Chapter III

Policy Environment

Macroeconomic policy in India during 2010-11 was aimed at achieving the twin objectives of sustaining economic growth and controlling inflation. Banking sector policy needs to be consistent with the broader objectives of macroeconomic policy through the provision of productive credit to bolster economic growth within the broad contours of monetary management. As the developed world was still battling low economic growth and deterioration in public finances, and repairing its financial regulatory architecture in the aftermath of the financial crisis, India successfully reverted back to its pre-crisis growth path in 2010-11. However, the inflationary pressures, which emerged partly on account of high global commodity prices and partly due to internal structural imbalances in demand and supply, remained above the comfort zone in 2010-11. These pressures called for repeated monetary policy responses, in order to ensure that economic growth, which was in the process of consolidation, was not sacrificed in the long-run. Indian banking sector policy with regard to financial liberalisation and innovation has always been calibrated, cautious and yet, consistent. The fact that the Indian banking system was not adversely affected during the recent crisis is a proof of the success of this policy. Treading on the same path, the Reserve Bank initiated important policy discussions with regard to providing new bank licenses, designing the road ahead for the presence of foreign banks, holding company structure for banks, and introduced credit default swaps for corporate bonds, while migrating to advanced approaches under the Basel II framework and facilitating the movement towards the Basel III framework. Financial Inclusion continued to remain high on the agenda of the Reserve Bank with the rolling out of Board-Approved Financial Inclusion Plans by banks.

1. Introduction

3.1 With the onslaught of the global financial crisis, banking sector policy across the world has received a newer meaning and relevance. There is a growing realisation that regulatory and supervisory policy needs to be strengthened to adopt a system-wide approach to counteract pro-cyclical movements in the banking sector. The perimeter of regulation also needs to be expanded to cover the unregulated segments in order to minimise regulatory arbitrage. India has been lauded as one of the few countries that has followed a vigilant and counter-cyclical policy approach to banking sector developments. It has also widened the regulatory perimeter steadily to bring non-banking entities into the ambit of regulation. This chapter presents major developments in various realms of banking sector policy, with special thrust on regulatory and supervisory policies adopted during 2010-11[1]. The other major aspects of the banking policy covered, include monetary policy, credit delivery, financial inclusion, technological developments, payment and settlement system, customer service and legal provisions for banking. Apart from the commercial banking sector, major policy measures relating to Regional Rural Banks (RRBs), Cooperative Banks, Non-Banking Financial Companies (NBFCs) and Financial Markets are also discussed in the chapter.

[1] The period covered in this chapter stretches from April 2010 to October 2011.

2. Monetary Policy[2]

Monetary Policy Stance and Measures

3.2 Monetary policy stance in 2010-11 was attuned to the growth-inflation dynamics prevailing in the economy in the broader context of global uncertainties. In the first half of 2010-11, the thrust of monetary policy was on avoiding policy impediments to the recovery amidst global uncertainties, while also containing inflationary pressures.

3.3 In the second half of 2010-11, while growth continued to consolidate, the moderating path of inflation reversed beginning December 2010 due to a series of supply side shocks, both domestic and global. Non-food manufacturing inflation remained much above the trend growth of 4 per cent during the second half of 2010-11. Therefore, policy rates were raised to contain inflation and anchor inflationary expectations. This was warranted to ensure that the long-term growth prospects were not harmed, even if it meant sacrificing some growth in the short-term.

3.4 As the inflation remained above the comfort level of the Reserve Bank even in 2011-12, the anti-inflationary stance was continued during this period. Since the exit from its crisis-driven expansionary monetary policy stance, the Reserve Bank has raised the policy rate (the repo rate) 13 times by 375 basis points. Till March 2011, the policy rate was raised eight times by 200 bps. In 2011-12 so far (up to October 25, 2011), it was further raised five times by 175 bps. The effective tightening since October 2009 has been of 525 bps as liquidity in the system transited from surplus to deficit. The CRR was also raised by 100 bps.

Changes in the Operating Procedure of Monetary Policy

3.5 Based on the Report of the Working Group on Operating Procedure of Monetary Policy (Chairman: Shri Deepak Mohanty), the Reserve Bank made a number of changes in the operating procedure of monetary policy with effect from May 2011. As per these changes, the weighted average overnight call money rate was made the operating target of monetary policy. Further, the repo rate was made the single policy rate to more accurately signal the monetary policy stance with the reverse repo rate pegged at a fixed 100 basis points below the repo rate. A new Marginal Standing Facility (MSF) was also instituted under which Scheduled Commercial Banks (SCBs) could borrow overnight up to one per cent of their respective Net Demand and Time Liabilities (NDTL), carved out of the required Statutory Liquidity Ratio (SLR) portfolio. The MSF rate is 100 basis points above the repo rate and provides an upper bound to the policy rate corridor with reverse repo rate as the lower bound. These changes were deemed necessary for improved liquidity management and effective monetary transmission.

Deregulation of Savings Bank Deposit Rate

3.6 With the steady process of deregulation since the early 1990s, the only rupee interest rate that continued to remain regulated was the savings deposit interest rate. In order to delineate the advantages and disadvantages of deregulating the savings deposit rate, the Reserve Bank prepared a discussion paper which was placed on the RBI website for suggestions from general public in April 2011. The Discussion Paper evoked wide ranging responses from a cross-section of stakeholders. The Reserve Bank after weighing both pros and cons, decided to deregulate the savings bank deposit rate in its Second Quarter Review of Monetary Policy 2011-12 released on October 25, 2011. Accordingly, banks can freely determine their savings bank deposit interest rates subject to the following two conditions:

- Each bank will have to offer a uniform interest rate on savings bank deposits up to

[2] This section deals with monetary policy developments in brief, as they have been covered in the RBI Annual Report 2010-11 in detail.

₹1 lakh, irrespective of the amount in the account within this limit.

- For savings bank deposits over ₹1 lakh, a bank may provide differential rates of interest, if it so chooses. However, there should not be any discrimination from customer to customer on interest rates for similar amount of deposit.

3. Credit Delivery

Priority Sector Lending Policy - Loans to NBFCs

3.7 The Reserve Bank advised all SCBs in February 2011 that loans sanctioned to NBFCs for on-lending to individuals or other entities against gold jewellery will not be eligible for classification under priority sector as agricultural credit. Similarly, investments made by banks in securitised assets originated by NBFCs, where the underlying assets are loans against gold jewellery and purchase/assignment of gold loan portfolio from NBFCs are also not eligible for classification under the agricultural sector.

Priority Sector Lending Policy - Loans to Agriculture

3.8 The scheme of interest subvention has been in existence since 2006-07 with regard to provision of short-term agricultural credit to farmers by public sector banks, RRBs and cooperative banks. In 2009-10, an interest subvention of 2 per cent was provided on short-term production credit of up to ₹3 lakh, which would ensure that credit was made available to farmers at the ground level at 7 per cent per annum. Further, an additional interest subvention of 1 per cent was also provided to public sector banks in respect of those farmers who were prompt in repaying their loans within one year of disbursement of such loans, reducing the effective rate for such farmers further to 6 per cent per annum. In 2010-11, the interest subvention was reduced to 1.5 per cent and the additional interest subvention for prompt-paying farmers has been increased to 2 per cent. Further, in the Union Budget for 2011-12, the Finance Minister has proposed an enhancement of the additional interest subvention for prompt-paying farmers to 3 per cent making the effective rate for such farmers to be 4 per cent per annum.

Loans to Micro, Small and Medium Enterprises (MSME) - Credit Target for Micro-Enterprises

3.9 Pursuant to the recommendations of the High Level Task Force constituted by the Government of India (Chairman: Shri T K A Nair), SCBs have been advised on June 29, 2010 to allocate 60 per cent of the MSE advances to micro-enterprises. This target is to be achieved in three stages *viz.*, 50 per cent in 2010-11, 55 per cent in 2011-12 and 60 per cent in 2012-13 with an annual growth of 10 per cent in the number of micro-enterprises accounts and an annual growth of 20 per cent in lending to micro and small enterprises. A suitable format has also been devised by the Reserve Bank to capture and closely monitor the achievement of these targets by banks on a half-yearly basis (March and September). From the quarter ending June 2011, the monitoring is being done on a quarterly basis. The Reserve Bank has also taken up the matter with banks that have failed to achieve the targets prescribed by the Task Force.

Credit Guarantee for Credit to Micro and Small Enterprises

3.10 Based on the recommendations of the Working Group (Chairman: Shri V.K. Sharma) constituted by the Reserve Bank in March 2010 to review the Credit Guarantee Scheme (CGS) of the Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE), the limit for collateral free loans to the MSE sector has been increased to ₹10 lakh and has been made mandatory for banks. SCBs are advised to follow the guidelines on collateral free lending,

encourage branch level functionaries to avail the credit guarantee cover and making performance in this regard a criterion in their appraisal. The Working Group has also made recommendations regarding an increase in the extent of guarantee cover, absorption of guarantee fees for the collateral free loans up to ₹10 lakh by CGTMSE, subject to certain conditions, simplification of procedure for filing claims with CGTMSE and increasing awareness about the scheme. The recommendations have been forwarded to CGTMSE for implementation.

Housing Loans

3.11 With the objective of improving affordability of housing for middle and lower income groups, the Union Budget of 2009-10 had announced a scheme of 1 per cent interest subvention in respect of individual housing loans of up to ₹10 lakh provided that the cost of unit did not exceed ₹20 lakh. The scheme was applicable initially for a period of one year effective from October 1, 2009 to September 30, 2010. An initial allocation of ₹1,000 crore was announced for this purpose. The Union Budget for 2010-11 had announced an extension of the scheme and also made a provision of ₹700 crore under the scheme for 2010-11. As per the Union Budget for 2011-12, the existing scheme has been further liberalised to housing loans of up to ₹15 lakh, where the cost of the house does not exceed ₹25 lakh as against the earlier limits of ₹10 lakh and ₹20 lakh, respectively. The scheme is being implemented through SCBs and housing finance companies. The Reserve Bank acts as the nodal agency in respect of SCBs. After sanctioning and disbursing the eligible loans, SCBs claim reimbursement of subsidy from the Reserve Bank on a monthly basis. The necessary instructions with regard to the liberalisation of the scheme have been issued to all SCBs by the Reserve Bank on April 21, 2011.

Loans to MFIs

3.12 Following concerns about the micro finance sector in Andhra Pradesh, a need was felt for a more rigorous regulation of NBFCs functioning as Micro-Finance Institutions (MFIs). Accordingly, a sub-Committee of the Central Board of the Reserve Bank (Chairman: Shri Y. H. Malegam) was constituted to study issues and concerns in the MFI sector. The Committee has submitted its report in January 2011, which has been placed in public domain. The Committee, *inter alia*, has recommended: (i) creation of a separate category of NBFC-MFIs; (ii) a margin cap and an interest rate cap on individual loans; (iii) transparency in interest charges; (iv) lending by not more than two MFIs to individual borrowers; (v) creation of one or more credit information bureaus; (vi) establishment of a proper system of grievance redressal procedure by MFIs; (vii) creation of one or more "social capital funds"; and (viii) continuation of categorisation of bank loans to MFIs complying with the regulation laid down for NBFC-MFIs, under the priority sector.

3.13 The recommendations of the Committee were discussed with all stakeholders, and in light of the feedback received, it has been decided to accept the broad framework of regulations recommended by the Committee. Accordingly, all SCBs have been advised on May 3, 2011 that:

1. Bank credit to MFIs extended on, or after, April 1, 2011 for on-lending to individuals and also to members of Self-Help Groups (SHGs)/ Joint Liability Groups (JLGs) will be eligible for categorisation as priority sector advances under respective categories *viz.*, agriculture, micro and small enterprises, and micro credit (for other purposes), as indirect finance, provided that

    (a) Not less than 75 per cent of the aggregate loans given by MFIs are extended for income generating activities;

    (b) Not less than 85 per cent of the total assets of MFI (other than cash, balances with banks and financial

institutions, Government securities and money market instruments) are in the nature of "qualifying assets". A "qualifying asset" has to satisfy the following criteria: (i) The loan is to be extended to a borrower whose household annual income in rural areas does not exceed ₹60,000, while for non-rural areas, it should not exceed ₹1,20,000; (ii) Loan does not exceed ₹35,000 in the first cycle and ₹50,000 in the subsequent cycles; (iii) Total indebtedness of the borrower does not exceed ₹50,000; (iv) Tenure of loan is not less than 24 months when loan amount exceeds ₹15,000 with right to borrower of prepayment without penalty; (v) The loan is without collateral; (vi) Loan is repayable by weekly, fortnightly or monthly installments at the choice of the borrower.

(c) Banks have to ensure that MFIs comply with the following caps on margin and interest rate as also other 'pricing guidelines': (i) Margin cap at 12 per cent for all MFIs; (ii) The interest cost is to be calculated on average fortnightly balances of outstanding borrowings and interest income is to be calculated on average fortnightly balances of outstanding loan portfolio of qualifying assets; (iii) Interest cap on individual loans at 26 per cent per annum to be calculated on a reducing balance basis; (iv) Only three components are to be included in pricing of loans *viz*., a processing fee not exceeding 1 per cent of the gross loan amount, interest charge, and insurance premium; (v) The processing fee is not to be included in the margin cap or the interest cap of 26 per cent; (vi) Only the actual cost of insurance *i.e.* actual cost of group insurance for life, health and livestock for borrower and spouse can be recovered and administrative charges must be recovered as per IRDA guidelines; (vii) There should not be any penalty for delayed payment; (viii) No Security Deposit/Margin is to be collected from borrowers.

(d) The banks should obtain, at the end of each quarter, a Chartered Accountant's Certificate from the MFI stating, *inter alia*, that all three conditions given above have been followed.

2. Bank loans to MFIs, which do not comply with above conditions and bank loans to other NBFCs, will not be reckoned as priority sector loans with effect from April 1, 2011. Bank loans extended prior to April 1, 2011 classified under priority sector will continue to be reckoned as priority sector till the maturity of such loans.

Progress under the Agriculture Debt Waiver and Debt Relief Scheme, 2008

3.14 As per the schedule of reimbursement provided by the Government of India in respect of the Agriculture Debt Waiver and Debt Relief Scheme, 2008, the lending institutions were compensated in a staggered manner as given in Table III.1. The Government of India has sanctioned ₹40,000 crore as the first and second instalments. Out of this, ₹28,000 crore was transferred to National Bank for Agriculture and Rural Development (NABARD) for reimbursement to RRBs and cooperatives. The remaining amount of ₹12,000 crore has been earmarked for reimbursing SCBs, Local Area Banks and Urban Cooperative Banks. The third instalment of ₹11,340.47 crore was released by the Government of India in January 2011 of which ₹1,240.12 crore has been transferred to NABARD for reimbursement of RRBs and cooperatives and the remaining amount of ₹10,100.35 crore has been utilised for reimbursing SCBs, Local Area Banks and Urban Cooperative Banks.

4. Financial Inclusion

3.15 Financial inclusion has been made an integral part of the banking sector policy in India. Reserve Bank is furthering financial inclusion in a mission mode through a combination of strategies ranging from relaxation of regulatory guidelines, provision of innovative products, encouraging use of technology and other supportive measures for achieving sustainable and scalable financial inclusion. During 2010-11 too, the Reserve Bank continued with policy initiatives aimed at expanding the outreach of banking services to remote parts of the country.

Mandating Opening of Branches in Rural Unbanked Centres

3.16 To further step up penetration of banking services in the rural areas, there is a need for opening of more brick and mortar branches, besides the use of Business Correspondents (BCs). Accordingly, banks have been mandated to allocate at least 25 per cent of their total number of branches to be opened during a year to unbanked rural centres. Further, in October 2011, to provide enhanced banking services in Tier 2 centres (with population of 50,000 to 99,999 as per Census 2001), it has been proposed to permit domestic SCBs (other than RRBs) to open branches in these centres without the need to take permission from the Reserve Bank in each case, subject to reporting. The opening of branches in Tier 1 centres (centres with population of 1,00,000 and above as per Census 2001) will continue to require prior permission of the Reserve Bank. While issuing such authorisation, the Reserve Bank will continue to factor in, among others, whether at least 25 per cent of the total number of branches to be opened during a year are proposed to be opened in unbanked rural centres.

Relaxation of KYC norms

3.17 Know Your Customer (KYC) requirements for opening bank accounts were relaxed for small accounts in August 2005, simplifying procedure by stipulating that introduction by an account holder who has been subjected to full KYC drill and any evidence of the identity and address of the customer to the satisfaction of the bank, would suffice for opening such accounts. In 2010-11, KYC norms have been further relaxed *vide* circular dated January 27, 2011 to include job cards issued by/under National Rural Employment Guarantee Act (NREGA) (duly signed by an officer of the State Government) or the letters issued by the Unique Identification Authority of India containing details of name, address and Aadhaar number can also be taken as the basis for opening small bank accounts. It was further relaxed *vide* circular dated September 28, 2011, making it applicable to all accounts.

Widening the Definition of Business Correspondent

3.18 Since 2006, the Reserve Bank has permitted banks to engage Business Facilitators and Business Correspondents (BFs/BCs) as intermediaries for providing banking services. The list of eligible individuals/entities who can

Table III.1: Compensation under Agriculture Debt Waiver and Debt Relief Scheme

(Amount in ₹crore)

Lending Institutions	Proposed reimbursement**			
	First instalment	Second instalment	Third instalment	Fourth instalment
	Sept 2008	July 2009	July 2010	July 2011
RRBs and Cooperatives	17,500	10,500	2,800	Balance amount, if any
SCBs, UCBs and LABs	7,500	4,500	9,200	Balance amount, if any
Total	**25,000**	**15,000**	**12,000**	**Balance amount, if any**

** Based on the current provisional estimates

be engaged as BCs has been widened from time to time. During 2010-11, in order to harness the large and widespread retail network of corporate for providing financial and banking services, 'for-profit' companies were also allowed to be engaged as intermediaries to work as BCs for banks in addition to entities permitted earlier.

Introduction of Innovative and Simple Products

3.19 Timely and hassle-free credit being the most important requirement of poor people, banks have been advised to provide in-built overdraft of small amount in no-frill accounts so that customers can avail of credit of small amount without any further documentation, for meeting emergency requirements.

Roadmap for Banking Services

3.20 With an objective to ensure uniform progress in provision of banking services in all parts of the country, banks were advised to draw up a roadmap for opening banking outlets in every unbanked village having a population of more than 2,000, through a brick and mortar branch or any of the various forms of ICT-based models, including through BCs. In alignment with the budget announcements, the timelines for completing the roadmap was extended to March 2012 *vide* circular dated September 16, 2010. About 72,800 such unbanked villages have been identified and allotted to various banks through State-level Bankers' Committee (SLBC).

Progress on Financial Inclusion Plans

3.21 In January 2010, all public and private sector banks were advised to put in place a Board-approved three-year Financial Inclusion Plan (FIP) and submit the same to the Reserve Bank by March 2010. These banks prepared and submitted their FIPs containing targets for March 2011, 2012 and 2013. These plans broadly include self-determined targets in respect of rural brick and mortar branches to be opened; BCs to be employed; coverage of unbanked villages with population above 2,000 as also other unbanked villages with population below 2,000 through branches/BCs/other modes; no-frill accounts opened including through BC-ICT; Kisan Credit Cards (KCC) and General Credit Cards (GCC) and other specific products designed by them to cater to the financially excluded segments. Banks were advised to integrate Board-approved FIPs with their business plans and to include the criterion on financial inclusion as a parameter in the performance evaluation of their staff. The implementation of these plans is being closely monitored by the Reserve Bank.

3.22 In order to review the progress of banks in the implementation of FIPs during the year 2010-11 and making way for accelerated progress in future, the Reserve Bank has been conducting one-to-one meetings with Chairman and Managing Director (CMD)/Chief Executive Officer (CEO) of banks. Few of the important action points which emanated out of the discussions held during May-June 2011 are as follows:

- Banks shall review their delivery models so that Financial Inclusion results in a profitable business for them.
- In addition to providing banking services in villages with more than 2,000 population, they will also focus on providing banking services in peripheral villages with population of less than 2,000.
- In future, banks need to focus more on opening of brick and mortar branches in unbanked villages. It may be a low cost and simple intermediary structure comprising of minimum infrastructure for operating small customer transactions and supporting upto 10 BCs at a reasonable distance of 2-3 km. Such an approach will help banks in having a better customer redressal mechanism and at the same time, help in developing a better BC-monitoring mechanism. This will lead to efficiency in cash management,

documentation and redressal of customer grievances.

- Banks shall expand financial inclusion initiatives in urban and semi-urban areas by targeting pockets of migrant workers and small vendors and leveraging Aadhaar enrolment for opening bank accounts.
- Banks shall formulate financial inclusion plans for RRBs sponsored by them and develop an effective monitoring mechanism so that targets assigned to the RRBs are also achieved meticulously.

5. Prudential Regulatory Policy

Migration to Advanced Approaches under Basel II

3.23 In March 2009, all commercial banks in India completed migration to the basic approaches of Basel II. While the implementation of the standardised approaches and Pillar 2 would continue to be improved, the focus has recently shifted to the implementation of the advanced approaches for computation of capital adequacy requirement under the Basel II framework. These advanced approaches would help in aligning individual banks' regulatory capital with their risk profiles and also improve their risk management practices. As banking products and business models become increasingly complex, the risks inherent in these products can be measured and managed better under the advanced approaches. Thus, migration to advanced approaches would also help in pricing of financial products and performance measurement.

3.24 Adoption of advanced approaches is more challenging than the standardised approaches. First, unlike in the advanced economies, banks in India are not quite familiar with the use of the advanced quantitative techniques in risk management which are essential for computing risk measures under Basel II. Secondly, banks have to build institutional capabilities for implementation of advanced risk management framework particularly in the form of adequate incentive and compensation schemes for staff. Thirdly, banks need availability of quality data, understanding of economic cycles, capability to use quantitative techniques and skilled staff for validation of risk models. Hence, it is advisable that relatively large banks having adequate risk management systems migrate to advanced approaches first with other banks focusing on improving the risk management systems and MIS in a way that is consistent with their present operations and simultaneously build up the requisite organisational skills for the advanced approaches.

3.25 Further, there are specific challenges in relation to implementation of individual approaches. First, as regards modelling credit risk under the Internal Rating Based (IRB) Approach, there is a need for modelling Probability of Default and Loss Given Default (LGD) based on bank's own historical credit data. Lack of adequate historical data poses a problem in such an exercise. Further, the relevant data is often kept in disparate systems and units, and the traditional asset classes used by banks are different from those required under IRB approach. The utility of credit risk models based on market data have only limited scope for application in India as most of the corporate borrowers are unlisted and do not have listed corporate bonds.

3.26 Secondly, modelling operational risk under the Advanced Measurement Approach (AMA) is challenging due to the absence of external loss data and quality internal loss data. Further, it requires considerable subjective judgement in incorporation of the effect of business environment, internal control factors and use of scenario analysis in computing the operational risk capital charge.

3.27 Thirdly, while Internal Models Approach (IMA) for market risk is relatively less demanding in terms of data requirements and modelling, the

methodologies for computation of Incremental Risk Charge (IRC) are still in the early stage of development.

3.28 The Reserve Bank has laid down the time line for banks to migrate to advanced approaches. Guidelines have been issued for Standardised Approach (TSA)/Alternate Standardised Approach (ASA) for operational risk in March 2010 and IMA for market risk in April 2010. Guidelines on AMA for operational risk have also been issued in April 2011. Draft guidelines on Foundation IRB as well as Advanced IRB Approach for calculating credit risk capital charge have been placed on the RBI website on August 10, 2011 inviting comments from banks and other stakeholders. As indicated in the Second Quarter Review of Monetary Policy of 2011-12, it is proposed to issue the final guidelines on IRB approach by end-December 2011.

Licensing of New Banks in Private Sector

3.29 Pursuant to the announcement made by the Union Finance Minister in his budget speech and the Reserve Bank's Annual Policy Statement for the year 2010-11, a Discussion Paper on "Entry of New Banks in the Private Sector" was placed on RBI website on August 11, 2010. Based on the responses received from various stakeholders and extensive internal discussions and consultations with the Government of India, the Draft Guidelines were prepared and released on August 29, 2011 on the RBI website, again seeking comments from various stakeholders. Suggestions and comments on the draft guidelines were to be sent by October 31, 2011.

Key features of the draft guidelines are as follows:

(i) Eligible promoters: Entities/groups in the private sector, owned and controlled by residents, with diversified ownership, sound credentials and integrity and having successful track record of at least 10 years will be eligible to promote banks. Entities/groups having significant (10 per cent or more) income or assets or both from real estate construction and/ or broking activities individually or taken together in the last three years will not be eligible.

(ii) Corporate structure: New banks will be set up only through a wholly owned Non-Operative Holding Company (NOHC) to be registered with the Reserve Bank as NBFC, which will hold the bank as well as all the other financial companies in the promoter group.

(iii) Minimum capital requirement: Minimum capital requirement will be ₹500 crore. Subject to this, actual capital to be brought in will depend on the business plan of the promoters. The NOHC shall hold minimum 40 per cent of the paid-up capital of the bank for a period of five years from the date of licensing of the bank. Shareholding by NOHC in excess of 40 per cent shall be brought down to 20 per cent within 10 years and to 15 per cent within 12 years from the date of licensing of the bank.

(iv) Foreign shareholding: The aggregate non-resident shareholding in the new bank shall not exceed 49 per cent for the first 5 years after which it will be as per the extant policy.

(v) Corporate governance: At least 50 per cent of the directors of the NOHC should be independent directors. The corporate structure should be such that it does not impede effective supervision of the bank and the NOHC on a consolidated basis by the Reserve Bank.

(vi) Business model: The model should be realistic and viable and should address how the bank proposes to achieve financial inclusion.

(vii) Other conditions:

- The exposure of the bank to any entity in the promoter group shall not exceed 10 per cent and the aggregate exposure to all the entities in the group shall not exceed 20 per cent of the paid-up capital and reserves of the bank.

- The bank shall get its shares listed on the stock exchanges within two years of licensing.
- The bank shall open at least 25 per cent of its branches in unbanked rural centres.
- Existing NBFCs, if considered eligible, may be permitted to either promote a new bank or convert themselves into banks.

(viii) In respect of promoter groups having 40 per cent or more assets / income from non-financial business, certain additional requirements have been stipulated.

It is pertinent to mention that certain amendments to the Banking Regulation Act, 1949 are under consideration of the Government of India, a few which, are vital for finalisation and implementation of the policy for licensing of new banks in the private sector. These vital amendments are the removal of restriction of voting rights and concurrently empowering the Reserve Bank to approve acquisition of shares and /or voting rights of 5 per cent or more in a bank to persons who are 'fit and proper', empowering the Reserve Bank to supersede the Board of Directors of a bank so as to protect depositors' interest, and facilitating consolidated supervision.

Final guidelines will be issued and the process of inviting applications for setting up of new banks in the private sector will be initiated after receiving feedback/comments on the Draft Guidelines, and after the amendments to Banking Regulation Act, 1949 are in place.

Presence of Foreign Banks in India

3.30 The Reserve Bank also released a Discussion Paper on the presence of foreign banks in India in January 2011 seeking feedback and suggestions from stakeholders and general public. After receiving feedback on the Discussion Paper, comprehensive guidelines on the mode of presence of foreign banks in India would be issued.

Holding Companies Structure for Indian Banks

3.31 Pursuant to the announcement made in the Monetary Policy Statement for the year 2010-11, a working group was constituted in June 2010 (Chairperson: Smt. Shyamala Gopinath) to examine the introduction of a holding company structure for banks and other financial entities and the required changes in legislative and regulatory framework. The Group had representatives from the Government of India, the Reserve Bank, Securities and Exchange Board of India (SEBI), Insurance Regulatory and Development Authority (IRDA), Indian Banks' Association (IBA) and a few banks. The Report of the Working Group was placed on the RBI website in May 2011 for public comments. The Report has been forwarded to the Government of India for consideration.

3.32 The Working Group has recommended Financial Holding Company (FHC) model as a preferred model for banks and all large financial groups irrespective of whether they contain a bank or not. The FHC would primarily be a non-operating entity and would carry out all financial activities through subsidiaries. The FHC would be well diversified and subject to strict ownership and governance norms. The ownership restrictions would be applied either at the level of the FHCs or at the entity level, depending upon whether the promoters intend to maintain majority control in the subsidiaries, wherever it is permissible as per law.

3.33 The Working Group observed that the FHC model would enable better oversight of financial groups from a systemic perspective and allow better resolution of different entities as compared to Bank Subsidiary Model where liquidation of the parent bank may make the liquidation of subsidiaries inevitable.

3.34 To address the systemic concerns, the Working Group has envisaged consolidated supervision at FHC level that would be

formalised through Memorandum of Understanding between financial sector regulators. The function of FHC regulation would be undertaken by a separate unit within the Reserve Bank with staff drawn from both the Reserve Bank as well as other regulators. To fully operationalise the FHC model, it has been recommended that a separate legislation for regulation of FHC be enacted and amendments be simultaneously made to other statutes governing public sector banks, Companies Act and Banking Regulation Act, 1949, wherever necessary. In addition, suitable amendments to various taxation provisions will have to be made to make the transition from bank subsidiary model to FHC model, tax and stamp duty neutral.

3.35 However, there are numerous challenges in implementing the FHC model in India due to legacy issues and multiplicity of regulatory and legal provisions that govern various sectors. Some of the major challenges can be identified as follows:

- Though enactment of a separate law for regulating FHCs has been recommended, it may take a while before this can be achieved. This is because the recommendations need to be accepted by all stakeholders including Government of India and also a simultaneous amendment to various other acts is made.
- There exist various policy issues in the financial sector including the differential Government ownership in financial entities, differential ownership and governance standards prescribed by various regulators and differential ceilings for foreign ownership prescribed for various sectors. Bringing all financial activities of a group within a single FHC would presuppose harmonisation among different sector policies.
- The most challenging task would be reorganising public sector banks from bank subsidiary model to FHC model as this involves both strategic and public policy issues for the Government. Irrespective of whether the Government chooses to maintain its control at the FHC level or at the bank level it would have to sort out implementation, administrative and management issues.

Compensation Policy

3.36 Compensation of Board of Directors, including that of the Chief Executive Officer (CEO) of banks in private sector and foreign banks has always been under RBI regulation in terms of the provisions of Banking Regulation Act, 1949, unlike the situation in many other jurisdictions. In terms of provisions of the Act, banking companies in India obtain approval from the Reserve Bank for conferring any benefit, amenity or perquisite in whatever form to their directors/CEOs whether during or after termination of their term of office.

3.37 Based on the Financial Stability Board (FSB) Principles for Sound Compensation Practices, the Reserve Bank placed draft guidelines on compensation in July 2010 on its website inviting public comments. In October 2010, the Basel Committee on Banking Supervision (BCBS) brought out a consultative paper titled “Range of Methodologies for Risk and Performance Alignment of Remuneration” and issued the final paper in May 2011.

3.38 Pursuant to the announcement made in the Monetary Policy Statement of May 2011 and taking into account the feedback received on draft guidelines, the impact analysis carried out with the help of external consultants and methodologies prescribed by BCBS on risk alignment, the Reserve Bank is in the process of finalising its guidelines on compensation.

Credit Information Companies

3.39 In 2010-11, a Certificate of Registration (CoR) was issued by the Reserve Bank to

Highmark Credit Information Services Private Limited to commence business of credit information after issuing CoR to Experian Credit Information Company of India Private Limited and Equifax Credit Information Services Private Limited earlier in 2009-10. The Reserve Bank issued a circular in September 2010 to banks/ financial institutions advising them to include the Director Identification Number (DIN) as one of the fields in the data submitted by them to credit information companies and Reserve Bank. This will ensure that names of directors of these credit information companies are correctly identified and in no case, persons whose names appear to be similar to the names of directors appearing in the list of Wilful Defaulters of ₹25 lakh and above or Defaulting borrowers of ₹1 crore and above are wrongfully denied credit facilities on such grounds.

Provisioning Coverage Ratio (PCR) for Advances

3.40 As a macro-prudential measure, banks were required to maintain PCR of 70 per cent of gross NPAs with reference to the position as on end-September 2010. The surplus of the provision over and above the prescribed prudential norms should be segregated into a separate account styled as “counter-cyclical provisioning buffer” which will be allowed to be used during periods of system-wide downturn with the prior approval of the Reserve Bank. This was intended to be an interim measure till such time the Reserve Bank introduces a more comprehensive methodology of counter-cyclical provisioning taking into account the evolving international standards.

Provision for Pension Liabilities

3.41 Banks provide various types of employee benefits such as pension, gratuity in accordance with the extant accounting standard AS 15, which is based on the International Accounting Standard IAS 19. Banks are expected to ensure that the commitments arising out of the wage settlement can be absorbed by them keeping in view their financial position. As witnessed during the last wage revision, public sector banks and 10 old private sector banks, under the 9th bipartite settlement, signed in April 2010, were apparently not able to absorb the impact of the additional burden arising on account of above. The IBA approached the Reserve Bank on behalf of the member banks, seeking approval to amortise the additional liability. Special regulatory dispensation of amortisation was granted to these banks by the Reserve Bank for a period of five years subject to certain conditions[3]. The laxity in building up adequate provisions for such liabilities is a matter of regulatory concern. This also has systemic stability issues arising from under-provisioning and non-compliance with extant accounting standards. It is, therefore, necessary that banks make proper assessment of their superannuation liabilities and provide for the same from the year in which the wage settlements fall due and not from the year in which such settlements are made.

Road Map for Basel III

3.42 The Basel Committee has prescribed a detailed roadmap for smooth transition to Basel III standards between January 1, 2013 and January 1, 2019. In this regard, the assessment shows that Indian Banks are well positioned to adjust to the Basel III norms well within the phase-in period. However, there exist many challenges, such as upgrading risk management systems and meeting the credit needs of a rapidly growing economy even while adjusting to a more demanding regulatory regime.

6. Supervisory Policy

Close and Continuous Supervision of Large and Systemically Important Banking Groups

3.43 For optimising the supervisory resources and also to have a more focused attention on banks, which are systemically important, it was

[3] For details, see RBI Annual Report - 2010-11.

decided to reorganise the supervisory processes and the organisational structure of the Department of Banking Supervision (DBS). The reorganisation of the Department was made effective from April 1, 2011, whereby a new division named Financial Conglomerate Monitoring Division (FCMD) was created to have a system of "close and continuous supervision" of 12 large and systemically important banking groups, which account for 52.7 per cent of the total assets of the banking system. Under the reorganised set up, the supervisory responsibility of FCMD would include exercising on-site and off-site supervision, and a more meaningful consolidated/conglomerate supervision of banking groups with a focus on group wide capital adequacy assessment, among others.

Steering Committee to Review Supervisory Processes for Commercial Banks

3.44 A High Level Steering Committee (Chairman: Dr. K. C. Chakrabarty) has been constituted to assess the adequacy of Reserve Bank's supervisory policies, procedures and processes and suggest enhancements for making the supervisory policies comparable with global standards. Shri B. Mahapatra, Executive Director, RBI, Dr. J. R. Varma, Professor, IIM, Ahmedabad, Shri Diwakar Gupta, MD and CFO, State Bank of India, Smt. Chanda Kochhar, MD and CEO, ICICI Bank Ltd., Shri. Basant Seth, CMD, Syndicate Bank, and Shri M. B. N. Rao, Retired CMD, Canara Bank are the members and Shri G. Jaganmohan Rao, Chief General Manager-in-Charge of the Department of Banking Supervision is the Member Secretary of the Committee. The Committee is mandated to submit its report by July 31, 2012.

Review of the Format for Annual Financial Inspection of Banks

3.45 Keeping in view the changes in the banking system, the way banks do business and the need for supervisors to keep pace with the fast changing business practices, the process of the Annual Financial Inspection (AFI) of banks has been redefined. The revised guidelines pertaining to AFI coverage and method of drafting AFI reports are designed to sharpen the focus and bring out precision in analysis and arrive at clear conclusions for enabling the Reserve Bank to take definitive supervisory actions based on the findings. The guidelines have been put in place in the current AFI cycle 2011-12.

Initiatives taken by Board for Financial Supervision

3.46 The Board for Financial Supervision (BFS), constituted in November 1994, remains the chief guiding force behind Reserve Bank's supervisory and regulatory initiatives. During July 2010 to July 2011, the BFS held 13 meetings. It reviewed 98 inspection reports (25 reports of public sector banks, 30 of private sector banks, 31 of foreign banks, 4 of local area banks, and 8 of financial institutions). During the period, the BFS also reviewed 15 summaries of inspection reports and 43 summaries of financial highlights pertaining to scheduled UCBs classified in Grade I/II. Some of the important issues deliberated upon by the BFS during the period are as follows:

- Continuing to exercise keen interest in fine tuning of supervisory rating, the BFS sought a complete review of the rating methodology. The suggestions included: (i) review of weightages given to sub-parameters; (ii) the adjustment in composite rating to reflect the deterioration or improvement in the bank's performance in various parameters. The supervisory rating framework is currently under review.
- During the period under review, the BFS had observed that in order to take advantage of favourable market conditions and book profits, many banks were resorting to sale of securities held under Held to Maturity (HTM) category on more than one occasion during the year. In response, as directed by BFS, a circular was issued in August 2010 advising

banks to disclose market value of investments held in HTM category and indicate the excess of book value over market value for which provision is not made, if the value of sales and transfers of securities to/from HTM category exceeds 5 per cent of the book value of investment in HTM. This disclosure is required to be made in "Notes to Accounts" in banks' audited Annual Financial Statements. In November 2010, it was clarified that one-time transfer of securities to/from HTM category with the approval of Board of Directors permitted at the beginning of the accounting year and sales to the Reserve Bank under pre-announced OMO auctions would be excluded from the 5 per cent cap prescribed in August 2010.

- The BFS approved a proposal to subject only those foreign banks to Annual Financial Inspection, which have a business share of more than 0.1 per cent of the market share (assets plus off-balance sheet business). Those foreign banks which have a market share of less than 0.1 per cent will be inspected once in two years provided their rating is 'B' and above. Those foreign banks with a market share of less than 0.1 per cent and with rating of 'C' and less will be inspected annually.
- Based on the suggestions of the BFS, it was decided that as supervisors, the Inspecting Officers (IOs) should have access to all the reports/review notes prepared by the Inspection/Audit teams of the bank, some of which may be from overseas and may not be available locally.

Whole Firm Liquidity Modification Regime in the UK: Implications for Indian Banks

3.47 A new liquidity regime through increased international cooperation in financial supervision arrangements was proposed by Financial Services Authority (FSA), UK to make the banking system more robust to withstand shocks. The Whole Firm Liquidity Modification regime which encompasses Indian banks operating through branches/subsidiaries in the UK would enable the UK branch of an Indian bank to place reliance on unlimited liquidity resources from anywhere within the whole firm (bank). Six Indian banks having presence in the UK have applied for "Whole Firm Modification" after obtaining prior approval of the Reserve Bank. Subsequently, agreements were entered into by the Reserve Bank with FSA in October 2010 to monitor the liquidity of the parent bank on an ongoing basis in respect of the six banks. As per the agreement, the specifications and monitoring of triggers for liquidity insufficiency in respect of UK branches of Indian banks would rest with the parent bank.

Reporting of Frauds by Public Sector Banks

3.48 The Reserve Bank issued a circular in October 2010 advising public sector banks about the increase in the upper limit for reporting of frauds to Central Bureau of Investigation (CBI) from ₹5 crore to ₹7.5 crore and accordingly, all fraud cases involving an amount of ₹1 crore and above going up to ₹7.5 crore, where staff involvement is *prima facie* evident must be reported to Anti Corruption Branch of CBI. However, in case where the staff involvement is *prima facie* not evident, it would be advised to CBI's Economic Offences Wing. Further, all cases involving more than ₹7.5 crore would have to be reported to respective centres of Banking Security and Fraud Cell, a specialised cell of the Economic Offences Wing for major bank fraud cases.

Internal Vigilance in Private Sector/Foreign Banks

3.49 In order to align the vigilance function in private and foreign banks to that of the public sector banks, the existing vigilance functions of a few private sector and foreign banks were mapped with the existing guidelines in the matter and it was observed that the practices

vary widely among the banks. Accordingly, detailed guidelines aimed at bringing about uniformity and rationalisation in the function of internal vigilance were issued for private sector and foreign banks in May 2011 to address all issues arising out of lapses with regard to corruption, malpractices and frauds for timely and appropriate action. Private sector banks and foreign banks operating in India were advised, *inter alia*: (i) to appoint Chief of Internal Vigilance (CIV) whose role has also been defined in the guidelines; (ii) to identify sensitive positions and have board-approved guidelines regarding rotation of staff and mandatory leave by staff handling sensitive desks.

Guidelines for Forensic Scrutiny

3.50 Forensic scrutinies at certain identified banks were conducted by the Reserve Bank due to occurrence of large value frauds and sharp increase in number of frauds at such banks to primarily identify the policy gaps, if any, and adequacy of controls. Based on the findings of the scrutinies, the operating framework for tracking frauds and dealing with them was advised to be structured along the lines of "Detection and Reporting of Frauds, Corrective Action and Preventive and Punitive Action" circular, issued earlier in this regard. The banks were advised to evolve suitable controls and disincentives in their HR process and internal inspection/audit process, which should focus on 'fit and proper criteria' for posting of staff in specialised branches and build a database at offices about staff having aptitude for investigation/data analysis and provide them training in investigation and forensic audit.

Penal Actions for Violations of RBI's Guidelines on Derivative Transactions

3.51 Penalties have been imposed on 19 commercial banks by the Reserve Bank in exercise of the powers vested with it under the provisions of Section 47A(1)(b) read with Section 46(4)(i) of the Banking Regulation Act, 1949. The penalties have been imposed for contravention of various directions and instructions issued by the Reserve Bank in respect of derivative transactions. The contraventions relate to failure to carry out proper due diligence on user appropriateness and suitability of products, and selling derivative products to users not having proper risk management policies, among others.

Return to Monitor Interest Rate Sensitivity

3.52 The Reserve Bank has introduced a new return to monitor interest rate sensitivity based on duration gap and has issued a circular in November 2010 for details on computing the duration gap. The details about the return and procedure for calculation are illustrated in Box III.1.

7. Regional Rural Banks

3.53 Regional Rural Banks (RRBs) are region-based and rural-oriented banks, which have been set up to correct the regional imbalances and functional deficiencies in the institutional credit structure *vis-à-vis* the weaker sections of the populace. New credit delivery models like business correspondents, business facilitators as well as new technologies are being experimented with, so as to reach the unreached customers. In this regard, RRBs are well placed to carry forward the movement of financial inclusion due to their local character and familiarity with the local clientele.

Amalgamation of RRBs

3.54 On account of the consolidation and amalgamation process which had started in September 2005, the number of RRBs has come down to 82. As on date, out of 82 RRBs, 80 RRBs have been included in the 2nd Schedule of the RBI Act, 1934. At present, two RRBs *viz*., Paschim-Banga Gramin Bank, West Bengal and Kalinga Gramin Bank, Orissa are ineligible for scheduling.

Box III.1: Monitoring Interest Rate Sensitivity based on Duration Gap Analysis

Interest rate risk is the risk where changes in market interest rates affect a bank's financial position. Changes in interest rates impact a bank's earnings through changes in its Net Interest Income (NII). Changes in interest rates also impact a bank's Market Value of Equity (MVE) or Net Worth through changes in the economic value of its rate-sensitive assets, liabilities and off-balance sheet positions. The interest rate risk can thus be viewed from two perspectives, *viz*., 'earnings perspective' and 'economic value perspective'. Generally, the former is measured using the Traditional Gap Analysis (TGA) and the latter is measured using more sophisticated Duration Gap Analysis (DGA).

Presently, the Reserve Bank monitors the interest rate risk of banks through a monthly return on interest rate sensitivity using the TGA. The focus of the TGA is to measure the level of a bank's exposure to interest rate risk in terms of sensitivity of its NII to interest rate movements over usually a one-year time horizon. It involves bucketing of all Rate-Sensitive Assets (RSA) and Rate-Sensitive Liabilities (RSL) and off-balance sheet items as per residual maturity/re-pricing date in various time bands and computing Earnings at Risk (EaR) or the loss of income under different interest rate scenarios over one year.

In addition to the existing return on Interest Rate Sensitivity under Traditional Gap Analysis, a new return is being introduced to monitor the interest rate risk using DGA, called Interest Rate Sensitivity under Duration Gap Analysis (IRSD). The DGA involves bucketing of all RSA and RSL as per residual maturity/re-pricing dates in various time bands and computing the Modified Duration Gap (MDG). The RSA and RSL include the rate-sensitive off-balance sheet assets and liabilities as well. MDG can be used to evaluate the impact on the MVE of the bank under different interest rate scenarios. The past few years have seen banks' foray into financing long-term assets, such as home loans and infrastructure projects. Banks have been allowed to raise funds through long-term bonds with a minimum maturity of five years to the extent of their exposure of residual maturity of more than five years to the infrastructural sector. Hence, the time buckets *viz*; 'over 5 years and up to 7 years', 'above 7 years and up to 10 years' and 'over 10 years and up to 15 years' and 'over 15 years', have been incorporated in the new return.

The step-by-step approach for computing modified duration gap has been detailed in the Reserve Bank circular (DBOD.No.BP.BC.59/21.04.098/2010-11) dated November 4, 2010. Banks will be required to compute their interest rate risk position, in each currency (including Rupees) by applying DGA to RSA and RSL items in that currency, where either the assets/liabilities are 5 per cent or more of the bank's total global assets/liabilities. The interest rate risk position in all other residual currencies has to be computed separately on an aggregate basis. The framework prescribed is aimed at determining the impact on the MVE arising from changes in the value of interest rate sensitive positions across the whole bank *i.e.*, both in the banking and trading books. Banks shall submit the report on interest rate sensitivity as per DGA in the stipulated format with effect from June 30, 2011 on a quarterly basis till March 31, 2012, and on a monthly basis with effect from April 30, 2012.

Branch Licensing Policy for RRBs

3.55 The Reserve Bank has recently liberalised branch authorisation policy considerably for RRBs and allowed them to open branches in Tier 3 to Tier 6 centres (with population of up to 49,999 as per 2001 Census) without prior authorisation from the Reserve Bank, subject to reporting to respective Regional Offices of the Reserve Bank, provided they fulfill certain conditions as specified in the relevant circular.

CBS Implementation

3.56 As on September 30, 2011, 65 out of 82 RRBs have migrated fully to core banking solutions (CBS), and implementation of CBS is in progress in the remaining RRBs. All sponsor banks have committed to implement CBS in RRBs by the prescribed time line *i.e.*, September 2011.

Amortisation of Gratuity

3.57 Owing to enhancement of maximum limit for payment of gratuity from ₹3.50 lakh to ₹10.00 lakh, RRBs' liability towards payment of additional premium to LIC has increased considerably. Hence, they have been permitted to amortise the enhanced expenditure over a period of five years beginning with the financial year ending March 31, 2011 subject to a minimum of 1/5th of the total amount involved every year.

8. Cooperative Banks

Urban Cooperative Banks (UCBs)

3.58 Cooperative banks assume importance in the Indian financial system under the inclusive growth agenda, which has laid emphasis on financial inclusion. During 2010-11, a number of policy initiatives have been taken to strengthen cooperative banking in India, details of which are as follows:

Opening of off-site ATMs by UCBs - Liberalisation

3.59 According to the liberalised policy, Financially Sound and Well-Managed (FSWM) UCBs can open off-site ATMs over and above their annual business plan provided they meet the following criteria: (i) maintenance of a minimum CRAR of 10 per cent; (ii) net NPAs being less than 5 per cent; (iii) no default in the maintenance of CRR/SLR during the preceding financial year; (iv) continuous net profit for the last 3 years; (v) sound internal control system with at least two professional directors on the Board; and (vi) regulatory comfort based on track record of compliance with the provisions of BR Act, 1949 (AACS), RBI Act, 1934 and instructions/directions issued by the Reserve Bank from time to time. In addition, the minimum owned funds of the FSWM UCBs should be commensurate with entry point capital norms for the centre where the off-site ATM is proposed/where the UCB is registered.

New Bank Licenses

3.60 As announced in the Annual Policy Statement 2010-11, the Reserve Bank set up an expert committee (Chairman: Shri Y.H. Malegam) comprising all stakeholders for studying the advisability of granting licenses to set up new UCBs. The expert committee submitted its report on August 18, 2011. The Committee is of the view that, there is need for a greater presence of UCBs, especially in unbanked districts and in centres having population of less than 5 lakh. In this regard, it is necessary to encourage new entrants to open banks and branches in States and districts which are unbanked or inadequately banked. The existing well-managed cooperative credit societies with sound track record should be given priority for granting licenses as UCBs particularly in unbanked or inadequately banked centres. Some of the recommendations by the Expert Committee are as follows:

- UCBs which want to operate in the North-east or only in one State would need a minimum capital of ₹50 lakh. The UCBs which want to operate in other States but keeping majority of branches in 'C' and 'D' category population centres would need minimum capital of ₹100 lakh. For UCBs which want to operate in other States without any requirement in 'C' and 'D' categories should have a minimum capital of ₹300 lakh. The UCBs which want to operate in more than one State after five years of successful operations would need a minimum capital of ₹500 lakh.
- There should be segregation of the ownership of the UCB as a cooperative society from its functioning as a bank. The new organisation structure shall consist of a Board of Management (BoM) in addition to the Board of Directors (BoD).
- The BoD will establish a BoM, consisting of persons with professional skills, which shall be entrusted with the responsibility for the control and direction of the affairs of the bank assisted by a CEO who shall have the responsibility of the management of the Bank. The appointment of the CEO shall be subject to the prior approval of the Reserve Bank.

Guidelines on Trading of Currency Options by UCBs

3.61 UCBs licensed as Authorised Dealers (Category I) were allowed to participate in the exchange traded currency option market of a designated exchange, recognised by SEBI as clients only, subject to RBI (Foreign Exchange Department) guidelines only for the purpose of hedging underlying forex exposure arising from customer transactions.

Exposure to Housing, Real Estate and Commercial Real Estate Sectors

3.62 As announced in the Second Quarter Review of Monetary Policy 2010-11, it was decided that UCBs' exposures to housing, real estate and commercial real estate loans would be limited to 10 per cent of their total assets, instead of 15 per cent of deposits, which can be exceeded by an additional limit of 5 per cent of assets in case of dwelling units costing upto ₹10 lakh, subsequently increased to ₹15 lakh for housing loans granted to individuals. Further, it was also decided that UCBs would not be allowed to exceed the aggregate ceiling for real estate, commercial real estate and housing loans to the extent of refinance availed from higher financing agencies and National Housing Bank (NHB).

Prudential Norms on Investment in Zero Coupon Bonds (ZCBs)

3.63 UCBs were advised not to invest in ZCBs unless the issuer builds up a sinking fund for all accrued interest and keeps it invested in liquid investments/securities (Government Bonds).

Limit for Housing Loans under Priority Sector Advances

3.64 The limit for housing loans considered as a priority sector was increased from ₹20 lakh to ₹25 lakh for housing loans sanctioned by UCBs on or after April 1, 2011.

Accounting Procedure for Investment: Settlement Date Accounting

3.65 UCBs were advised that to bring in uniformity in the practice adopted by banks while accounting for investing in Government securities, they should follow "Settlement Date" accounting for recording both outright and ready forward purchase and sale transactions in Government securities.

Enhancement of Gratuity Limits - Prudential Regulatory Treatment

3.66 Consequent to the increase in the gratuity payment on account of the Amendment to Payment of Gratuity Act, 1972, UCBs were allowed to defer the expenditure related to enhancement of gratuity, if not fully charged to the Profit and Loss Account during the financial year 2010-11, over a period of five years beginning with the financial year ended March 31, 2011 subject to charging to the Profit and Loss Account a minimum of $1/5^{th}$ of the total amount involved every year. UCBs have to disclose the expenditure so deferred in their Annual Financial Statements.

Financing of Self-Help Groups (SHGs) and Joint Liability Groups (JLGs)

3.67 With a view to further expanding the outreach of UCBs and opening an additional channel for promoting financial inclusion, which would also help them in achieving the sub-target of lending to weaker sections, UCBs were allowed to lend to SHGs/JLGs. Loans to SHGs/JLGs for agricultural and allied activities would be considered as priority sector advances. Further, other loans to SHGs/JLGs up to ₹50,000 would be considered as Micro Credit and hence treated as priority sector advances. Lending to SHGs, which qualify as loans to priority sector, would also be treated as part of lending to weaker sections.

Internet Banking for Customers of UCBs

3.68 Scheduled UCBs having a minimum net worth of ₹100 crore, CRAR of at least 10 per cent, net NPAs less than 5 per cent and have earned net profit continuously in the last three years were allowed to provide internet banking facility to their customers subject to obtaining prior approval of the Reserve Bank.

Rural Cooperative Banks

Status of Licensing of Cooperative Banks

3.69 There are 31 State Cooperative Banks (StCBs) and 371 District Central Cooperative Banks (DCCBs) in the country. Consequent to the issuance of revised guidelines on licensing of StCBs and DCCBs, ten StCBs and 160 DCCBs were licensed. As on June 30, 2011,

seven StCBs and 136 DCCBs were still unlicensed.

Limit imposed on Housing Finance for State and Central Cooperative Banks

3.70 State and Central Cooperative Banks were advised to limit the exposure to housing finance to 5 per cent of their total assets as against 10 per cent of their total loans and advances.

9. Non-Banking Financial Companies

Amendment to Definition of Infrastructure Loan

3.71 The term “Infrastructure Loan” which had been defined in Para 2(viii) of Non-Banking Financial (Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007 and Non-Banking Financial (Non-Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007, respectively, were amended. Consequently, NBFCs have been advised to include “Telecom Towers” under infrastructure. Further NBFCs have been advised that only Credit Rating Agencies (CRAs) approved by the Reserve Bank can give the rating to Infrastructure Finance Companies (IFCs).

Regulatory Framework for Core Investment Companies (CICs)

3.72 Under the extant regulatory framework, Core Investment Companies (CICs) with an asset size of less than ₹100 crore are exempt from the requirements of registration with the Reserve Bank. However, CICs with an asset size of ₹100 crore or more and accessing public funds would be considered as Systemically Important Core Investment Companies (CICs-ND-SI) and would be required to obtain Certificate of Registration (CoR) from the Reserve Bank under Section 45-IA of the Reserve Bank of India Act, 1934 even if they have been advised in the past that registration would not be required.

Introduction of Provision of 0.25 per cent for Standard Assets of NBFCs

3.73 In the interest of counter-cyclicality and also to ensure that NBFCs create a financial buffer to protect themselves from the adverse effects of economic downturns, provisioning of 0.25 per cent of the outstanding standard assets has been introduced.

Participation in Currency Options

3.74 NBFCs (excluding RNBCs) have been permitted to participate in the designated currency options exchanges recognised by SEBI, subject to RBI (Foreign Exchange Department) guidelines, only for the purpose of hedging their underlying forex exposures with an appropriate disclosure in their balance sheets.

Submission of Data to Credit Information Companies

3.75 NBFCs are required to become a member of at least one credit information company. They are required to provide the credit information to the credit information companies in the prescribed format. NBFCs are also required to provide historical data in order to enable the new credit information companies to develop a robust database.

Balance Sheet and Profit and Loss Account Information

3.76 NBFCs are advised to prepare their balance sheet and profit and loss account as on March 31 every year. Any extension of date of balance sheet would require prior approval of the Reserve Bank. Further, NBFCs are required to submit a certificate from Statutory Auditor with respect to the position of the company as on March 31 every year within one month from the date of finalisation of the balance sheet and in any case not later than December 30 of that year.

NBFCs not to be Partners in Partnership Firms

3.77 On account of the risks involved in NBFCs associating themselves with partnership firms, NBFCs are prohibited from contributing capital to any partnership firm or to be partners in partnership firms. In cases of existing partnerships, NBFCs have been advised that they may seek early retirement from the partnership firms.

Ready Forward Contracts in Corporate Debt Securities

3.78 NBFCs registered with the Reserve Bank (other than Government companies as defined in Section 617 of the Companies Act, 1956) are eligible to participate in repo transactions in corporate debt securities. NBFCs participating in such repo transactions have been advised to comply with the Directions and accounting guidelines issued by the Reserve Bank. All Systemically Important Non-Deposit taking Non-Banking Financial Companies (NBFCs-ND-SI) are eligible to participate in the repo transactions.

Loan Facilities by NBFCs to the Physically/ Visually Challenged

3.79 NBFCs have been advised that there shall be no discrimination in extending products and facilities including loan facilities to the physically /visually challenged applicants on grounds of disability.

Enhancing CRAR to 15 Per cent

3.80 It was decided to align the minimum capital ratio of all deposit-taking NBFCs with that of NBFCs-ND-SI at 15 per cent. Accordingly, all deposit taking NBFCs have been advised to maintain a minimum capital ratio consisting of Tier I and Tier II capital, which shall not be less than 15 per cent of its aggregate risk weighted assets on balance sheet and risk adjusted value of off-balance sheet items with effect from March 31, 2012.

Setting up of Central Electronic Registry under the SARFAESI Act, 2002

3.81 To prevent frauds in loan cases involving multiple lending from different banks on the same immovable property, a central electronic registry has been established under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act.

Opening of Branch/Subsidiary/Joint Venture/Representative Office or Undertaking Investment Abroad by NBFCs

3.82 NBFCs desirous of making any overseas investment must obtain 'No Objection' (NoC) under the terms of Regulation of the Foreign Exchange Management (Transfer or Issue of Any Foreign Security) (Amendment) Regulations, 2004 and the Non-Banking Financial Companies (opening of Branch/Subsidiary/ Joint Venture/Representative Office or Undertaking Investment Abroad by NBFCs) Directions, 2011 issued by the Reserve Bank before making such investment, from the Regional Office of the Reserve Bank in whose jurisdiction the head office of the company is registered.

Entry of NBFCs into Insurance Business

3.83 NBFCs registered with the Reserve Bank would be permitted to set up a joint venture (JV) company for undertaking insurance business with risk participation, subject to certain safeguards: (i) the maximum equity contribution such an NBFC can hold in a JV company is 50 per cent of the paid-up capital of the insurance company; (ii) subsidiary or company in the same group of an NBFC or of another NBFC engaged in the business of a non-banking financial institution or banking business shall not be allowed to join the insurance company on risk participation basis. In this regard, it was clarified that in case, if more than one company in the same group of the NBFC wishes to take a stake in the insurance company, the contribution by all companies in the same group shall be

counted for the limit of 50 per cent prescribed for the NBFC in such an insurance JV.

Returns to be Submitted by NBFCs – Revised Formats

3.84 In terms of extant instructions, all NBFCs (excluding RNBCs) are required to file various returns related to deposit acceptance, prudential norms and capital market exposure, among others. It has been decided to rationalise the returns to streamline the reporting system and to improve the present method of collecting data. The Reserve Bank has since hosted the format of the revised returns on the Bank's website, *viz.*, <https://cosmos.rbi.org.in>. NBFCs shall submit all the returns online in the revised formats.

10. Customer Service in Banks

3.85 The Reserve Bank focuses on customer empowerment through enhanced dissemination of information. Towards providing more efficient and transparent services to customers, a number of initiatives were taken in 2010-11.

Credit Card Services

3.86 As there have been numerous complaints about credit card operations of banks, the Reserve Bank advised banks to strictly adhere to the guidelines issued in the Master Circular on Credit Card Operations of July 1, 2011, both in *letter* and *spirit*. A failure to observe these guidelines could lead to suitable penal action, including levy of monetary penalties under the relevant statutory provisions.

Online Alerts for ATM Services

3.87 The Reserve Bank has advised banks to put in place a system of online alerts latest by June 30, 2011 to cardholders, for all types of transactions, irrespective of the amount involved through various channels due to the increased instances of fraudulent withdrawals at ATMs. Further, banks have been also advised to provide complaint templates at all ATM sites for lodging ATM-related complaints.

Real Time Gross Settlement (RTGS) and National Electronic Fund Transfer System (NEFT) Services

3.88 To ensure prompt redressal of customer complaints regarding RTGS transactions, banks have been advised to use existing Customer Facilitation Centres set up for NEFT and RTGS customer complaints. To facilitate easy reconciliation of RTGS/NEFT return transactions, banks have been advised to provide necessary information to customers on return transactions in the account statement. Further, banks have also been advised to furnish remitter details to customers in their pass book or account statement for credits received through NEFT/National Electronic Clearing Service (NECS) / Electronic Clearing System (ECS).

Cheque Drop-Box Services

3.89 In view of complaints about refusal by banks to give acknowledgements to customers for cheques tendered at the counter, compelling them to drop them in the drop-box, banks have been advised to ensure stricter compliance with the extant instructions regarding cheque drop-box facility. Banks have been further advised that no branch should refuse to accept cheques over the counter and give proper acknowledgement.

Loan Services

3.90 With a view to bring fairness and transparency, banks have been advised to disclose ' all in cost ', inclusive of all charges involved in the processing and sanction of loans to enable the customer to compare the charges with other sources of finance. Banks need to ensure that these charges are non-discriminatory.

Committee on Customer Service in Banks

3.91 The Reserve Bank has constituted a

Committee to study various aspects of customer service in banks. The major observations made by the Committee are given in Box III.2.

Customer Satisfaction Survey: ATM Transactions

3.92 The Reserve Bank commissioned a survey to assess customer satisfaction in the usage of ATMs across the country. The Survey covered 600 ATMs distributed proportionately over metro, urban, semi-urban and rural regions, constituting 1 per cent of the total number of 60,000 ATMs in the country. The interim report was presented to the Board for Payment and Settlement Systems in June 2011. The major findings of the Survey *inter alia* were as follows: (i) cards were mainly used for withdrawing cash or shopping purposes; (ii) the use of debit cards for bills payment/ticket purchase was still low; (iii) the use of debit cards for shopping was the highest in Maharashtra and Andhra Pradesh; (iv) the use of cards for shopping was more among the youth; (v) females used cards with less frequency.

Silver Jubilee Year of Consumer Protection Act

3.93 The year 2010-11 was the Silver Jubilee Year of the Consumer Protection Act, 1986. The theme for celebration, proposed by the Ministry of Consumer Affairs, was “Consumers Discharge Your Responsibilities: Assert Your Rights”. To commemorate the occasion, the Department of Consumer Affairs proposes to bring out a book titled “Consumer Protection in India” containing papers written by experts, which would be released in December 2011.

Exclusive Board Meetings on Customer Service

3.94 To increase Board oversight on customer service-related issues in banks, the Annual Monetary Policy - 2010-11 had announced that banks should devote exclusive time in a Board meeting once every six months to deliberate on these issues. All banks would submit a detailed memorandum regarding customer service to the Board of Directors, once every six months and initiate prompt corrective action, wherever quality and skill gaps were observed.

11. Financial Markets

Adherence to Foreign Exchange Management Act (FEMA) Guidelines for Online Payment Transactions

3.95 The Online Payment Gateways have emerged as popular modes of e-commerce and

Box III.2: Report of the Committee on Customer Service in Banks

The Reserve Bank constituted a Committee (through a Board Memorandum dated May 26, 2010) under the chairmanship of Shri M. Damodaran, former Chairman, SEBI to examine banking services rendered to retail and small customers, including pensioners. The Committee also had a mandate to look into the grievance redressal mechanism prevalent in banks, its structure and efficacy, and suggest measures for expeditious resolution of complaints.

The Committee had interactions with various stakeholders on all aspects of customer service fair treatment, improvement in services to pensioners, attitude of the bank staff towards the small and rural customers, service charges and fees, transparency in operations, grievance redressal, promptness in service, education and information on new products, and customer rights and expectations, among others. The Committee also called for public suggestions.

The Committee submitted its report to the Bank in July 2011. According to the Committee, the major expectations of consumers are that banks should: (i) have a customer-centric approach; (ii) render fair and non-exploitative treatment and adhere to full disclosure of information; (iii) put in place an expeditious grievance redressal; (iv) provide a simple deposit account instead of *suo moto* offering bouquet services without customer demand and charging for the same.

The recommendations of the Committee are based on the above customers expectations. They include *inter alia*: (i) creation of a toll free Common Bank Call Number; (ii) providing plain vanilla savings account without prescription of minimum balance; (iii) setting up of a trusted third party KYC data bank, which can be relied upon for KYC purposes; (iv) providing small remittances at reasonable price; (v) zero liability against loss in ATM and online transactions; (vi) enhancement of Deposit Insurance and Credit Guarantee Corporation (DICGC) cover to ₹5,00,000.

have facilitated exports, particularly in small-value goods and services. The Reserve Bank has issued guidelines in November 2010 to Authorised Dealer (AD) banks allowing them to offer the facility of repatriation of export-related remittances (up to US$ 500 per transaction) by entering into standing arrangements with Online Payment Gateway Service Providers subject to certain conditions. Enhancing the existing limit per transaction of US$ 500 is under consideration.

Over-the-Counter (OTC) Foreign Exchange Derivatives

3.96 The comprehensive guidelines on OTC foreign exchange derivatives and overseas hedging of commodity price and freight risks were issued on December 28, 2010. The important elements of the revised guidelines, which became effective in February 2011, are *inter alia*: (i) AD category banks can only offer plain vanilla European Cross Currency Options; (ii) allowing embedded cross currency option in the case of foreign currency-rupee swaps; (iii) permitting the use of cost reduction structures, both under the contracted exposures and past performance routes, subject to certain safeguards; (iv) undertaking swaps to move from Rupee liability to forex liability is allowed, subject to certain safeguards.

Introduction of Credit Default Swaps (CDS) for Corporate Bonds

3.97 The Reserve Bank had issued draft guidelines on introduction of CDS in 2003 and 2007. However, taking into account the adverse developments in the international financial markets, the issuance of final guidelines was deferred. Following the proposal of introducing plain vanilla over-the-counter (OTC) single-name CDS for corporate bonds made in the Second Quarter Review of Monetary Policy of 2009-10, an internal Working Group (Convener: Shri R. N. Kar) was constituted to finalise the operational framework. Based on the feedback received from stakeholders on the draft guidelines prepared by the Group, final guidelines have been issued in May 2011. The salient features of the guidelines, among others, are as follows:

i. The CDS shall be permitted on listed corporate bonds, unlisted but rated bonds of infrastructure companies and unlisted/ unrated bonds issued by the Special Purpose Vehicles (SPVs) set up by infrastructure companies as reference obligations.

ii. The reference entities shall be single legal resident entities.

iii. The permitted participants have been categorised into:

    a) Market Makers: Participants, such as commercial banks, NBFCs and stand-alone PDs are permitted to undertake both protection buying and protection selling subject to satisfying certain eligibility norms. Insurance companies and mutual funds can act as market-makers subject to the approval of their respective regulators.

    b) Users: Participants, among others, include commercial banks, PDs, NBFCs, mutual funds, insurance companies and listed corporates, who can hedge only their underlying exposures. Users cannot purchase CDS without having the underlying exposure and the protection can be bought only to the extent (both in terms of quantum and tenor) of such underlying risk.

iv. For users, physical settlement is mandatory. Market makers can opt for any of the three settlement methods (physical, cash or auction settlement), provided the CDS documentation includes such settlement method.

v. Reporting requirements: It is mandatory for market makers to report their CDS trades

within 30 minutes from the deal time, on CDS trade reporting platform.

vi. As CDS markets are exposed to various risks, market participants are required to take these risks into account and build appropriate risk management systems. The guidelines prescribe counterparty credit exposure limits, PV01 limit (Change in price of ₹100 nominal bond for one basis point change in yield) and an independent risk management framework for monitoring and controlling of all aspects of risks.

12. Payment and Settlement System

3.98 The Reserve Bank has set up a robust technology-based payment and settlement systems infrastructure with enhanced assurance of uninterrupted and efficient provision of services. Major policy initiatives taken during the year to further strengthen the payment and settlement system were as follows:

Paper Clearing: Express Cheque Clearing System

3.99 To impart more efficiency to clearing process in non-MICR clearing houses, an advanced clearing house automation package Express Cheque Clearing System (ECCS) has been introduced. The ECCS would accept multi-user inputs in a networked environment, core-banking integration and graphic interface compatibility. The National Payments Corporation of India (NPCI) has been entrusted with the task of operationalising this package.

Electronic Payment Systems

3.100 To provide near-to-real-time funds transfer facility to retail customers, as also to cater to the stock market timings, 11-hourly settlements on week days and five-hourly settlements on Saturdays in National Electronic Fund Transfer (NEFT) was introduced in March 2010, which has now been extended to over 79,000 branches. This is expected to enhance customers' preference for electronic modes of payment.

Prepaid Payment Instruments

3.101 Keeping in view the increasing popularity of prepaid payment instruments, the guidelines issued in April 2009 were revisited in November 2010 and the following amendments *inter alia* were effected: (a) Extension of the use of semi-closed prepaid payment instruments used for payment of utility bills for the purchase of travel tickets; (b) Permission to banks to issue semi-closed prepaid payment instruments through agents and BCs. Further, the maximum value of prepaid instruments that can be used in the form of mobile-wallets (m-wallets) has been increased from ₹5,000 to ₹50,000.

Mobile Banking Transactions

3.102 Recognising the true potential of using mobile phones as a banking tool towards furthering financial inclusion, the bank-led model of mobile banking has been adopted, which would extend all banking facilities, including money transfer facility, through the mobile channel. The Reserve Bank has so far approved proposals of 50 banks to commence mobile banking services. The Bank has also authorised the NPCI to provide a seamless, instant, 24X7, mobile-based inter-bank fund transfer system through mobile phones, called Inter-Bank Mobile Payment Service.

Card-based Transactions

3.103 Given the increasing usage of cards (credit/debit/prepaid) issued by banks, there is a definite need to make both Card Present (CP), where card is swiped at ATMs and Points of Sale (PoS), and Card Not Present (CNP) transactions, safe and secure. An important step taken by the Reserve Bank, which is unique globally, is the mandate given to banks to provide additional authentication for all CNP transactions based on information not available on the card. The banks introduced additional authentication for CNP

transactions except the Interactive Voice Response (IVR) transactions in April 2009, and extended the same to all IVR transactions in February 2011. The mandate presently applies to all transactions using cards issued in India for payments on merchant sites where no outflow of foreign exchange is contemplated. This initiative has increased the confidence of customers in this channel leading to a steep fall in the frauds in e-commerce transactions. The Reserve Bank has recently constituted a Working Group to look into the issue of security of all CP transactions; the major recommendations of the Group are discussed in Box III.3.

Efficiency in the ATM Delivery Channel

3.104 To improve the operational efficiency of ATMs for customers, the Reserve Bank in May 2011 has *inter alia* advised banks: (a) To reduce the time limit for resolution of customer complaints from 12 working days to seven working days from the date of receipt of the customer complaint; (b) The customer is entitled to receive compensation for delay at the rate of ₹100 per day, provided the complaint is lodged with the issuing bank within 30 days from the date of the transaction; (c) All disputes regarding ATM-failed transactions should to be settled by the issuing bank and acquiring bank only through the ATM system provider leaving no scope of bilateral settlement arrangement outside the dispute resolution mechanism of the system provider. This measure would bring down the instances of disputes in payment of compensation between the issuing and acquiring banks.

Oversight of Payment Systems

3.105 To ensure that the payment systems operate in a safe and efficient manner and in line with extant policy prescriptions, the Reserve Bank has initiated a process of assessment, comprising both off-site surveillance and on-site inspections complimented by market intelligence. As part of the off-site surveillance, a database on the various payment instruments, their volume and value has been created and placed on the RBI website. An assessment template has been devised to aid authorised entities to carry out a self-assessment of their operations, risk management and business continuity arrangement.

13. Technological Developments

3.106 Technology is central to the design and delivery of banking services. The modern-day banking services are critically dependent on technological innovation and improvement. During 2010-11, several new initiatives were taken by the Reserve Bank towards improving the banking sector technology.

Business Continuity Management and Disaster Recovery

3.107 During the year, periodical drills were conducted in order to ensure effectiveness of the Business Continuity Management and Disaster Recovery (DR) arrangements for shared

Box III.3: Recommendations of the Working Group on Securing Card Present Transactions

A Working Group was constituted by the Reserve Bank on March 31, 2011 for recommending measures to secure all Card Present (CP) transactions. The Group, which submitted its report on May 31, 2011, made *inter alia* the following recommendations: (a) The technology and payment infrastructure like implementation of Unique Key Per Terminal (UKPT) and Terminal Line Encryption (TLE) should be strengthened within 18-24 months; (b) An additional factor (Personal Identification Number (PIN) or Biometric) for all domestic debit card transactions should be introduced within 24 months; (c) After monitoring the progress made in the roll-out of Aadhaar UID, it may be considered to use the biometric finger-print capture in lieu of PIN at the ATM and PoS for 18 months; (d) Based on the above recommendations, a decision should be taken to introduce Euro pay Master Card Visa (EMV) Chip and PIN for credit cards and debit cards for all domestic transactions within five and seven years, respectively; (e) EMV Chip Card and PIN should be issued in lieu of Magstripe cards when at least one purchase is evidenced at an overseas location. The Report was placed on the RBI website for public comments. The recommendations of the Group have been accepted by the Bank and appropriate directions have been issued in September 2011.

infrastructure, and payment and settlement systems. A quarterly report on the Business Continuity Planning (BCP)-DR and Vulnerability Assessment and Penetration Testing (VAPT) exercise conducted by commercial banks at their end was obtained. The major points emerging from these exercises have been included as inputs for analysis in the Financial Stability Report brought out by the Reserve Bank.

IT Vision Document - 2011-17

3.108 A High Level Committee (Chairman: Dr. K. C. Chakrabarty) and members from IIT, IIM, IDRBT, Banks, and the Reserve Bank prepared the "IT Vision Document – 2011-17", for the Reserve Bank and banks, which provides an indicative road map for enhanced usage of IT in the banking sector.

Automated Data Flow (ADF) and New Generation RTGS (NG-RTGS)

3.109 In order to improve the quality and efficiency of regulatory reporting, a project on straight through flow of data (ADF) from banks to the Reserve Bank has been taken up. Banks have been advised to submit a roadmap indicating returns which can be sourced directly from their systems to a centralised repository for submission to the Reserve Bank. The project is expected to be completed by December 2012.

3.110 As indicated in the Annual Monetary Policy Statement for 2010-11, a Working Group comprising representatives from the Reserve Bank and select commercial banks was constituted for preparing an approach for implementation of next generation RTGS. The Group submitted its report in August 2010, which has since been accepted. The Group has suggested several new features in the new generation RTGS (NG-RTGS), such as advanced liquidity management facility, extensible mark-up language-based messaging system and real time information and transaction monitoring. The implementation of the Group's recommendations has been initiated and the NG-RTGS project is expected to be implemented by December 2012.

14. Banking Sector Legislation

3.111 A number of important legislative changes have either been initiated or effected during the year, which pave way for re-examination of banking laws, creation of the inter-regulatory mechanism in the form of Financial Stability and Development Council (FSDC) and strengthening of Reserve Bank's powers with respect to commercial banks.

Constitution of the Financial Sector Legislative Reforms Commission (FSLRC)

3.112 The FSLRC has been constituted under the Chairmanship of Justice B.N. Srikrishna by the Central Government in March 2011, with a view to rewriting, streamlining and harmonising financial sector laws, rules and regulations with the requirements of India's growing financial sector. The Terms of Reference of the Commission *inter alia* include the following: (i) examining the architecture of the legislative and regulatory system governing the Indian financial sector; (ii) examining if public feedback for draft subordinate legislation should be made mandatory, with exception for emergency measures and; (iii) examining the most appropriate means of oversight over regulators and their autonomy from the Government.

The Securities and Insurance Laws (Amendment and Validation) Act, 2010

3.113 The Act, effective from June 18, 2010, has amended the Reserve Bank of India Act, 1934, the Insurance Act, 1938, the Securities Contracts (Regulation) Act, 1956 and the Securities and Exchange Board of India Act, 1992. As noted in the RBI Annual Report 2010-11, a new chapter on "Joint Mechanism" has been inserted in the Reserve Bank of India Act, 1934. The Chapter provides for a Joint Mechanism, consisting of Union Finance Minister as its *ex-officio* Chairperson, Governor,

Reserve Bank, as its *ex-officio* Vice-Chairman, Finance Secretary and Chairpersons of SEBI, IRDA and Pension Fund Regulatory and Development Authority (PFRDA), as its members to resolve any difference of opinion among the regulators. The Act provides for a reference being made to the Joint Committee only by the regulators and not by the Central Government. The decision of the Joint Committee would be binding on the Reserve Bank, SEBI, IRDA and PFRDA.

The Banking Laws (Amendment) Bill, 2011

3.114 The Bill, introduced in Lok Sabha in March 2011, seeks to amend the Banking Regulation Act, 1949, the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 and the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980 to make the regulatory powers of the Reserve Bank more effective and to increase the access of the nationalised banks to capital market to raise capital required for expansion of banking business. The Bill seeks to *inter alia*: (i) enable the nationalised banks to increase or decrease the authorised capital with approval from the Central Government and the Reserve Bank without being limited by the ceiling of ₹3,000 crore; (ii) make provisions to ensure that control of banking companies is in the hands of 'fit and proper' persons; (iii) allow nationalised banks to issue two additional instruments (bonus shares and rights issue) for accessing the capital market to raise capital required for expansion of banking business; (iv) substantially increase the penalties and fine for some violations of the Banking Regulation Act, 1949; and (v) confer power upon the Reserve Bank to levy penal interest in case of non-maintenance of required cash reserve ratio.

15. Conclusions

3.115 This chapter discussed the major developments in the area of banking sector policy in 2010-11 and 2011-12, so far. These policy developments have been broadly in-sync with the major policy objectives of maintaining price stability, while supporting economic recovery, financial stability, financial inclusion and financial sector development.

3.116 During the year, the Reserve Bank took important policy decisions with regard to forming draft guidelines about granting new licenses to private sector banks and release of two major discussion papers regarding the presence of foreign banks and promoting holding company structure for banks. Each of these initiatives was aimed at financial sector development, while keeping in view the concern of financial stability. In the field of financial inclusion, the most noteworthy development was the formation of Board-approved Financial Inclusion Plans by banks for a time horizon of next three years. The other salient policy developments, which would pave way towards further reforms in the banking sector, included changes in major banking sector statutes including the Banking Regulation Act, 1949 and constitution of the Financial Sector Legislative Reforms Commission.

3.117 With a view to improving the use of technology and customer services in the banking sector, the Reserve Bank undertook a variety of measures during the year, including the initiation of new generation RTGS and constitution of a committee to analyse expectations of customers from banks. Another salient policy development that would impact financial sector development in a major way in the years to come, with specific relevance for banks - as market makers and users - was the introduction of CDS for corporate bonds. Finally, for both RRBs and UCBs, a number of regulatory and developmental measures towards strengthening the health and physical outreach of these institutions were taken during the year.

3.118 During the year, the inflationary pressures, which kept re-surfacing partly as a fallout of external developments and partly on account of domestic structural imbalances,

necessitated continuous monetary policy responses. However, while containing inflation, it was necessary that economic recovery, which had been delicate in the aftermath of the crisis, was also not thwarted. The Reserve Bank dealt with the inflationary pressures with a view of not to sacrifice the long-term growth prospects.

3.119 Going forward, a continued and consistent momentum of the banking sector policy, with focused attention on financial stability and financial inclusion, would ensure a healthier and more inclusive banking sector, which can contribute towards sustained and inclusive growth of the Indian economy.