOR/ Swap rates *plus* 125 basis points for 1-5 year maturity earlier. The interest rate ceiling for overseas line of credit for exporters by banks is currently at 6 months LIBOR/ EURO LIBOR/ EURIBOR *plus* 250 basis points effective November 15, 2011, subject to a review as and when warranted. The current all-in-cost ceiling on buyers credit is at 6 months LIBOR *plus* 350 basis points, subject to a review based on experience gained in this regard.

Deregulation of export credit interest rate to facilitate foreign currency loans

3.9 The interest rate on export credit in foreign currency was deregulated effective May 5, 2012. This measure is expected to increase foreign currency loans to exporters.

Enhanced liquidity cushion for banks under MSF

3.10 With a view to contain volatility in the overnight inter-bank money market, the Marginal Standing Facility (MSF) Scheme was introduced effective May 9, 2011, under which scheduled commercial banks (SCBs) were allowed to borrow overnight up to one per cent of their respective Net Demand and Time Liabilities (NDTL) without the obligation to seek a specific waiver for default in SLR compliance arising out of use of this facility. Effective December 21, 2011, banks were also permitted to avail of funds from the Reserve Bank under the MSF against their excess SLR holdings. In order to provide a greater liquidity cushion, the borrowing limit was further raised to 2 per cent of NDTL effective April 17, 2012.

Bank Rate aligned with MSF Rate

3.11 In the context of changed operating procedure of monetary policy, the policy repo rate and the MSF rate have become operational, while the Bank Rate continued to remain at 6 per cent. The Bank Rate acts as the penal rate charged on banks for shortfalls in meeting their reserve requirements. The Bank Rate is also used by several other organisations as a reference rate for indexation purposes. Being the discount rate as per the Reserve Bank Act, the Bank Rate should technically be higher than the policy repo rate. Therefore, the Reserve Bank felt that the Bank Rate should stay aligned with the MSF rate, which is instituted at 100 basis points above the policy repo rate. Accordingly, the Bank Rate was increased by 350 basis points from 6.0 per cent to 9.5 per cent per annum, with effect from February 13, 2012. This was a one-time technical adjustment to align the Bank Rate with the MSF rate rather than any change in the monetary policy stance. Consequently, the Bank Rate has remained aligned to the MSF rate.

3. Credit Delivery

3.12 The Reserve Bank has been laying considerable emphasis on ensuring adequate and timely credit at reasonable rates to different sectors of the economy. For achieving the objective of sustainable and inclusive economic growth, it is important to bring the under-served sectors/ sections of society within the banking fold. Against this backdrop, several initiatives were taken during the year, which include revising the priority sector norms to refocus direct agricultural lending by banks; extending the interest subvention relief to farmers to post-harvest operations; setting up a new short-term refinance facility for on-lending to agriculture; providing debt relief under the

Agricultural Debt Waiver and Debt Relief (ADWDR) Scheme, 2008; revising the Kisan Credit Card (KCC) Scheme to suit current requirements; and introducing measures to enhance the flow of credit to micro and small enterprises (MSEs). Steps were also taken during the year to promote Women SHGs in backward and Left-Wing Extremism (LWE)-affected districts of the country. Further, to make the approach and design of the SHG-Bank Linkage Programme more flexible, some client-friendly product level changes were also made in tune with the changing requirements of customers.

Ambit of priority sector lending revisited

3.13 The changing economic conditions and experience from the operation of the priority sector lending scheme over the years led to a need for revisiting the priority sector guidelines and updating it in line with current national priorities. Accordingly, the Reserve Bank in August 2011 set up a Committee (Chairman: Shri M. V. Nair) to re-examine the existing classification and suggest revised guidelines with regard to priority sector lending classification and related issues. The Committee submitted its report in February 2012. In the light of comments/ suggestions on the Committee's recommendations received from the various stakeholders, priority sector lending guidelines were revised by the Reserve Bank on July 20, 2012. Under the revised guidelines, there is no change in the overall target of priority sector since it was felt that fresh targets would distort the allocation of credit. However, in view of the growing network of foreign banks, it was felt that there is a need to relook into the preferential treatment given to them under priority sector lending. Accordingly, it was decided that foreign banks that have 20 branches or more will be subject to the same targets as domestic banks, to be achieved within a period of five years from April 1, 2013; in the case of other foreign banks, the existing overall target of 32 per cent would continue to apply.

3.14 The focus of the Committee was on direct lending by banks to small/ marginal farmers and micro enterprises. The revised guidelines aim to refocus direct agricultural lending to individuals, Self-Help Groups (SHGs) and Joint Liability Groups (JLGs) engaged in agriculture and allied activities, while keeping the targets unchanged both under direct and indirect agriculture lending. Bank loans to farmers through entities like Primary Agricultural Credit Societies (PACS) ceded to or managed/ controlled by banks have been included under direct lending to agriculture. This would facilitate banks that do not have a wide presence in rural areas and would otherwise have difficulty in meeting the targets. In view of inadequate credit flow to the services sector, some changes were made by expanding the definition of the services sector to include services, which were not specifically listed earlier under priority sector lending, with a ceiling of `10.0 million per unit.

3.15 As per the revised guidelines, the items that would be reckoned under the priority sector include loans up to `2.5 million for housing in metropolitan centres (with population above 10 lakh) and `1.5 million at other centres; loans to individuals for education including vocational courses up to `1.0 million in India and `2.0 million abroad; loans for housing projects for economically weaker sections (EWS) and low income groups (LIG), provided the cost does not exceed `0.5 million per dwelling unit; loans to distressed farmers indebted to non-institutional lenders; loans to individuals other than farmers up to `50,000 to prepay their debt to non-institutional lenders; and loans to individuals to set up off-grid solar and other renewable energy solutions for households.

3.16 Further, in the light of discussions held with select banks on the operational issues and based on the feedback received, certain additions/ amendments were made in the guidelines on October 17, 2012. It was decided that loans up to `20 million to corporates including farmers' producer companies, partnership firms and co-operatives of farmers directly engaged in agriculture and allied activities will also be classified as direct finance to agriculture. The limit

for loans under priority sector in respect of services provided by MSEs was raised to `20 million and and the cost of dwelling unit for housing projects for EWS and LIG categories was raised to `1 million. Further it was decided to include under priority sector, bank loans to Housing Finance Companies (HFCs) for on-lending for housing up to `1 million per borrower provided the interest rate charged to the ultimate borrower does not exceed the lowest lending rate of the lending bank for housing loans *plus* two per cent per annum.

Interest rate subvention relief to farmers extended to post-harvest operations

3.17 In order to make credit available at a reasonable cost to the farmers, it was announced in the Union Budget 2006-07 that the farmers would be made available short term credit at an interest rate of 7.0 per cent per annum, with an upper limit of `0.3 million on the principal amount. Towards this end, the Government of India announced interest subvention for public sector banks, RRBs and co-operative banks. The Union Budget 2011-12 provided interest subvention of 2 per cent for short-term production credit up to `0.3 million and enhanced the additional interest subvention for prompt-paying farmers to 3 per cent, so that the effective interest rate for such farmers would be 4 per cent. Further, the benefit of interest subvention has been extended to small and marginal farmers who have a Kisan Credit Card (KCC) for a further period of upto six months (post-harvest) against negotiable warehouse receipts. This is expected to discourage distress sale of crops by these farmers and encourage them to store their produce in warehouses. As announced in the Union Budget 2012-13, the scheme of interest subvention will continue for the year 2012-13 on the same lines.

New short-term refinance facility for on-lending to agriculture

3.18 With a view to provide adequate and timely credit to farmers, during 2011-12, it was decided to introduce a separate Short-Term Refinance Facility from NABARD for Central Co-operative Banks (CCBs) with sound financial position and a new line of short-term refinance support for public sector banks and RRBs for financing the PACS in such areas where CCBs are weak. The quantum of refinance is fixed at a uniform rate of 45 per cent of the Realistic Lending Programme. The facility is available at an interest rate of 4.5 per cent per annum provided that the rate charged to the ultimate borrower for crop loans upto `0.3 million does not exceed 7 per cent per annum.

Additional refinance facility for agriculture in the Eastern and North-Eastern Regions

3.19 NABARD extended additional refinance to the co-operative banks and RRBs in the Eastern and North-Eastern Regions (including hilly regions), which are disbursing crop loans upto `0.3 million per borrower at 7 per cent interest per annum. Accordingly, State Co-operative Banks (StCBs) and RRBs in the Eastern and North-Eastern Region are eligible to receive additional quantum of refinance of 5 per cent and 25 per cent, respectively, over and above the normal quantum of refinance. Further, the facility of additional refinance of 5 per cent was made applicable to banks in 28 districts of Eastern Uttar Pradesh.

Concessional refinance support for agriculture investment activities

3.20 The scheme to provide refinance at a concessional rate of 7.5 per cent per annum to banks was introduced in the year 2011-12 to ensure investments in agriculture to enhance the production and productivity of crops in the Eastern Region. The operative period of the scheme is two financial years, *viz.,* 2011-12 and 2012-13. Four activities, *viz.,* water resource development, land development, farm equipment (including tractor financing on group mode basis) and seed production area are covered under the Scheme. The banks were offered refinance *plus* support for (a) forming and linking of JLGs,

(b) awareness programmes for promoting the scheme, (c) organising sensitisation meets for branch officials and (d) training and capacity building needs of entrepreneurs identified under the Scheme.

Progress under the Agricultural Debt Waiver and Debt Relief (ADWDR) Scheme, 2008

3.21 Under the ADWDR scheme, lending institutions were compensated by the Government of India in a staggered manner (Table III.1). The Government has so far released `525 billion in five installments. Of this, about `293 billion was passed on to NABARD for reimbursement to RRBs and co-operatives. Besides, an amount of `232 billion was released for reimbursement by the Reserve Bank to SCBs, Local Area Banks (LABs) and Urban Co-operative Banks (UCBs). Of this, as on September 10, 2012, an amount of `232 billion has been disbursed, while `0.81 billon is being held as balance in the relevant account by the Reserve Bank for further payments, if any, and/ or for refund to the Government of India.

New Electronic Kisan Credit Card to facilitate credit delivery to farmers

3.22 The Kisan Credit Card (KCC) has proved to be an innovative credit delivery mechanism to meet the production credit requirements of farmers in a timely and hassle-free manner. The scheme has been under implementation in the entire country and has received wide acceptability among bankers and farmers. With a view to simplifying and attuning the Scheme to suit current requirements and to facilitate the issue of Electronic Kisan Credit Cards, a Working Group (Chairman: Shri T.M. Bhasin), was constituted. Pursuant to its recommendations, a revised KCC scheme was put in place in May 2012. The salient features of the revised scheme include KCC limit to comprise crop loan portion, post-harvest expenses, consumption requirements, working capital and investment credit for agriculture and allied activities; all farmers/ owner cultivators, tenant farmers, oral lessees and share croppers to be eligible for finance under KCC; limit to be drawn through any delivery channel, such as ATMs, Business Correspondents (BCs), point of sale (PoS) and mobile-based transactions with agricultural input dealers and *mandis*; interest subvention/ incentive for prompt repayment; and loan against the warehouse receipt. The National Payments Corporation of India (NPCI) will design the KCC to be adopted by all banks.

Table III.1: Agricultural Debt Waiver and Debt Relief Scheme

(Amount in ` billion)

Lending Institutions	Amount Reimbursed by Government of India (in instalments)					
	First	Second	Third	Fourth	Fifth	Total
	Sept 2008	Jul 2009	Jan 2011	Nov 2011	Mar 2012	
RRBs and Co-operatives	175	105	12	0.4	0.0	293
SCBs, UCBs and LABs	75	45	101	10	1*	232
Total	250	150	113	11	1*	525

*includes ` 0.81 billion balance held by RBI.

Greater focus on lending to MSMEs

3.23 A High Level Task Force was constituted by the Government of India (Chairman: Shri T. K. A. Nair), to consider various issues relating to the Micro, Small and Medium Enterprises (MSMEs) in September 2009. The Task Force submitted its Report in January 2010. Pursuant to its recommendations, SCBs were advised that the share of micro enterprises in MSE lending should amount to 60 per cent. This is to be achieved in a phased manner, *i.e.,* 50 per cent during 2010-11, 55 per cent in 2011-12 and 60 per cent in 2012-13, with 10 per cent annual growth in the number of micro enterprise accounts and also 20 per cent y-o-y growth in MSE lending. The Reserve Bank is closely monitoring the achievements of targets by banks on a quarterly basis. The Reserve Bank has held one to one meetings with banks to know the constraints and also impress upon them to devise strategies to gear up the credit mechanism for the sector. It has also taken up the matter with the banks that have failed to achieve the targets prescribed by the Task Force.

Rural Infrastructure Development Fund (RIDF)

3.24 The RIDF was established in NABARD in 1995 as a repository of the shortfall in priority sector lending by commercial banks. The corpus of the fund for the year 2011-12 would be contributed by domestic scheduled commercial banks, having shortfall in achievement of priority sector lending target (40 per cent) and/ or agriculture lending target (18 pre cent) and/ or weaker sections lending target (10 per cent), as on the last reporting Friday of March 2011. Funds from RIDF are lent to State Governments for implementing rural infrastructure projects. Originally, the objective was to allocate these funds only to finance the funding gap, that is, to provide financing for projects that are nearly, but not fully, complete. RIDF funding is now available for 31 eligible activities relating to rural infrastructure projects. Since 1995-96, the Government has announced an annual allocation in each Union Budget to the Fund. Since RIDF I, the corpus has grown manifold and stood at ` 180 billion under RIDF XVII (2011-12). The total cumulative allocation across all tranches taken together stood at ` 1,525 billion including ` 185 billion under a separate window for funding rural roads under the Bharat Nirman Programme. Further, under RIDF XVII, ` 20 billion has been exclusively dedicated for the creation of warehousing facilities.

Microfinance

Revisiting the SHG Bank Linkage Programme

3.25 The SHG Bank Linkage Programme (SHG - BLP) continues to be the leading model in India's microfinance sector. To make the approach and design of SHG-BLP more flexible, guidelines were issued by NABARD on March 27, 2012 suggesting some client friendly product level changes in tune with the changing needs of customers under SHGs, such as allowing voluntary savings by members with surplus funds, which could be maintained separately or used for intra-group lending; providing need-based access to funds and longer tenure of credit from banks through the introduction of a cash credit system to obviate the need for frequent documentation and also delays in the renewal of loans; extending JLG or other non-collateral lending models of higher credit needs to smaller livelihood groups; a self-rating mechanism to improve the quality of the group; and developing federations to continuously guide, nurture and cater to the needs of the groups.

Promotion of women SHGs in backward and LWE districts

3.26 A scheme for promotion and financing of Women Self-Help Groups (WSHG) in association with the Government of India is being implemented across 150 backward and Left-Wing Extremism affected districts of the country. The scheme aims to encourage viable and self-sustainable WSHGs by involving NGOs/ support agencies, which shall promote and facilitate credit linkage of these groups with banks, provide continuous handholding support and also take responsibility for loan repayments. NABARD shall provide grant support of ` 10,000 per SHG to these NGOs and also bear the cost of training and other capacity-building initiatives.

Promotional assistance for capacity building of SHGs/ JLGs and MFIs

3.27 The Revolving Fund Assistance, Capital Support and Grant Support for rating provided to eligible microfinance institutions (MFIs) by NABARD out of the Microfinance Development and Equity Fund (MFDEF) has been discontinued from April 1, 2011 following the announcement in the Union Budget 2011-12. Accordingly, the existing MFDEF will henceforth be exclusively used for the purpose of training and capacity building support for SHGs and MFIs, supporting matured SHGs to undertake livelihood promotion activities and forming JLGs.

4. Financial Inclusion

3.28 In India, growth with equity has been the central objective right from the inception of the planning process. In this direction, the objective of financial inclusion is to provide financial services at affordable cost to those who are excluded from the formal financial system. This is vital for sustaining long-term equitable development, since a sizeable proportion of households/ areas do not have access to basic banking facilities, notwithstanding the existence of a vast institutional framework in the country. In recent years, there has been growing emphasis by the Government and the Reserve Bank on providing formal financial services to the hitherto unbanked/ under-banked areas. A multi-pronged strategy has been adopted to enhance the outreach of banking services across all sections of society. In order to achieve the objective of universal financial inclusion, banks have been directed to use a combination of strategies, which include: (a) provision of basic banking products; (b) introduction of the Business Correspondent/ Business Facilitator (BF) model; (c) relaxation of existing regulatory guidelines in the form of lenient Know Your Customer (KYC) norms; (d) enhanced use of technology; and (e) setting up financial literacy and credit counseling centres in districts to achieve greater outreach. During 2011-12, the Reserve Bank continued with the policy initiatives aimed at expanding the outreach of banking services to remote parts of the country.

Branch authorisation policy geared for greater rural outreach

3.29 Keeping in view the goal of bringing banking services to an identified 72,800 villages with a population above 2,000 by March 2012, and thereafter progressively to all villages over a period, banks were advised that while preparing their Annual Branch Expansion Plan, they should allocate at least 25 per cent of the total number of branches proposed to be opened during a year to unbanked rural (Tier V and Tier VI) centres. With the aim of providing enhanced banking services in Tier II centres, the general permission being granted to domestic scheduled commercial banks for opening branches in Tier III to Tier VI centres was extended to opening branches in Tier II centres (with population of 50,000 to 99,999 as per Census 2001) without the need to take permission from the Reserve Bank in each case, subject to reporting.

Inter-operability at retail outlets

3.30 In order to facilitate financial inclusion further, it was decided to permit inter-operability at the retail outlets or sub-agents of Business Correspondents *(i.e.,* at the point of customer interface), provided the technology available with the bank that has appointed the BC supports inter-operability, subject to the following conditions: (i) the transactions and authentications at such retail outlets or sub-agents of BCs are carried out on-line; (ii) the transactions are carried out on a core banking solution (CBS) platform; and (iii) the banks follow the standard operating procedures to be advised by the Indian Banks' Association (IBA). However, the BC or its retail outlet or sub-agent at the point of customer interface would continue to represent the bank that has appointed the BC.

Intermediate brick-and-mortar structure to facilitate Business Correspondents

3.31 Recognising the fact that the success of the BC model is dependent on the support provided and monitoring by the base branches of the concerned banks, the Reserve Bank had advised banks that they may establish outlets in rural centres, which are intermediate brick-and-mortar structures (Ultra-Small Branches) between the existing base branch and BC locations, so as to provide support to a cluster of about 8-10 BC units at a reasonable distance of about 3-4 kilometers. Such Ultra-Small Branches should have the minimum required infrastructure, such as a CBS, and would have to be managed full-time by bank officers/ employees. It is expected that such an arrangement would lead to efficiency in cash management, documentation, redressal of customer grievances and close

supervision of BC operations. Further, BCs can operate from such Ultra-Small Branches, which would enhance their legitimacy and credibility in the area and boost confidence among the public to use their services.

Special Dispensation Scheme to improve bank presence in the North-Eastern Region

3.32 Under the Special Dispensation Scheme, the Reserve Bank had undertaken to reimburse a one-time capital cost and recurring expenses for five years to banks for setting up branches at agreed centres in the North-Eastern Region, and the State Governments had agreed to provide the necessary premises, security and rental accommodation for the bank staff. The special dispensation provided by the Reserve Bank would be available for only those branches that have been opened at allotted centres by June 30, 2012.

5. Prudential Regulatory Policy

3.33 The recent global financial crisis has redefined the broad contours of regulation of the banking sector. There is a growing recognition that regulatory and supervisory policies need to be strengthened, particularly by adopting a system-wide approach to counteract pro-cyclical movements in the banking sector. The regulatory initiatives by the Reserve Bank during the year continued to focus on adopting international best practices. The migration of commercial banks to the Basel II framework has made considerable progress and efforts are on to move towards advanced approaches. One of the important initiatives taken during the year was setting up the roadmap for Basel III implementation. Measures were also taken to examine the implementation of countercyclical capital buffers in India. Initiatives have also been undertaken to move towards a dynamic provisioning framework, aligning securitisation norms with international best practices, adopting sound compensation practices, setting up prudential limits on banks' investment in non-financial companies, checking the menace of money laundering/ terrorism financing activities and regulating foreign contributions to banks.

Migration to Basel II advanced approaches

3.34 The Basel II framework provides two broad methodologies, namely, the Foundation/ Standardised Approach and more advanced approaches, to banks to calculate the capital requirements for credit, market and operational risks. All the SCBs in India have been Basel II compliant as per the standardised approach with effect from April 1, 2009. In July 2009, the timetable for the phased adoption of advanced approaches was also placed in the public domain. Migrating to Basel II advanced approaches offers many benefits to banks which, *inter-alia,* include improvement in risk assessment and management, monitoring and reporting processes, accurate risk-adjusted pricing of products and efficient allocation of capital. Nonetheless, to adopt these advanced risk-sensitive approaches, banks also need to be more sophisticated in terms of overall risk management infrastructure, systems, practices and culture.

3.35 Banks desirous of moving to advanced approaches under Basel II have been advised that they can apply for migrating to advanced approaches of Basel II for capital calculation on a voluntary basis based on their preparedness and subject to the Reserve Bank approval. The appropriate guidelines for advanced approaches of market risk, operational risk and credit risk were issued in April 2010, April 2011 and December 2011, respectively. Banks are presently assessing their preparedness and applying to the Reserve Bank for migrating to advanced approaches.

Roadmap set for Basel III implementation

3.36 The Basel Committee on Banking Supervision (BCBS) issued a comprehensive reform package, "Basel III: A global regulatory framework for more resilient banks and banking systems" in December 2010. The objective of the reform package is to improve the banking sector's ability to absorb shocks arising from financial and

economic stress, whatever the source, thus reducing the risk of spillover from the financial sector to the real economy. Consequently, the Reserve Bank issued final guidelines on Basel III implementation in Indian banks on May 2, 2012 after due consideration of the comments/ suggestions received from various stakeholders on the draft guidelines issued on December 30, 2011.

3.37 The guidelines issued by the Reserve Bank will become effective from January 1, 2013 in a phased manner. In order to allow banks to prepare and plan and also to minimise any unintended consequences arising out of higher capital requirements, a long phase-in period has been provided. The Basel III norms will be made fully applicable from March 31, 2018.

The key features of the guidelines are as follows:

(i) **Minimum capital requirements:** Total capital must be at least 9 per cent of risk-weighted assets (RWAs). Tier 1 capital must be at least 7 per cent of RWAs; and Common Equity Tier 1 (CET1) capital must be at least 5.5 per cent of RWAs.

(ii) **Capital Conservation Buffer (CCB)**: The CCB in the form of common equity of 2.5 per cent of RWAs is required to be maintained; and total capital with CCB will be 11.5 per cent of RWAs.

(iii) **Leverage ratio**: A non-risk-based Tier 1 leverage ratio has been prescribed. There will be a parallel run for the leverage ratio from January 1, 2013 to January 1, 2017, during which banks should strive to maintain a minimum Tier 1 leverage ratio of 4.5 per cent. The leverage ratio requirement will be finalised taking into account the final proposal of the Basel Committee.

3.38 The implementation period of Basel III capital requirements, including capital conservation buffer and regulatory deductions, will begin from January 1, 2013 and will be fully implemented by March 31, 2018, before the timeline (January 1, 2019) indicated in Basel III rules. In India, implementation of Basel III has been advanced by nine months to ensure that full implementation is co-terminus with the financial closure of banks (Table III.2).

3.39 As a prudential measure, the Reserve Bank has always prescribed minimum capital adequacy ratio 1 per cent higher at 9 per cent compared to 8 per cent stipulated by the Basel Committee under Basel I/ Basel II capital adequacy framework. The higher prescription has served Indian banking system well over the years. The higher capital adequacy norms will ensure that individual banks are stronger and internationally competitive. The higher prescription also enhances the resilience of the Indian banking system. It is important to consider that banks are exposed to certain risks, which cannot be properly explained and quantified. Therefore, such risks can be taken care of to a larger extent by the additional capital cushion. Besides the Basel Committee provides flexibility to national regulators in deciding the higher minimum capital requirements in their respective

Table III.2: Phase-wise Timeline for Basel III Implementation

(Per cent of RWAs)

Minimum Capital Ratios	Jan 1, 2013	Mar 31, 2014	Mar 31, 2015	Mar 31, 2016	Mar 31, 2017	Mar 31, 2018
Minimum Common Equity Tier 1 (CET1)	4.5	5.0	5.5	5.5	5.5	5.5
Capital Conservation Buffer (CCB)	-	-	0.625	1.25	1.875	2.5
Minimum CET1+ CCB	4.5	5.0	6.125	6.75	7.375	8.0
Minimum Tier 1 Capital	6.0	6.5	7.0	7.0	7.0	7.0
Minimum Total Capital	9.0	9.0	9.0	9.0	9.0	9.0
Minimum Total Capital + CCB	9.0	9.0	9.625	10.25	10.875	11.5
Phase-in of all deductions from CET1 (in %)	20.0	40.0	60.0	80.0	100.0	100.0

jurisdictions. Many regulators have prescribed higher capital adequacy requirements than the minimum prescribed by the Basel Committee.

Working Group to examine countercyclical capital buffers in India

3.40 Procyclicality has been among the identified underlying causes for the recent global financial crisis. Against this backdrop, the BCBS has prescribed the creation of a countercyclical capital buffer to protect the banking sector from periods of excess aggregate credit growth often associated with build-up of system-wide risk. This would enable the banking sector to have capital on hand to maintain the flow of credit even during periods of system-wide stress. To operationalise the system of a countercyclical capital buffer in India, an internal Working Group (Chairman: Shri B. Mahapatra) has been constituted within the Reserve Bank to examine the appropriateness of the credit-to-GDP guide and to consider other indicators that may be used for the capital buffer decision in the Indian context.

Efforts are on to move towards Dynamic Provisioning Framework

3.41 In the context of the recent global financial crisis, there has been a growing emphasis on a review of the impairment-accounting framework for financial assets, which is engaging the attention of accounting standard-setting bodies, the Basel Committee and other international bodies. To address the pro-cyclicality of provisioning requirements, efforts at the international level are being made to introduce dynamic provisioning framework. The Reserve Bank accordingly prepared a discussion paper on the dynamic provisioning framework and placed it on its website on March 30, 2012. The comments and feedback received from banks and other stakeholders on the discussion paper are currently under examination. Banks with the capability to calibrate their own parameters may, with the prior approval of the Reserve Bank, introduce the dynamic provisioning framework using the theoretical model indicated by the Reserve Bank. Other banks would have to use the standardised calibration arrived at by the Reserve Bank.

Revised guidelines on securitisation to align with international best practices

3.42 The market for securitisation of standard assets was growing significantly during the pre-financial crisis period. In order to ensure orderly development of the market, the Reserve Bank had issued a set of guidelines on securitisation of standard assets in February 2006. However, during the global financial crisis, market failures in securitisation, particularly securitisations of US subprime mortgages, played a precipitating role. Though the securitisation market in India is marked by relatively simple structures and stable ratings, concerns over asset quality have affected investor appetite for securitisation in the post-crisis scenario.

3.43 Post-crisis, international endeavours to better align the incentives of the originators and investors of securitisation by way of regulatory changes resulted in many new regulatory proposals being considered. The important features of such endeavours were a Minimum Holding Period (MHP) and Minimum Retention Requirement (MRR). The regulations proposed that originators should be allowed to securitise assets only after demonstrating a minimum recovery performance and the originators should continue to have a stake throughout the life of the transaction by way of retention of a portion of the assets securitised. In order to adopt the best international practices, the Reserve Bank issued revised guidelines on securitisation transactions in May 2012. The guidelines have introduced norms on MHP, MRR, prohibition of securitisation of single loans, loan origination standards, standards of due diligence, *etc.,* with regard to securitisation transactions. Concomitantly, the Reserve Bank has issued a set of detailed guidelines on transactions involving transfer of assets through direct assignment of cash flows and the underlying securities to do away with the possible regulatory arbitrage that

existed between the securitisation route and the direct assignment route.

Sound compensation practices among Indian banks

3.44 In the aftermath of the global financial crisis, the Financial Stability Board (FSB) brought out a set of principles and implementation standards on sound compensation practices in April and September 2009, respectively. The principles are intended to reduce incentives towards excessive risk-taking that may arise from the structure of compensation schemes. The principles call for effective governance of compensation and its alignment with prudent risk-taking, effective supervisory oversight and stakeholder engagement. Based on the FSB principles for sound compensation practices, the Reserve Bank had in July 2010 placed draft guidelines on compensation on its website, inviting public comments. Meanwhile, in October 2010 the BCBS brought out a consultative paper and issued the final paper in May 2011.

3.45 Taking into account the feedback received on the draft guidelines and the impact analysis carried out with the help of external consultants and methodologies prescribed by the BCBS on risk alignment, the Reserve Bank issued final guidelines in January 2012 applicable to all private sector and foreign banks operating in India. The guidelines are implemented from financial year 2012-13. These guidelines require the board of directors of banks to ensure effective governance of compensation of employees, alignment of compensation with prudent risk-taking and appropriate disclosure of compensation. The banks have also been advised that, as hitherto, private sector banks and foreign banks operating in India would be required to obtain regulatory approval for grant of remuneration to their whole-time directors/ Chief Executive Officers.

3.46 To undertake ongoing monitoring of the progress in implementing the FSB principles, the FSB has recently established a Compensation Monitoring Contact Group (CMCG) comprising experts from member jurisdictions, with regulatory or supervisory responsibility on compensation practices. The Reserve Bank is also a member of CMCG.

Prudential limits set on banks' investment in non-financial companies

3.47 Banks' investments in companies that are not subsidiaries are governed by Section 19(2) of the Banking Regulation Act, 1949. Hitherto, there was no requirement for obtaining prior approval of the Reserve Bank for such investments except in cases where the investee companies were financial services companies. It was, therefore, possible that banks could, directly or indirectly through their holdings in other entities, exercise control on such companies or have significant influence over such companies and, thus, engage in activities directly or indirectly not permitted to banks under Section 6(1) of the Act. This would be against the spirit of the provisions of the Act and is not considered appropriate from a prudential perspective. It was, therefore, decided to lay down prudential guidelines for banks' investments in companies that are not subsidiaries and are not 'financial services companies'. The revised guidelines prescribe prudential limits for bank's investments in non-financial companies in order to ensure that banks do not engage in activities that are not permitted under the Act.

Banks to identify/ assess risks of money laundering/ financing of terrorism

3.48 The Government of India constituted an Anti-Money Laundering (AML)/ Combating Financing of Terrorism (CFT) Risk Assessment Committee to present a comprehensive overview of AML/ CFT risk in the financial sector in a consolidated manner. As recommended by the Committee, banks/ FIs have been advised to take steps to identify and assess their ML/ TF risk for customers, countries and geographical areas as also for products/ services/ transactions/ delivery channels. In this regard, banks/ FIs are required to have in place policies, controls and procedures, duly approved by their boards, to effectively

manage and mitigate their risk by adopting a risk-based approach and apply enhanced measures for products, services and customers with a medium or high risk rating.

Foreign Contribution (Regulation) Act, 2010 to regulate receipt of foreign contributions

3.49 The Government of India enacted the Foreign Contribution (Regulation) Act in 1976 to regulate the receipt of foreign contributions and acceptance of hospitality by various entities. Over the years, deficiencies in the existing Act were noticed. Accordingly, the Government enacted the new Foreign Contribution (Regulation) Act, 2010 and notified Foreign Contribution (Regulation) Rules, 2011 framed there under, which came into force from May 1, 2011. Banks were advised to ensure compliance with the relevant provisions of FCRA, 2010 through guidance under Section 36(1)(a) of the Banking Regulation Act, 1949.

Reduction in the validity period of cheques/ drafts

3.50 The Government of India constituted an Inter-Ministerial Group (IMG) on Street Financing as there were reports of certain persons misusing the existing 6 month validity of cheques/ drafts by circulating the same instrument as cash for 6 months. In compliance with the recommendations of the IMG, banks were advised that with effect from April 1, 2012, they should not make payment of cheques/ drafts/ pay orders/ banker's cheques bearing that date or any subsequent date, if they are presented beyond the period of three months from the date of such instrument.

Unique Customer Identification Code (UCIC) to enable better risk profiling of bank customers

3.51 Banks were advised to introduce UCIC for their customers in India. The UCIC will help banks to identify customers, track the facilities availed of, monitor financial transactions in a holistic manner and enable banks to have a better approach to risk profiling of customers. It would also smoothen banking operations for customers. The risk categorisation of customers, compilation, periodic updating of customer profiles and monitoring of accounts by banks are extremely important for effective implementation of KYC/ AML/ CFT measures. Banks were advised to complete the process of risk categorisation and compiling/ updating profiles of all their existing customers by end-March 2013 (Box III.1).

Box III.1: Unique Customer Identification Code for Banks' Customers in India

One of the fundamental building blocks of financial data is reference data about companies, organisations, firms and individual customers. An essential component of reference data is a systematic structure or code that uniquely identifies each entity/ individual. Around the globe, regulators are considering ways to create common identifiers. A unique Legal Entity Identifier is considered ideal for financial data as it assists in improving regulation and risk management. The importance of creating a common system of identifiers has been recognised by the Financial Stability Board (FSB) and G-20 Finance Ministers and leaders. The FSB has been supporting the work by financial regulators and industry to establish a single global system for uniquely associating individuals/ institutions with financial transactions.

In India, banks are required to follow customer identification procedures while opening new accounts to reduce the risk of fraud and money laundering. While some banks in India have voluntarily developed a Unique Customer Identification Code (UCIC), in the absence of regulatory prescription, this practice was so far not followed uniformly by all banks. A UCIC will help banks to identify a customer, track the facilities availed of, monitor financial transactions in various accounts, improve risk profiling, take a holistic view of customer profiles and smoothen banking operations for the customer. In this regard, a working group constituted by the Government of India has proposed the introduction of unique identifiers for customers across different banks and financial institutions. While such a system for the entire financial system is desirable, it is likely to take some time for a complete roll-out.

Against this backdrop, the Reserve Bank has advised banks to initiate steps to allot a UCIC number to all their new customers to begin with. Banks have also been advised to allot UCIC to existing individual customers by the close of April 2013.

Grant of new bank licenses after the Amendment of the BR Act, 1949

3.52 It was announced in the Union Budget on February 26, 2010 that the Reserve Bank was considering providing additional banking licenses to private sector players, and non banking financial companies could also be considered, if they meet the required eligibility criteria. The Reserve Bank has accordingly prepared a discussion paper taking into account international practices and experience with private sector banks, and placed it in the public domain in August 2010. After examining the comments and suggestions received from the public and holding detailed discussions with all the stakeholders and the Government, the draft guidelines were prepared and placed in the public domain on August 29, 2011.

3.53 The draft guidelines stipulate conditions relating to eligible promoters, minimum capital, foreign shareholding, business model and desirable corporate structure and governance standards of the applicant group. As indicated in the draft guidelines, certain amendments to the Banking Regulation Act, 1949 are under consideration by the Government of India including a few that are vital for finalisation and implementation of the policy for licensing new banks in the private sector. The final guidelines will be issued and the process of inviting applications for setting up new banks in the private sector will be initiated only after the Banking Regulation Act is amended.

Enhancement of borrowing limit for FIs

3.54 As at end-March 2012, there were five financial institutions (FIs) under the regulation of the Reserve Bank, *viz.*, EXIM Bank, NABARD, National Housing Bank (NHB), Small Industries' Development Bank of India (SIDBI) and Industrial Investment Bank of India (IIBI). Of these, four FIs (EXIM Bank, NABARD, NHB and SIDBI) are under full-fledged regulation and supervision of the Reserve Bank. IIBI is under the process of voluntary winding-up. During 2011-12, in view of the difficulties expressed by NABARD and NHB, their aggregate borrowing limit has been enhanced to 11 times of their net owned funds (NOF) for one year, subject to a review. Further, the aggregate borrowing limit for EXIM Bank has been enhanced to 12 times of NOF for a period of one year, *i. e.,* up to August 31, 2013 due to fund constraints and thereafter it will revert back to 10 times of NOF. Additionally, borrowing under the umbrella limit for all four FIs has been enhanced from 100 per cent of NOF to 150 per cent of NOF for a period of one year, subject to a review. The guidelines on prudential norms issued to banks are also made applicable to select all-India FIs.

6. Supervisory Policy

Strengthening concurrent audit to combat frauds

3.55 A study of large-value frauds, including frauds under housing loan segment, reported by banks to the Reserve Bank was undertaken to identify gaps in the control mechanism that contributed to the perpetration of these frauds, particularly when the branches were also under concurrent audit. It was observed that a large number of frauds were perpetrated on account of the submission of forged documents by borrowers, which had been certified by professionals, *i.e.,* valuers/ advocates/ chartered accountants. In light of the findings of the study, banks were advised to enhance the efficacy of concurrent audit, *inter alia*, to ensure verification of title documents, especially for large-value loans; seek verification reports from local revenue authorities in the case of loans against the security of land; conduct independent verification of the authenticity of chartered accountants' certificates, property valuation certificates and legal certificates submitted by the borrower; and inculcate internal discipline, staff rotation, and a system of checks and balances.

A new return to capture interest rate sensitivity of banks

3.56 In terms of a notification dated November 4, 2010, a new return was introduced under DSB returns to capture banks' interest rate sensitivity under Duration Gap Analysis (economic value perspective) with effect from the quarter ended June 2011. The format of the extant report of the interest rate sensitivity under Traditional Gap Analysis (earnings perspective) has also been revised to capture the global position and the relevant currencies (against the existing reporting of domestic position and the Indian rupee).

BFS initiatives to strengthen the supervisory system of banks

3.57 The Board for Financial Supervision (BFS), constituted in November 1994, has been the chief guiding force behind the Reserve Bank's supervisory and regulatory initiatives. The BFS had 10 meetings during the period July 2011 to June 2012. The BFS examined, *inter alia*, the performance and the financial position of banks and financial institutions during 2009-10 and 2010-11, besides reviewing memorandum on inspection reports. It reviewed memorandum on 88 inspection reports of banks/ FIs. The BFS also reviewed summaries of inspection reports/ financial highlights pertaining to scheduled urban co-operative banks. Keeping in view the directions of the BFS, various initiatives were taken to strengthen the supervisory system of banks such as reviewing the coverage of the Annual Financial Inspection Reports and putting in place a revised format and the new guidelines; conducting thematic reviews on areas like real estate and KYC/ AML and appraising their findings to BFS; advising the foreign banks that the CEO should be held responsible for effective oversight over the audit process and its compliance; and advising banks not to include stamp duty, registration and other documentation charges for arriving at the eligible bank finance as these charges are not realisable.

HLSC recommends a risk-based supervisory approach for banks

3.58 The banking sector in India has witnessed considerable changes in recent years with significant growth in size, number and complexities in the banking business. To improve the quality of the Reserve Bank's supervisory processes/ techniques and benchmark them with global best practices, the Reserve Bank had set up a High-Level Steering Committee (HLSC) (Chairman: Dr. K. C. Chakrabarty), which submitted its report on June 11, 2012. The HLSC has recommended measures to transform the extant supervisory approach of examining past performance through a transaction-testing based (CAMELS) framework to a risk-based approach using trend analysis to find risk drivers and predict the path and passage of risks in the banks' books. The present 'one size fits all approach' of annual financial inspection of banks is intended to be replaced with a continuous supervision approach that is based on the risks posed by the bank to the supervisory objectives. The supervisory stance of the Reserve Bank based on the position of the bank in the risk matrix could be one of four - "Baseline Monitoring", "Close Monitoring", "Active Oversight" and "Corrective Action" - and would comprise specific supervisory actions to be initiated by the supervisor during the supervisory cycle. The risk assessment and the supervisory actions are intended to enable identification of risks and effective intervention at an early stage so as to minimise losses/ potential disruptions to the banking system. Overall, the Committee's recommendations are intended to encourage banks to adopt risk-based business conduct within an indicative timeframe through a system of incentives and disincentives. The Committee's recommendations are under examination for implementation. As a first step, banks have been advised of the decision to make transition to a risk based approach to supervision from the next supervisory cycle (2013-14). They have been

advised to assess the status of their risk management architecture, culture, practices and related processes against certain essential requirements identified for the introduction of risk based supervision.

Strengthening supervisory/ regulatory framework for financial conglomerates under FSDC umbrella

3.59 One of the mandates for the Financial Stability and Development Council (FSDC) and its sub-Committee is supervision of Financial Conglomerates (FCs). To institutionalise the framework for supervision of FCs and monitoring and management of systemic risks emanating from the activities of FCs, the Sub-Committee of the FSDC has approved the creation of an Inter-Regulatory Forum under the Chairmanship of the Deputy Governor, Reserve Bank with Executive Director-level membership from other peer regulatory/ supervisory agencies. The Inter-Regulatory Forum would be responsible for framing policies for the FCs (such as identification, group-wide risk management, group-wide capital adequacy and corporate governance) as well as for conducting high-level supervision of FCs. The Forum would also try to strengthen the supervisory co-ordination/ co-operation mechanism among the domestic supervisors for effective supervision of FCs.

7. Regional Rural Banks

Recapitalisation to revive the financial position of RRBs

3.60 On accepting the recommendations of the Committee (Chairman: Dr. K. C. Chakrabarty) to study the current level of capital to risk-weighted assets ratio (CRAR) of RRBs and to suggest a roadmap for enhancing the same to 9 per cent by March 31, 2012, the Government of India announced a Recapitalisation Programme in 40 of the 82 RRBs to ensure that their CRAR level reaches 9 per cent by March 2012. The Government of India, along with other shareholders, decided to recapitalise the RRBs by infusing funds to the extent of ₹ 22 billion. The shareholder-wise GoI/ sponsor banks/ State Governments proportion and amount is 50:35:15 and ₹11 billion: ₹8 billion: ₹3 billion, respectively. The Government of India made a budgetary provision of ₹5 billion for the financial year 2011-12 for this purpose.

3.61 An amount of ₹10 billion was released to 27 RRBs in 16 States as on March 31, 2012. The recapitalisation is complete in respect of 16 RRBs (in Odisha, Madhya Pradesh, Uttaranchal, Assam, Arunachal Pradesh, Nagaland, Tripura, Jammu and Kashmir and Karnataka). Six State Governments (Manipur, Uttar Pradesh, West Bengal, Rajasthan, Mizoram and Jammu and Kashmir) have not released any amount in respect of 13 RRBs. Among the 16 fully recapitalised RRBs, as on March 31, 2012, 12 have achieved the stipulated CRAR of 9 per cent. Further, of the 82 RRBs, 15 RRBs have failed to achieve the stipulated CRAR level.

Branch expansion of RRBs to promote the agenda of financial inclusion

3.62 As part of the strategy to promote financial inclusion, the RRBs were advised to undertake an aggressive branch expansion programme, particularly in hitherto unbanked areas. With the help of technology and the consolidation of RRBs, staff can be judiciously deployed in branches in the expansion plan. As on March 31, 2012, RRBs had a network of 16,914 branches. As per the advice of the Government of India, RRBs were to open 2,000 branches in two years, *i.e.,* 2010-11 and 2011-12. Against this, RRBs have opened 521 branches during 2010-11 and 913 branches during 2011-12 and have fallen short of the target. The Government of India has advised all sponsor banks of RRBs that 10 per cent of the existing RRB branch network will be the target for the year 2012-13. Accordingly, RRBs will be required to open 1,700 branches during the year 2012-13.

3.63 Under the agenda of financial inclusion, 73,000 villages that are not covered by any bank

and have a population of 2,000 and above were to be covered by RRBs through ICT-enabled Business Correspondents by March 31, 2012. RRBs have been allocated 20,000 villages and, at places where it is not viable to open a brick-and-mortar branch, the banks may start with Ultra-Small Branches (USBs); thereafter, at places where the bank reaches the desired level of business, the Ultra-Small Branches can be upgraded into regular bank branches.

Supervisory and regulatory initiatives for RRBs

3.64 During the year 2011-12, several policy initiatives were undertaken on supervision related matters of RRBs. These measures include revised guidelines to improve the fraud monitoring and reporting system; circulation of *modus operandi* of attempted fraud and best practices followed by some banks to strengthen the internal checks and control systems; conducting sensitisation workshops covering aspects related to implementation of KYC guidelines; ensuring compliance with the provisions of the Prevention of Money Laundering Act; internal checks and control system; corporate governance; and asset liability management.

8. Co-operative Banks

Urban Co-operative Banks

Internet banking permitted for eligible UCBs

3.65 Scheduled UCBs that have a minimum net worth of ` 1 billion, CRAR of at least 10 per cent, net NPA less than 5 per cent and have earned net profit continuously in the last three financial years were allowed to offer an internet banking facility with the approval of the Reserve Bank so as to enable them to serve their customers better.

Revision in housing loan limits and repayment period

3.66 UCBs in the Tier I category were permitted to extend individual housing loans upto a maximum of ` 3.0 million per beneficiary of dwelling unit; those in the Tier II category were permitted to extend individual housing loans upto a maximum of ` 7.0 million per beneficiary of a dwelling unit, subject to extant prudential exposure limits. Based on the representations received from the UCB sector, the maximum repayment period of housing loans granted by UCBs was revised from the present 15 years to 20 years.

Extension of interest rate subvention on Rupee export credit

3.67 With a view to encouraging exports in certain specified sectors, the Government of India decided to extend interest subvention of 2 per cent on rupee export credit for these sectors. Accordingly, the AD category 1 UCBs were advised of the decision to extend interest subvention of 2 per cent on pre-shipment and post-shipment Rupee export credit to these sectors from April 1, 2011 to March 31, 2012 and from April 1, 2012 to March 31, 2013, respectively.

Grant of NDS-OM membership to UCBs

3.68 NDS-OM is a screen-based electronic anonymous order matching system for secondary market trading in government securities owned by the Reserve Bank. At present, membership is open to entities like banks, primary dealers, insurance companies and mutual funds. UCBs that fulfill certain eligibility criteria were allowed direct access to the negotiated dealing system (NDS) order matching (OM), subject to obtaining prior approval from the Reserve Bank.

Submission of credit information to CIBIL and other credit information companies

3.69 UCBs were advised to submit quarterly, a list of suit-filed accounts of ` 10.0 million and above that were classified as doubtful or loss and a list of suit-filed accounts of willful defaulters of ` 2.5 million and above to the Credit Information Bureau of India Limited (CIBIL) and/ or any other credit information company that has obtained a Certificate of Registration (CoR) from the Reserve Bank and of which the bank is a member.

Supervisory Action Framework for UCBs

3.70 The Reserve Bank monitors and initiates supervisory actions based on its assessment of the financial position of UCBs. A Supervisory Action Framework was introduced for UCBs with effect from March 1, 2012. The framework envisages self-corrective action by the management of the UCBs themselves in the initial stage of deterioration in the financial position and supervisory action by the Reserve Bank in case the financial position of the bank does not improve.

Convergence of IAS with IFRS standards

3.71 As announced in the Annual Monetary Policy Statement 2010-11, UCBs with net worth in excess of ` 3 billion were advised to take necessary steps to ensure that they are in readiness to adopt the Indian Accounting Standards (IAS) converged with International Financial Reporting Standards (IFRS) from April 1, 2013 and those with net worth in excess of ` 2 billion but not exceeding ` 3 billion from April 1, 2014.

Revision of UCBs exposure to housing/ commercial real estate loans

3.72 The UCBs were earlier permitted to assume aggregate exposure on real estate, commercial real estate and housing loans upto a maximum of 10 per cent of their total assets, with an additional limit of 5 per cent of their total assets for housing loans upto ` 1.5 million. It was decided to permit UCBs to utilise the additional limit of 5 per cent of their total assets for granting housing loans up to ` 2.5 million, so that all priority sector housing loans are covered under this additional limit.

9. Non-Banking Financial Companies

Working Group to examine issues relating to gold loans

3.73 There has been a significant increase in loans by Non-Banking Financial Companies (NBFCs) against gold in the recent period. There are also complaints that some NBFCs are not scrupulously following the proper documentation process and KYC norms, among others, in order to quickly dispose of the cases relating to gold loans. Gold imports have also increased sharply, raising macroeconomic concerns. To undertake a detailed study of these aspects, a Working Group (Convener: Shri K. U. B. Rao) was constituted. The major terms of reference of the Group were: (i) to assess the trends in demand for gold loans and how they have influenced gold imports; (ii) to analyse the implications of gold imports for external and financial stability; (iii) to study the trends in gold prices and to examine whether NBFCs that extend gold loans play any role in influencing the price of gold; (iv) to examine the sources of funds of NBFCs for gold loans, especially their borrowings from the banking system; and (v) to examine the current practices of NBFCs involved in lending against the collateral of gold. The Working Group submitted its Report in August 2012.

10. Customer Service in Banks

Implementation of the Damodaran Committee recommendations to improve customer service in banks

3.74 The Committee on Customer Service in Banks (Chairman: Shri M. Damodaran) submitted its report in July 2011. The Committee made a total of 232 recommendations, of which 152 recommendations have since been implemented. The Reserve Bank has held discussions with the IBA, the Banking Codes and Standards Board of India (BCSBI), the Institute for Development and Research in Banking Technology (IDRBT) and the National Payment Corporation of India (NPCI) to work out the modalities for taking forward the implementation of the remaining recommendations. The IBA has now constituted a sub-group to examine the implementation of the remaining recommendations after studying the relevant international standards and best practices.

Abolition of foreclosure charges to lead to better pricing of home loans

3.75 The Committee on Customer Service in Banks (Chairman: Shri M. Damodaran) observed that foreclosure charges levied by banks on prepayment of home loans were resented by home loan borrowers across the board, especially since banks were found to be hesitant in passing on the benefits of lower interest rates to existing borrowers in a falling interest rate scenario. As such, foreclosure charges were seen as a restrictive practice that deterred borrowers from switching to a cheaper available source. It was, therefore, decided that banks would not be permitted to charge foreclosure charges/ pre-payment penalties on home loans on a floating interest rate basis, with immediate effect. The removal of foreclosure charges on home loans will lead to a reduction in the discrimination between existing and new borrowers, and the competition among banks will result in finer pricing of home loans with the floating rate.

Banks to offer basic savings bank deposit account to all customers

3.76 To take forward the agenda of financial inclusion, in November 2005, the Reserve Bank advised the banks to make available a basic banking 'no-frills' account with either 'nil' or very low minimum balance as well as charges that would make such accounts accessible to vast sections of the population. The experience since the introduction of 'no frills' accounts highlights the fact that banks had taken this initiative more to achieve their targets on compliance. On a review, it was decided to modify the guidelines on opening of basic banking 'no-frills' accounts and make basic banking facilities available in a more uniform manner across the banking system. In the Annual Monetary Policy Statement 2012-13, it was announced that banks should offer a 'basic savings bank deposit account' with certain minimum common facilities and without the requirement of a minimum balance to all their customers. This would also take care of customer grievances regarding charges for non-maintenance of a minimum balance.

Banks to ensure minimal variation in interest rates on deposits

3.77 Despite the stipulation by the Reserve Bank that banks should not discriminate in the interest rate paid on deposits, except in respect of fixed deposit schemes specifically meant for resident Indian senior citizens and single term deposits of ` 1.5 million and above, wide variations were observed in banks' retail and bulk deposit rates, making it unfair to retail depositors. Banks were also offering significantly different rates on deposits with very little difference in maturities. This suggested an inadequate liquidity management system and inadequate pricing methodologies among banks. In the Annual Monetary Policy Statement 2012-13, the Reserve Bank, therefore, announced that banks should have a Board-approved transparent policy on pricing of liabilities and they should also ensure that variation in interest rates on single term deposits of ` 1.5 million and above and other term deposits is minimal.

Facilitating intra-bank deposit accounts portability

3.78 Some banks were insisting that customers open a fresh account when the customer requested a transfer of account from one branch to another branch of the same bank. This practice, which required the customer to undergo KYC procedure again, was causing inconvenience, resulting in poor customer service. Under the core banking solution environment, this practice was not reasonable. Banks were, therefore, advised that if full KYC was done by one branch of the bank, it should be valid for transfer of the account within the bank. The customer should be allowed to transfer his/ her account from one branch to another branch without restrictions. In order to comply with KYC requirements of correct address of the person, fresh address proof may be obtained upon such transfer by the transferee branch.

Banks to levy fair service charges for outstation cheques and speed clearing

3.79 The Reserve Bank accorded banks the freedom to determine collection charges for cheques valuing above `0.1 million cleared through speed clearing and the out-station cheque clearing mechanism, subject to such charges being levied in a fair and transparent manner. The term 'fair and transparent manner', *inter-alia*, included fixing the service charges on a cost-*plus* basis. However, there were instances of banks levying charges as an arbitrary percentage of the value of the instrument. The Reserve Bank, therefore, advised such banks to review and fix the charges on a cost-*plus* basis. Banks were also advised to ensure that the collection charge fixed for instruments valuing `0.1 million is lower under speed clearing *vis-à-vis* out-station cheque collection, so as to encourage the use of speed clearing.

11. Financial Markets

Steps to strengthen the PD system

3.80 Various policy initiatives were taken during the year 2011-12 to strengthen the primary dealers (PDs) system. Final guidelines on the authorisation of PDs were issued on August 30, 2011, covering, *inter-alia*, seasoning requirement to become PDs, minimum turnover in government securities on behalf of mid-segment and retail investors and the exit/ termination process. With a view to providing market participants a tool to transfer and manage the credit risk associated with corporate bonds, the Reserve Bank introduced Credit Default Swaps (CDS) on corporate bonds in November 2011. Standalone PDs can undertake transactions in CDS, both as market-makers as well as users. As a user, a PD can use CDS to hedge credit risk in corporate bonds held in its trading book.

Administrative steps to curb volatility in the forex market

3.81 In view of the volatility in the Indian forex market during 2011-12, especially the depreciation of the INR against the USD by more than 20 per cent since August 2011, a number of administrative measures were initiated by the Reserve Bank on December 15, 2011 such as withdrawing the facility of cancellation and rebooking of contracts available under contracted exposure to residents and foreign institutional investors (FIIs); reducing the limit under past performance facility for importers to 25 per cent of the current limit available; making the past performance facility available to exporters and importers only on delivery basis; making all transactions by the ADs on behalf of clients be undertaken for actual remittances/ delivery only, which could not be cancelled/ cash settled; reducing the Net Overnight Open Position Limit (NOOPL) of ADs; and specifying that the intra-day position/ daylight limit of ADs should not exceed the existing NOOPL approved by the Reserve Bank.

3.82 Guidelines were also issued on May 10, 2012, stipulating that out of the balances in the Exchange Earners' Foreign Currency (EEFC) accounts, 50 per cent should be converted forthwith into rupee balances and credited to the rupee accounts within a fortnight. Further, in respect of all future forex earnings, an exchange earner is eligible to retain 50 per cent (as against the previous limit of 100 per cent) in non-interest-bearing EEFC accounts. The balance 50 per cent shall be surrendered for conversion to rupee balances.

3.83 The Reserve Bank initiated further measures to contain volatility in the foreign exchange market on May 21, 2012. These include: the current NOOPL of the banks as applicable to the positions involving the Rupee as one of the currencies shall not include the positions undertaken in the currency futures/ options segment in the exchanges; the positions in the exchanges cannot be netted/ offset by undertaking positions in the OTC market and *vice versa;* the positions initiated in the exchanges shall be liquidated/ closed in the exchanges only; and the position limit for the trading member AD

Category I bank in the exchanges for trading currency futures and options to be US$ 100 million or 15 per cent of the outstanding open interest, whichever is lower. In order to provide some operational flexibility to exporters, they were allowed to cancel and rebook 25 per cent of the total contracts booked for hedging their export exposure on July 31, 2012.

3.84 Further, on a review on July 31, 2012, it was decided to restore the erstwhile stipulation of allowing credit of 100 per cent foreign exchange earnings to the EEFC account subject to the condition that the sum total of the accruals in the account during a calendar month should be converted into Rupees on or before the last day of the succeeding calendar month after adjusting for utilisation of the balances for approved purposes or forward commitments.

Caution against fictitious offers like cheap funds/ lottery winnings from abroad

3.85 The Reserve Bank has launched several public awareness campaigns to fight the menace of fictitious offers of cheap funds from abroad through advertisements in the electronic and print media, letters to colleges/ schools and interactive/ training sessions with police personnel by the Regional Offices. The Reserve Bank has given the list of nodal agencies with whom the public can register complaints on its website. In this regard, a detailed Press Release was issued on February 6, 2012. It has also been decided to include fictitious offers as one of the agenda items of the State Level Security Committee Meeting. Campaign against fictitious offers has been included as part of the outreach programme of the Bank.

3.86 The IBA has been advised to publicise the issue among member banks. All SCBs have been advised that they would be held responsible for losses incurred by customers if they are found to be in violation of the regulations, KYC/ AML and/ or other regulatory/ statutory requirements relating to remittance towards participation in lottery, money circulation schemes and other fictitious offers of cheap funds. Co-operative banks have also been sensitised in the matter.

12. Payment and Settlement Systems

3.87 The regulatory initiatives of the Reserve Bank during the year were guided by the mission statement laid down in the Payment Vision Document 2009-12. The major policy initiatives taken during the year include the following.

Express cheque clearing system operationalised

3.88 The Express Cheque Clearing System (ECCS) introduced in 2011 for non-MICR[1] clearing houses with the facility of speed clearing for out-station cheques has been operationalised at 1,170 out of 1,241 centres (as on June 30, 2012).

Expansion of Cheque Truncation System (CTS)

3.89 The scope of the CTS was expanded by introducing grid-based CTS in Chennai. The grid clearing allows banks to present/ receive cheques to/ from multiple cities to a single clearing house through their service branches in the Chennai grid location. The pan-India roadmap for rolling out the grid-based CTS across the country has also been finalised by NPCI, which has been entrusted with this task.

Access criteria revised to enable wider access to electronic payment systems

3.90 In order to facilitate wider access to payment systems and strengthen the risk management framework, the access criteria were revised in September 2011. Two sets of access criteria, *viz.,* one for centralised payment systems and the other for decentralised payment systems, were accordingly laid down. The revised and rationalised criteria enable access to both

[1] Clearing house where cheque sorting is not mechanised.

centralised and decentralised payment systems based on CRAR, NPA, networth and the recommendation of the regulatory department. Under the new access criteria, approval has been accorded to 53 banks as on June 30, 2012 for becoming members of the centralised payment systems. A sub-membership route was also introduced in April 2012 to enable all licensed banks to participate in the centralised payment systems. This was in addition to the facility provided to RRBs to participate in National Electronic Fund Transfer (NEFT) through their Sponsor banks. As on June 2012, 71 out of 82 RRBs (12,000 RRB branches) were participating in NEFT.

3.91 Banks that were managing clearing houses/ processing centres were permitted to levy processing charges with effect from July 2011 from the originating banks. Service charges for outward transactions in the RTGS System were also introduced from October 2011.

Criterion for pre-paid payment instruments relaxed to provide impetus to alternate payment channels

3.92 The guidelines for pre-paid payment instruments (PPIs) were first issued in the year 2009. During the year 2011-12, around 591 million PPIs were issued for a value of over `70 billion. The average monthly issuance of PPIs was about 49 million for a value of `6 billion. The growth in the issuance of PPIs is yet to gain substantial traction. In order to provide impetus to this payment channel, the following relaxations were effected: (i) mobile wallets (a category of PPIs), that could earlier be issued up to `5000 were brought on par with other PPIs by raising the limit to `50,000; (ii) banks were permitted to issue PPIs to listed corporates, with the verification of employee identity being the responsibility of the corporate concerned. Additionally, rationalisation in the categorisation and value limits of PPIs was effected by introducing three broad categories such as (a) instruments up to `10,000 can be issued in electronic form with minimum details of the customer, (b) instruments from `10,001 to `50,000 can be issued in electronic but non-reloadable form by accepting any 'officially valid document' defined under the Prevention of Money Laundering Act, and (c) instruments up to `50,000 with full KYC can be reloadable in nature. The extant domestic fund transfer scheme was also rationalised to enable person to person fund transfer. Simultaneously, the escrow mechanism has been strengthened by mandating the non-bank entities that the escrow account should be credited immediately as and when the issuer/ agent/ distributor sells a PPI to the end-user. It has been reiterated that the balances in the escrow account should be adequate to cover the outstanding balances on the PPIs with end-users and the obligations to merchants arising out of the usage of PPIs by the end users at any given point of time.

Promotion of mobile banking to step up financial inclusion

3.93 Mobile banking transactions refer to banking transactions through mobile phones by bank customers that involve credit/ debit to their accounts. To enhance usage through mobile banking, the threshold limit of transactions permitted without end-to-end encryption was raised from `1,000 to `5,000. Further, the limit of `50,000 per transaction was done away with by permitting banks to fix the limits based on their own risk perception. With "for-profit" companies being allowed to act as Business Correspondents, which include mobile network operators (MNOs), it is expected that this unique bank-MNO partnership model being piloted in India will provide a boost to mobile payments and help in financial inclusion, given the wide network of the MNOs in terms of providing mobile services to their customers.

White Label ATMs to provide access in un-banked/ under-banked areas

3.94 To deepen the ATM infrastructure in the country especially in Tier III to Tier VI centres, non-banks have been permitted to set up, own

and operate White-label ATMs (WLAs) in India. To operate WLAs, entities need to obtain authorisation from the Reserve Bank as laid down under the Payment and Settlement Systems Act, 2007. They can choose any one of the three schemes as laid down in the guidelines. To spread the ATM infrastructure in under-banked areas, it has been mandated that 10 per cent of the new WLAs under any scheme must be installed in Tier V and VI centres. This initiative is expected to expand the availability of access points for payment services (Box III.2).

Enabling migrant population to access the formal money transfer system

3.95 To bring in the migrant population that is financially excluded into the formal banking fold, the domestic money transfer guidelines were relaxed in October 2011 to provide for fund transfer without the need for bank accounts at both ends. (For details refer to Box. No. IX.1 of the Annual Report 2011-12)

Payment Systems in India: Vision 2012-2015 aims to make payment system safe, secure and inclusive

3.96 The Payment System Vision Document 2012-15 has been released. The document sets out the path for the period 2012-15 to enable the payment systems to meet the growing payment needs of the country. Towards this end, the Vision Document outlines the course of action over the three-year period to make the payment systems in the country safe, efficient, inter-operable,

Box III.2: White-Label ATMs (WLAs)

The Automated Teller Machine (ATM) has been hailed as one of the most innovative and revolutionary technological developments in the history of banking. The channel, which was initially a medium for disbursal of cash to customers at bank branches, has now developed into a touch-point for delivery of a wide variety of banking services at branches and convenient off-site locations. Though banks initially owned and deployed their own ATMs, over time this has undergone a broad change, with banks now preferring outsourcing all or many of the activities associated with ATM operations - starting from deployment, maintenance, cash loading and technology upgrading. This has helped them reduce their operational costs and stay more focused on their core business.

Internationally, in addition to bank-owned and deployed ATMs, Independent ATM Deployers (IADs) and Independent Service Organisations (ISOs) are engaged in the ATM business. Such ATMs are called White-label ATMs (WLAs). IADs and ISOs are almost similar in their operations, barring the following differences:

(i) ISOs are usually larger operators that own and deploy ATMs and the entire related infrastructure. They have a sponsorship arrangement with the banks for cash loading and services. The relationships with sponsor banks are guided by local regulatory requirements. The ISO scheme works either through a single sponsor bank or the multi-sponsor bank model.

(ii) In the IAD model, the entities concentrate on investment in the assets (ATMs). They own the ATM and connect to any existing network provider for the payment infrastructure. The IADs can include entities ranging from individual business owners to large retail outlets/ supermarkets. Such entities do not have a direct arrangement with any bank for any aspect related to the operation of such ATMs, including cash loading.

Under both models, an additional important revenue source is through on-site advertisements. A large portion of the revenue for the IAD/ ISO is generated through such advertisements.

ATMs and WLA Scheme in India

The number of ATMs in the country stands at 98,074, of which 38 per cent are owned by private sector banks, 33 per cent by public sector banks, 27 per cent by the SBI and Associates, and 2 per cent by foreign banks. There has been a 30 per cent year-on-year growth in the number of ATMs deployed in the country since 2008, but the penetration of ATMs in Tier III to Tier VI centres remains below the desired level. In order to ensure deeper penetration of ATMs in unbanked/ under-banked areas, the Reserve Bank has permitted White-Label ATMs in the country to supplement the existing ATM schemes operated by banks. Under the policy guidelines, non-bank entities incorporated in India under the Companies Act, 1956 would be authorised to set up, own and operate ATMs in India, which will provide banking services to the customers of banks in India, based on the cards (debit/ credit/ pre-paid) issued by banks. Such non-bank entities should have a minimum net worth of ` 1 billion as per the latest financial year's audited balance sheet, which is to be maintained at all times. The model envisages that cash management and customer redressal would continue to be the responsibility of the sponsor banks. The scheme offers scope for large volumes, especially in unbanked/ under-banked areas. It is expected that WLA operators in India will use the features of the IAD and ISO models, as permitted under the guidelines, and collaborate closely with the sponsor banks.

authorised, accessible, inclusive and compliant with international standards. The vision proactively aims to encourage electronic payment systems for ushering in a less-cash society in the country.

Oversight of payment and settlement systems

3.97 The Reserve Bank exercises and carries out its oversight functions, through on-site inspections, off-site surveillance complemented by market intelligence under the powers derived under the Payment and Settlement Systems Act, 2007. Eleven entities including the National Payments Corporation of India (NPCI) were inspected during 2011-12. As a part of the off-site surveillance mechanism, data pertaining to payment systems are being collected in structured templates through the Online Return Filing System (ORFS).

13. Technological Developments

Banks conduct business continuity/ vulnerability assessment and penetration tests

3.98 Today technology plays a very important role in driving banking business. In view of the increasing dependence on technology, managing business continuity remains a challenge for overall financial stability. It is, therefore, important for the banks to put in place appropriate Business Continuity Plan (BCP). Further, in order to test their CBS and other internal systems to handle unforeseen disruptions, it is important for the banks to conduct Disaster Recovery (DR) Drills on a regular basis. It is also important that these arrangements are subject to periodic testing. Further, considering that cyber attacks could threaten the confidentiality, integrity and availability of data and the systems, it is imperative for the banks to conduct Vulnerability Assessment and Penetration (VAPT) Tests periodically to prevent any such attacks. This information is received by the Reserve Bank on a quarterly basis; the summary of which is taken as an input for the Financial Stability Report. Banks have also been advised to obtain the approval of their Board/ Top Management for BCP/ DR/ VAPT calendars.

Putting in place appropriate frameworks for IT and IS governance

3.99 As announced in the Annual Monetary Policy Statement 2012-13, adoption of well-structured IT governance models will assist banks in enabling better alignment between IT and business, create efficiencies, enhance conformity to internationally accepted best practices and improve overall IT performance, as also enable better control and security. In order to achieve these objectives, banks need to move towards adoption of well-structured IT governance models. Further, banks are increasingly relying on various IT based channels to operate their businesses and market interactions. Ability of banks to take advantage of new opportunities is largely contingent upon their capability to provide accessible and secure service channels. However, this would also increase their exposure to technology and operational risks, which have potential implications for individual banks as also for the entire financial sector. Adoption of comprehensive information security (IS) frameworks suiting the prevalent banking environment, business goals, processes, people and technology will be imperative to meet these challenges. Therefore, banks have been advised to take suitable steps to adopt appropriate frameworks for IT and IS governance and put in place the proper structure and systems, which would ensure that the issues relating to governance, information security and business continuity get adequate attention at the Board level.

14. Banking Sector Legislation

3.100 During the year, a number of legislative changes were initiated to review the laws pertaining to the banking sector. The most important development has been the move towards setting up the Financial Sector Legislative Reforms Commission, which would pave the way for the examination and review of the extant architecture of the legislative and regulatory system governing the financial sector in India.

(A) Factoring Regulation Act, 2011

3.101 The Factoring Regulation Act, 2011 came into force on April 2, 2012. The Act provides a regulatory framework under which factors would be required to register with the Reserve Bank. The Reserve Bank has been empowered to issue directions, call for information and prohibit financial institutions from undertaking factoring business if they fail to comply with its directions. Penalties are provided for non-compliance with the directions of the Reserve Bank. It enables any company, big or small, to register with the Reserve Bank for conducting the business of factoring, which is made subject to the provisions of Chapter IIIB of the Reserve Bank of India Act, 1934 as well as the Factoring Regulation Act. It is expected that financing against receivables will pick up with the required registration of assignments with the Central Registry (constituted under the SARFAESI Act, 2002). This will reduce the risk in multiple financing against the same receivables and is a significant milestone towards fewer NPAs for banks. Even companies that do not have financial activity as their principal activity would now come within the regulatory ambit of the Reserve Bank.

(B) The Coinage Act, 2011 consolidates laws relating to Coinage and Mints

3.102 The Coinage Act, 2011 came into force on March 28, 2012. The Act seeks to consolidate the laws relating to Coinage and the Mints, and repeals the earlier Coinage Acts. It prohibits the making, melting or destroying of coins except by persons authorised by the Government of India and prescribes penalties for contravention of these provisions. Bringing in a piece of metal to be used as a coin by sea, land or air without the permission of the Government continues to be prohibited.

(C) The EXIM Bank (Amendment) Act, 2011 strengthens its capital base

3.103 The Export-Import Bank of India (Amendment) Act, 2011 came into force on February 1, 2012. The Act provides for an increase in the authorised capital of EXIM Bank from ` 20 billion to `100 billion. It also provides for the appointment of two whole-time directors by the Central Government to the Board of EXIM Bank.

(D) The Constitution (97th Amendment) Act, 2011 to promote democratic and professional management of co-operatives

3.104 The Constitution (Ninety-seventh Amendment) Act, 2011 came into force on February 15, 2012. The Act adds a new Directive Principle of State Policy, which requires the State to promote voluntary formation, autonomous functioning, democratic control and professional management of co-operative societies. Part IX B in the Constitution empowers Parliament in respect of Multi-State Co-operative Societies and State legislatures in the case of other co-operative societies to make an appropriate law for the incorporation, regulation and winding up of co-operative societies. This law would be based on the principles of democratic member-control, member-economic participation and autonomous functioning, and would specify that the maximum number of directors of a co-operative society should not exceed 21 members with a fixed tenure of five years from the date of election in respect of the elected members of the Board and its office bearers. The State Legislature will have to ensure that the State laws adhere to the principles laid down in the Constitution and State interference will be reduced. The Amendment states that the provisions of the Banking Regulation Act, 1949 relating to supersession and suspension of the Board of Directors will be applicable to co-operative societies that carry out banking activities.

(E) Enforcement of the Security Interest and Recovery of Debts Laws (Amendment) Bill, 2011

3.105 This Bill was introduced in the Lok Sabha on December 12, 2011 and is pending. It seeks to amend the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 and the Recovery of Debts Due

to Banks and Financial Institutions Act, 1993. The Bill empowers banks and financial institutions to accept the immovable property in full or partial satisfaction of the bank's claim against the defaulting borrower when they cannot find a buyer for the securities. The measures for recovery through the Debt Recovery Tribunal (DRT), which had not been available to multi-state co-operative banks, are now made available by including multi-state co-operative banks under the definition of 'bank' in DRT Act, thereby providing them the option of an additional effective recovery mechanism apart from the mechanism available under the Multi-State Co-operative Societies Act, 2002.

(F) Banking Laws (Amendment) Bill, 2011

3.106 On December 13, 2011, the Standing Committee on Finance presented its report to the Lok Sabha on the Banking Laws (Amendment) Bill, 2011, which was introduced before the Lok Sabha on March 22, 2012.

(G) Financial Sector Legislative Reforms Commission

3.107 The Government of India, pursuant to the announcement made in the Union Budget 2010-11, set up the Financial Sector Legislative Reforms Commission (Chairman: Justice B.N. Srikrishna), on March 24, 2011. The terms of reference are wide in their ambit and include the examination of the architecture of the legislative and regulatory system governing the financial sector in India and reviewing the existing laws that govern the financial sector. The comments, suggestions and inputs from the Reserve Bank have been submitted to the Commission, which include the need for a clear and specific mandate to the Reserve Bank for the pursuit of financial stability, monopoly of the Reserve Bank in the regulation of public deposits, the consolidation of banking laws, the need for globally compatible secrecy laws and continuation of the debt management function with the Reserve Bank.

15. Overall Assessment

3.108 The banking sector policy during 2011-12 was attuned to the broader objectives of macroeconomic policy, such as price stability, growth, broader financial and banking sector development, while ensuring uninterrupted credit flow to the productive sectors of the economy. In the context of weakening domestic macroeconomic conditions, the Reserve Bank had to maintain a fine balance between price stability and growth. The Reserve Bank undertook several measures to maintain adequate liquidity in the system to ensure smooth functioning of the financial markets. Several administrative steps were also initiated to contain volatility in the forex market.

3.109 During the year, the priority sector norms were revisited to refocus direct agricultural lending to individuals, SHGs and JLGs, and to focus on direct lending by banks and not through intermediaries. The KCC Scheme was revised to suit the current requirements of farmers and a special and concessional refinancing facility was also extended to improve the availability of credit to agriculture.

3.110 Amidst turbulent global financial market conditions, banks and financial entities have to grapple with growing complexities and risks associated with their businesses. In this context, policy initiatives, such as the adoption of Basel II advanced approaches, the phased implementation of Basel III norms, efforts to move towards a dynamic provisioning framework/ countercyclical capital buffers, adoption of securitisation norms in line with best international practices, sound compensation practices and the adoption of a risk-based supervisory approach for banks will go a long way in placing the Indian banking system on a strong footing and enhance the banking sector's ability to absorb shocks arising from any financial and economic stress

and encourage prudent risk-taking. The implementation of the recommendations of the Committee on Customer Service in Banks (Chairman: Shri M. Damodaran) are expected to improve customer service in banks. The multi-pronged strategy and outreach visits for financial inclusion are expected to enhance the outreach of the banking system to the remotest parts of the country. The other major policy developments include steps to combat money laundering/ terrorism financing activities and steps to strengthen the payment and settlement systems. The major development that would pave the way towards further reforms in the financial sector include the setting up of the Financial Sector Legislative Reforms Commission.

3.111 Going forward, a steady movement towards improving the resilience of financial institutions and banks, with focused attention on containing systemic risks, would pave the way for financial stability. The growth in the financial and banking sector has to keep pace with growth in the real sector and has to be in tune with domestic macroeconomic fundamentals. The banking sector has to pursue the agenda of financial inclusion with a greater sense of social commitment to usher in inclusive growth of the overall economy.