Policy Developments in Commercial Banking

Chapter II

1. Introduction

2.1 Financial intermediaries are going through significant changes all over the world under the impact of deregulation, technological upgradation and financial innovations. Indeed, the traditional face of banking is no longer as it was even a few years ago. The way financial services are provided are changing dramatically. In many countries, banks are now providing services that do not come under the domain of traditional banking. The old institutional demarcations are getting increasingly blurred. Consequently, increased competition from non-bank intermediaries has led to a decline in traditional banking wherein banks only accepted deposits and made advances that stayed on their books till maturity. The business of banking has been moving rapidly in recent years to a 'one-stop shop' of varied financial services. This process of transformation is particularly striking in emerging market economies like India.
2.2 Recent international financial developments have also brought into sharp focus the importance of regulation and supervision of the financial system. In India, financial sector reforms have sought to strengthen the regulatory and supervisory framework and to bring them at par with the international best practices with suitable country-specific adaptations. This has been the guiding principle in the approach to the New Basel Accord. During 2002-03, improvements in management of risk and non-performing assets (NPAs) were sought to be achieved through the issuance of comprehensive guidelines on credit, market, country and operational risks to banks, and through the implementation of several regulatory changes. The changes in supervision included progress towards risk-based and consolidated supervision. Steps were also taken to improve credit delivery and to strengthen the technological and legal infrastructure.

2.3 In the context of the changing contours of banking, the present Chapter provides an overview of the policy initiatives in the Indian commercial banking sector during 2002-03 as well as 2003-04, so far. The overall thrust of monetary and credit policy and changes in its instruments and variables in terms of interest rates, refinance facilities and statutory preemptions are presented first. This is followed by developments in supervision and supervisory policy. In the context of ensuring a stable and sound banking system, policy developments regarding risk management and management of non-performing assets are discussed next. This is followed by a brief delineation of the evolving consultative approach to policy formulation. A discussion on steps for improvement in credit delivery, changes in money and Government securities markets and technological and legal infrastructure are presented in the subsequent sections. Actions taken on recommendations of the Joint Parliamentary Committee (JPC) on Stock Market Scam and Matters Relating Thereto are presented at the end of the Chapter.

2. Monetary and Credit Policy

2.4 A vibrant, resilient and competitive financial sector is vital for a growing economy. The Reserve Bank's endeavour has been to enhance the allocative efficiency of the financial sector and to preserve financial stability. Consequently, the Monetary and Credit Policy statements of the Reserve Bank have been focusing on the structural and regulatory measures to strengthen the financial system. The monetary policy framework has evolved over the recent period in response to the reforms in the financial sector. The reform measures have been guided by the objectives of increasing operational efficacy of monetary policy, redefining the regulatory role of the Reserve Bank, strengthening prudential norms, improving credit delivery systems, and developing technological and institutional infrastructure. In order to achieve the above objectives, the Reserve Bank has been adopting a policy of extensive consultations with experts and market participants before introducing policy measures while allowing sufficient lead time for better preparedness.

2.5 The monetary policy stance in recent years has underlined the Reserve Bank's commitment to maintain adequate liquidity in the market with a preference for soft interest rates**,** in order to revive economic growth while keeping a vigil on the price level. The monetary and credit policy for 2002-03 was set against the backdrop of easy liquidity conditions fostered by strong capital flows and weak credit off-take. Under the circumstances, the Reserve Bank proposed to continue its policy of active demand management of liquidity in order to maintain the current interest rate environment with a bias towards a soft interest rate regime in the medium-term. The overall stance of monetary policy for 2002-03 consisted of:

- Provision of adequate liquidity to meet credit growth and support investment demand in the economy while continuing a vigil on movements in the price level;
- In line with the above, continuation of the present stance on interest rates including preference for soft interest rates; and
- Imparting greater flexibility to the interest rate structure in the medium-term.

2.6 The monetary and credit policy of 2003-04 has proposed to continue with the broad policy stance of the previous year.

Interest Rate Structure

Bank Rate and Repo Rate

2.7 The monetary policy stance of preference for a soft and flexible interest rate regime for generating growth impulses was supported by the Reserve Bank's money market operations that combined judiciously open market operations and the Liquidity Adjustment Facility (LAF). The cut in the Bank Rate from 6.5 per cent to 6.25 per cent effective October 30, 2002 had a sobering impact on the structure of interest rates. The Bank Rate was further reduced by 25 basis points to 6.0 per cent on April 29, 2003. Moreover, in terms of short-term signalling, the one-day and 14 day repo rates were reduced from 6.0 per cent to 5.75 per cent effective June 27, 2002 and further to 5.5 per cent and 5.0 per cent effective October 30, 2002 and March 4, 2003, respectively. In view of the macroeconomic and overall monetary conditions, one-day repo rate was reduced further on August 25, 2003 to 4.5 per cent.

Interest Rates on Deposits

2.8 The interest rates on domestic and ordinary non-resident savings deposits as well as the Non-resident (External) Savings Accounts Scheme were reduced from 4.0 per cent to 3.5 per cent per annum effective March 1, 2003. The interest rate on deposits in Account 'A' under the Capital

Gain Account Scheme, 1988 introduced by the Government of India, was also revised downwards from 4.0 per cent to 3.5 per cent per annum with effect from March 1, 2003.

NRI Deposit Scheme

2.9 As announced in the Monetary and Credit Policy for 2003-04, it was decided that, with a view to providing uniformity in the maturity structure for all types of repatriable deposits, the maturity period of fresh non-resident external (NRE) deposits will normally be one year to three years, with immediate effect. If a bank wishes to accept deposits with a maturity of more than three years, it may do so provided the interest rate on such long-term deposits is not higher than that applicable to three-year NRE deposits. In order to bring consistency in interest rates offered to non-resident Indians, the interest rates on NRE deposits for one to three years contracted effective July 17, 2003 were limited to not exceeding 250 basis points above the LIBOR / SWAP rates for US dollar of corresponding maturity. The ceiling rate was later reduced on September 15, 2003 to 100 basis points and further, on October 18, 2003, to 25 basis points above the corresponding US dollar LIBOR / SWAP rates.

Interest Rates on Advances

2.10 In supersession of the earlier instructions on the system of charging interest on loans and advances at monthly rests, the banks have been advised the following:

- banks have the option to compound interest at monthly rests effective either from April 1, 2002, or July 1, 2002 or April 1, 2003;
- with effect from quarter beginning July 1, 2002, banks should ensure that the effective rate does not go up merely on account of the switchover to the system of charging / compounding interest at monthly rests and increase the burden on the borrowers; interest at monthly rests shall be applied to all running accounts (*e.g.*, cash credit, overdraft, export packing credit), all new and existing term loans and other loans of longer / fixed tenor but not to agricultural advances; and
- banks may obtain consent letters / supplemental agreements from the borrowers for the purpose of documentation.

Lending Rates (Non-Export Credit)

2.11 A soft and flexible interest rate regime has generally meant lower deposit rates. With the decline in the cost of funds to the banking sector, the Prime Lending Rates (PLRs) of commercial banks have also declined. The decline in PLRs, however, was somewhat muted given the structural rigidities, such as, high non-interest operating expenses and cost of servicing non-performing loans. Furthermore, banks have mobilised a large proportion of their deposits at relatively high fixed rates, which also limited the downward shift in the PLRs. In order to impel banks to reduce their lending rates, the Reserve Bank has encouraged them to improve manpower productivity and reduce establishment costs. Banks have also been advised on the need to reduce spreads over PLR. Nevertheless, as banks have been permitted to lend to exporters and their prime customers at sub-PLR rates effective April 19, 2001, the cost of bank borrowings to such corporates has been coming down even further.

2.12 In order to reduce information asymmetries, as proposed in the Monetary and Credit policy for 2002-03, the Reserve Bank is presently disseminating the bank-wise information on lending rate after consultation with select banks on its website.

2.13 In the annual policy Statement of April 2003, banks were advised to announce a benchmark PLR with the approval of their Boards, taking into consideration: (i) actual cost of funds, (ii) operating expenses and (iii) a minimum margin to cover regulatory requirements of provisioning and capital charge, and profit margin. It was also indicated that the system of determination of benchmark PLR by banks and the actual prevailing spreads around the benchmark PLR would be reviewed in September 2003. Accordingly, the issues relating to the implementation of the system of benchmark PLR were discussed with select banks and the Indian Banks Association (IBA). The IBA has made the following suggestions: (i) permitting separate PLRs for working capital and term loans, (ii) continuation of the practice of multiple PLRs, (iii) flexibility in offering fixed or floating rate loans based on time-varying term premia and market benchmarks, (iv) flexibility in pricing of consumer loans, and (v) accounting for transaction costs for different types of loans.

2.14 In the Mid-term Review of Monetary and Credit Policy for 2003-04, it was clarified that since lending rates for working capital and term loans can be determined with reference to the benchmark PLR by taking into account term premia and/or risk premia, a need for multiple PLRs may not be compelling. It is also clarified that banks have the freedom to price their loan products based on time-varying term premia and relevant transaction costs. Banks may price floating rate products by using market benchmarks in a transparent manner. As IBA has indicated broad agreement with the approach proposed for the benchmark PLR, IBA may advise its members suitably, keeping in view the operational requirements.

Interest Rate on Export Credit

2.15 The Monetary and Credit Policy for 2002-03 also indicated that linking domestic interest rates on export credit to PLR has become redundant under the present circumstances as effective interest rates on export credit in Rupee terms were substantially lower than the PLR. Therefore, in order to encourage competition among banks and also to increase flow of credit to the export sector, the Reserve Bank liberalised the interest rates on local currency export credit effective May 1, 2003 for pre-shipment credit above 180 days and post-shipment credit above 90 days.

Refinance

Export Credit Refinance facility

2.16 With effect from April 1, 2002, scheduled commercial banks (SCBs) are provided export credit refinance to the extent of 15.0 per cent of the outstanding export credit eligible for refinance as at the end of the second preceding fortnight.

2.17 After deregulation of interest rates on post-shipment rupee export credit beyond 90 days and up to 180 days with effect from May 1, 2003, it was decided, in response to suggestions received from the exporting community, that the refinance facility would continue to be extended to eligible export credit remaining outstanding under post-shipment rupee credit beyond 90 days and up to 180 days.

Collateralised Lending Facility - Withdrawal

2.18 The liquidity support under the Collateralised Lending Facility (CLF) was provided to SCBs against the collateral of excess holdings of Government of India dated securities/Treasury bills over their SLR requirement. The extent of liquidity support available to each bank under the CLF was stipulated at 0.25 per cent of its fortnightly average outstanding aggregate deposits in 1997-98. However, subsequent to reduction in refinance limits under CLF by 50 per cent in two stages of 25 per cent each effective July 29, 2000 and August 12, 2000 the limit was reduced to 0.125 per cent of aggregate deposits of each bank in 1997-98. With the emergence of Liquidity Adjustment Facility (LAF) as the primary instrument for modulating systemic liquidity on a day-to-day basis, limits under CLF were reduced by another 50 per cent effective July 27, 2002 before it was completely withdrawn from October 5, 2002.

Statutory Pre-emptions

Cash Reserve Ratio (CRR)

2.19 There has been a distinct shift in the monetary policy framework and operating procedures from direct instruments of monetary control to market-based indirect instruments in the recent years. The rationalisation of CRR and its maintenance facilitated reducing reliance on reserve requirements, even while retaining it as a monetary tool. The CRR of SCBs that was at 15.0 per cent of Net Demand and Time Liabilities (NDTL) between July 1, 1989 and October 8, 1992 was brought down in phases to 4.5 per cent on June 14, 2003. While the CRR reduction over the last few years has been consistent with the objective of reducing it to the statutory minimum level of 3.0 per cent, the Reserve Bank could continue to use the instrument, in either directions, for liquidity management, taking into account the liquidity conditions, inflation trends and other macroeconomic developments. For example, the reserve requirements were increased temporarily in 1997 to combat pressures arising from contagion from East Asian financial crisis. However, as part of the medium-term objective of reducing CRR to its statutory minimum and also to step up lendable resources of the banks to support real activity, the CRR was reduced by as much as 400 basis points over last three years, with a reduction of 25 basis points since June 2003.

Statutory Liquidity Ratio (SLR)

2.20 While there was no change in SLR requirements during 2002-03 for SCBs in general, policy changes were effected in respect of composition of SLR assets of RRBs in 2002-03 on prudential considerations. The RRBs' balances maintained in call money or fixed deposits with their sponsor banks were earlier treated as 'cash' and hence reckoned towards their maintenance of SLR. As a prudential measure, RRBs were advised in April 2002 to maintain their entire SLR holdings in Government and other approved securities. Specifically, RRBs were advised to convert their existing deposits with sponsor banks into Government securities by March 31, 2003. A number of RRBs have already achieved the minimum level of SLR in Government securities. Some RRBs and their sponsor banks, however, expressed difficulties relating to premature withdrawal of deposits reckoned for SLR purposes and those were allowed to retain such deposits till maturity. RRBs were advised to achieve the target of maintaining 25 per cent SLR in Government securities and, on maturity, their deposits with sponsor banks may be converted into Government securities to be reckoned for SLR purposes.

Mid-Term Review of Monetary and Credit Policy for 2003-04

2.21 The Mid-term Review of Monetary and Credit Policy for 2003-04, announced on November 3, 2003 reviewed the recent monetary and macro developments in the Indian economy with expectations of higher GDP growth during 2003-04 (placed at 6.5 - 7.0 per cent, with an upward bias) and benign inflation outlook (4.0-4.5 per cent, with a downward bias). It was proposed to continue with the overall stance of monetary policy announced in April 2003 in terms of provision of adequate liquidity to meet credit growth and supporting investment demand with a vigil on the price level and a preference for soft and flexible interest rate environment. The Mid-term Review emphasised continuance of measures already taken with an accent on implementation, facilitating ease of transactions by the common persons, further broadening of the consultative process and continued emphasis on institutional capacity to support growth consistent with stability in a medium-term perspective (Box. II.1).

3. Supervision and Supervisory Policy[1] Supervision

Board for Financial Supervision

2.22 The Board for Financial Supervision (BFS), set up in November 1994 under the Reserve Bank of India (Board for Financial Supervision) Regulations, is entrusted with the supervision of commercial banks, select financial institutions (FIs) and non-banking financial companies (NBFCs). During the period from July 2002 to June 2003, the BFS reviewed the performance of banks, FIs and local area banks with reference to their position as on March 31, September 30 and December 31, 2002.

2.23 The BFS reviewed the monitoring by the Reserve Bank with regard to bank frauds and house-keeping in public sector banks (PSBs) including reconciliation of entries in inter-branch accounts, inter-bank accounts (including *nostro* accounts) and balancing of the books of accounts. Since it was perceived that a major reason behind bank frauds is non-observance of the laid down rules and procedures, based on the Report of the Expert Committee on Legal Aspects of Bank Frauds (Chairman: Dr. N.L. Mitra), all banks were advised to ensure that each and every desk in the branches certify that there was no laxity in implementing the laid down systems and procedures. Similarly, in the area of reconciliation of entries in inter-branch and inter-bank as well as balancing of books of account, considerable improvement has been ensured through constant monitoring by the Reserve Bank and continuous review by the BFS. The BFS also reviewed the monitoring of select all-India FIs and NBFCs over which the Reserve Bank has regulatory jurisdiction. Besides delineating the course of action to be pursued in respect of institution-specific supervisory concerns, the BFS provided guidance on several regulatory and supervisory policy issues. In addition, the BFS reviewed the status of supervision of urban co-operative banks. Considering the poor inherent financial strength of existing local area banks (LABs), the policy for licensing of LABs was revised.

2.24 A supervisory rating model for the FIs was approved and introduced from the inspection of 2002-03. The report on the weak / problem NBFCs with public deposits of Rs.20 crore and above is being reviewed by the BFS on a quarterly basis. However, with a view to protecting the interest of depositors in medium-sized companies as well, weak and problematic NBFCs, with public deposits of Rs.10 crore and above, have been brought within the purview of quarterly review of the BFS.

Annual Financial Inspections

2.25 For the year 2002-03, Annual Financial Inspections of 92 banks (26 PSBs, 30 private sector banks and 36 Foreign banks), 14 Local Head Offices of SBI and 4 LABs have been completed under Section 35 of Banking Regulation Act, 1949. Nine all-India FIs were inspected under Section 45 N of the Reserve Bank of India Act, 1934. Inspection of 4 foreign banks, closing their operations in India, was carried out under Section 44 of the Banking Regulation Act, 1949.

Box II.1: Major Policy Measures Announced in the Mid-term Review of Monetary and Credit Policy for the year 2003-04

1. Monetary Measures: Bank Rate was kept unchanged at 6.0 per cent, prevailing since April 29, 2003. Cash Reserve Ratio (CRR) was kept unaltered at 4.50 per cent, prevailing effective fortnight beginning June 14, 2003, in view of the existing liquidity situation.

2. Interest Rate Policy: It was clarified that since lending rates for working capital and term loans can be determined with reference to the benchmark PLR, by factoring in term premia and / or risk premia, a need for multiple PLRs may not be compelling. Banks were free to price their loan products based on time-varying term premia and relevant transaction costs. Freedom has also been given for pricing loan products on the basis of market benchmark in a transparent manner. Indian Banks' Association is to advise banks on the benchmark PLR keeping in view the operational requirement.

3. Credit Delivery Mechanism

- *Credit Facilities for Small Scale Industries:* In order to improve the flow of credit to small scale industries (SSIs), it was proposed that banks may, on the basis of good track record and the financial position of the SSI units, increase the loan limit from Rs.15 lakh to Rs.25 lakh (with the approval of their Boards) for dispensation of collateral requirement. It was further proposed that (i) the interest rate on the deposits of foreign banks placed with SIDBI towards their priority sector shortfall will be at the Bank Rate, (ii) SIDBI will take appropriate steps to ensure that priority sector funds are utilised expeditiously and benefits of reduction in interest rates are passed on to the borrowers. Finally, it was proposed that all new loans granted by banks to NBFCs for the purpose of on-lending to SSI sector would also be reckoned for priority sector lending.
- *Micro-finance:* Considering the recommendations of the four informal groups constituted to examine issues concerning micro-finance delivery, it was proposed that banks should provide adequate incentives to their branches in financing the self help groups (SHGs) and establish linkage with them. The approach to micro-finance to SHGs should be totally hassle-free and

may include consumption expenditures to enable smoothing of consumptions as needed relative to time-profile of income flows.

4. Money Market

- *Moving towards Pure Inter-bank Call/Notice Money Market:* In view of further market developments as also to move towards a pure inter-bank call/notice money market, it was proposed that with effect from the fortnight beginning December 27, 2003, non-bank participants would be allowed to lend, on average in a reporting fortnight, up to 60 per cent of their average daily lending in the call/notice money market during 2000-01, down from 75 per cent announced in April 2003.
- *Rationalisation of Standing Facilities:* In order to move further towards phasing out sector-specific standing facilities as also to rationalise the rates at which liquidity is injected into the system, it was proposed that the "normal" and "back-stop" standing facilities will be available in the ratio of one-third to two-thirds (33:67) from the fortnight beginning December 27, 2003 as against the prevailing ratio of 50:50.

- Primary Dealers' Access to Call/Notice Money Market:
  With a view to further develop the repo market as also to ensure a balanced development of various segments of money market, it was proposed that with effect from February 7, 2004, PDs will be allowed to borrow, on average in a reporting fortnight, up to 200 per cent of their net owned funds as at end-March of preceding financial year.

5. Foreign Exchange Market

(a) Unhedged Forex Exposures of Corporates: It was decided that all foreign currency loans by banks above US $ 10 million can be extended to corporates only on the basis of a well laid out policy of the Board to ensure hedging, except for loans to finance exports and for meeting forex expenditure.

(b) Export Follow–up: Beginning January 1, 2004, all exporters may write-off outstanding export due on their own and may also extend the renewal period of realisation beyond 180 days on their own up to 10 per cent of their export proceeds in a calendar year.

(c) Issue of Units of Mutual Fund – General Permission:
In order to provide single window clearance to Indian Asset Management Companies (AMCs) who launch off-shore funds abroad, in consultation with SEBI, it was proposed to accord general permission to AMCs to issue units, remit dividend and redeem the units issued, once SEBI's approval is obtained for launching off-shore funds, subject to reporting requirements.

6. Prudential Measures

(a) Prudential Norms for FIs: To harmonise the asset classification norms of FIs and banks, in line with international norms, it was proposed to adopt the 90-day norm for recognition of loan impairment for FIs from the year ending March 31, 2006.

(b) Monitoring of Systemically Important Financial Intermediaries (SIFIs): In consultation with the Chairman, SEBI and Chairman, IRDA, it was decided to establish a special monitoring system in respect of SIFIs that would encompass (i) a reporting system for SIFIs on financial matters of common interest to the Reserve Bank, SEBI and IRDA; (ii) the reporting of intra-

group transactions of SIFIs; and (iii) the exchange of relevant information among the Reserve Bank, SEBI and IRDA.

(c) Corporate Governance: It was proposed to harmonise the approaches suggested by the Ganguly Committee and the SEBI Committee in regard to corporate governance by banks, and to extend such practices to PDs, NBFCs and other financial institutions.

Frauds

2.26 The notable features in respect of frauds during 2002-03 were the following:

- During July-December 2002, commercial banks reported 1,597 cases of frauds involving Rs.267 crore; during July-June 2001-02, 2,253 cases of frauds involving Rs.414 crore were reported by commercial banks.
- During July-March 2002-03, 69 caution advices were issued to commercial banks (except RRBs) in respect of firms / companies committing serious irregularities in their borrowal accounts; during July-June 2001-02, 81 caution advices were issued for alerting commercial banks (except RRBs) against fraudulent operations of certain unscrupulous elements.
- During July-December 2002, 40 cases of robberies / dacoities involving Rs.280 crore were reported by PSBs; during July-June 2001-02, 118 cases involving Rs.596 crore of robberies / dacoities were reported.

Computerisation of Fraud-related Information System

2.27 A module on fraud monitoring and reporting system was developed by the Reserve Bank and forwarded to banks. From the quarter ending June 2003, banks are required to submit a number of frauds and vigilance returns through this module to the Reserve Bank.

Committees related to Banking Supervision

Guidelines on Consolidated Accounting and Supervision of Banks and FIs

2.28 In view of the sharper focus on empowering supervisors to undertake consolidated supervision of bank groups and since the Core Principles for Effective Banking Supervision have underscored this requirement as an independent principle, the Reserve Bank set up a multi-disciplinary Working Group in November 2000 (Chairman: Shri Vipin Malik). The Working Group examined the feasibility of introducing consolidated accounting and other quantitative methods to facilitate consolidated supervision. Based on the recommendations of this Working Group, guidelines were issued to banks on February 25, 2003 and FIs on August 1, 2003.

2.29 Initially, consolidated supervision has been mandated for all groups where the controlling entity is a bank. All banks that come under the purview of consolidated supervision of the Reserve Bank have been advised to prepare and disclose Consolidated Financial Statements (CFS) from the financial year commencing from April 1, 2002, in addition to their single financial statements. The CFS are to be prepared in accordance with the Accounting Standard 21 (related to CFS) and other related Accounting Standards prescribed by the Institute of Chartered Accountants of India (ICAI), *viz.,* Accounting Standards 23 (relating to Investments in

Associates in CFS) and 27 (financial reporting of investment in joint ventures). In addition, banks are presently required to prepare Consolidated Prudential Reports (CPR). These reports have been initially introduced on a half-yearly basis from March 31, 2003 as part of the off-site reporting system on the lines of the existing off-site returns for banks. The banks are expected to prepare the CPR adopting the same principles as laid down in Accounting Standards 21, 23 and 27. However, since there is a possibility of including mixed conglomerates in due course, to start with, CPR is expected to contain information and accounts of related entities which carry on activities of banking or financial nature and need not include related entities engaged in insurance or business not pertaining to financial services.

2.30 For the purpose of application of prudential norms on a group-wide basis, the prudential norms / limits, such as, capital to risk-weighted asset ratio (CRAR), single / group borrower exposure limits, liquidity ratios, mismatches limits and capital market exposure limits have also been prescribed for compliance by the consolidated bank.

Working Group Relating to Empanelment of Statutory Auditors

2.31 The Working Group constituted to review and suggest modifications in the existing norms for empanelment of audit firms to be appointed as statutory auditors of PSBs, seven all-India FIs and the Reserve Bank submitted its report on March 12, 2003. The recommendations of the Group were approved with certain modifications by the Audit Sub-Committee of the BFS in its meeting held on April 25, 2003. The revised norms and other recommendations will be implemented with effect from the year 2004-05. The major recommendations of the Working Group for eligible audit firms are:

- minimum seven full-time chartered accountants with the firm (as against six) of which five should be full-time partners, each with a minimum continuous association of 15,10, 5, 5 and 1 year, respectively, with the firm;
- a professional staff of 18 (as against 15 in the existing norms); a minimum standing of 15 years (as against 10 years in the existing norms);
- a minimum statutory bank / branch audit experience of 15 years (as against 8 years in the existing norms); and
- at least one partner or paid chartered accountant with Certified Information Systems Auditor (CISA) / ISA or any other equivalent qualification.

Checklist for Computer Audit

2.32 An assessment of the system of computer audit in banks was made based on the findings of the inspection reports of banks for the years 1998-99 and 1999-2000. In this context, the following specific feedback received from banks was taken into account, *viz*., nature of the Information Technology (IT) management function, IT risk management, electronic data processing (EDP) audit systems, EDP audit methodology, and other related matters. It was evident from the assessment that the computer audit in India was still in a nascent stage and a major constraint encountered by banks has been the general shortage of skilled technical personnel for the task. The findings of the assessment were considered by the Audit SubCommittee of the BFS, which directed the constitution of a committee to examine the aspects related to computer audit in detail. It was also decided to draw up a checklist in a standardised form so that all banks operating in the country can ensure that their computerised branches put in place requisite controls in the computerised environment and that the branch auditors also verify the same and incorporate their observation in the report. Accordingly, a committee was constituted comprising representatives of the Reserve Bank, ICAI and a few select banks. The Committee recommended that the internal security audit checklist needed to be platform independent, while the necessary platform dependent control questionnaire could be framed by the banks themselves. The Committee classified the risk areas into 15 categories and prepared checklists in respect of each of the areas[2] . It is expected that these checklists would serve as a minimum standard in conducting computer audit in banks and FIs.

2.33 The main purpose for preparing checklists for conducting computer audit was to sensitise banks on the emerging concerns arising on account of computerisation and growing dependence on computers and technology for conducting business. The checklists, as approved by the Audit Sub-Committee of the BFS, were forwarded to banks and FIs in December 2002.

Supervisory Policy Developments

Quarterly Review

2.34 Currently, only half-yearly results of listed companies are subjected to limited review by the auditors. The Securities and Exchange Board of India (SEBI) made an amendment in January 2003 to clause 41 (related to half-yearly limited review of listed companies) of the Listing Agreement to make it mandatory for all listed companies (including commercial banks) to get their quarterly results subjected to “limited review” by the auditors of the company (or by a Chartered Accountant in case of public sector undertakings) and a copy of the Review Report is required to be submitted to the Stock Exchanges. It has been decided by the Audit

Sub-Committee of the BFS that such quarterly review should be carried out by the listed public sector banks also, on the same lines of half-yearly limited review, with effect from the quarter ended June 30, 2003.

Prompt Corrective Action

2.35 A system of Prompt Corrective Action (PCA), based on a pre-determined rule-based structured early intervention, has been put in place with effect from December 2002 as a part of ongoing efforts to enhance the existing supervisory framework. The Reserve Bank will initiate certain structured action in respect of banks which will hit trigger points in terms of three parameters, *viz*., (a) CRAR, (b) ratio of net NPAs to net advances, and (c) return on assets. It was decided that PCA scheme may be put into operation, initially for a period of one year from December 2002. The scheme was circulated among banks on December 21, 2002, advising them to take steps to ensure that they do not come under the provisions of PCA. Banks were also advised to place the scheme before their Board of Directors. It was also decided that the banks, which have already breached the trigger points under the PCA scheme, will be advised of the specific actions to be taken by them separately. Such banks were also cautioned of the impending actions. A review of the scheme is envisaged in December 2003.

Risk-Based Supervision

2.36 After having put in place the essential aspects of risk-based supervision (RBS) during 2001-02, the implementation of the RBS approach was taken up in phases during 2002-03. For ensuring a smooth transition to risk-based supervision of banks, the new RBS Manual has been prepared keeping in view international best practices customised to suit the Indian conditions. For compiling risk profiles of banks, the detailed risk profile template was designed for use by the Reserve Bank supervisory staff. Similar templates were designed for use of banks and forwarded to them for self-assessment of risks taken by them. In order to create greater awareness among bank professionals, training programmes on risk management and risk-based supervision are being conducted in the Reserve Bank training establishments on an ongoing basis since June 2002.

2.37 A Discussion Paper was issued in August 2001 to familiarise banks with the RBS approach. The paper also identified five areas of action for the commercial banks, *viz.*, (a) putting in place appropriate risk management architecture, (b) setting up of risk-based internal audit function, (c) upgrading management information and information technology systems, (d) undertaking human resource initiatives, and (e) setting up of dedicated compliance units necessary for adoption of the RBS approach. As part of the consultative process, high-level meetings were held with banks to identify issues on which they required further guidance / assistance from the Reserve Bank in the process of transition. Guidance notes on credit risk management, market risk management and risk based internal audit were issued to banks. Banks were advised to put in place an institutional mechanism to monitor the progress in preparedness for RBS, which is being reviewed by the Reserve Bank through periodic returns received from them and also by holding periodic meetings with them.

2.38 Eight banks, representing a mix of banks in the public sector, private sector and foreign banks have been identified for the implementation of RBS on a pilot basis. The compilation of risk profiles of the selected banks has commenced at Regional Offices of the Reserve Bank. Based on individual risk profiles, customised supervisory programme, together with bank-level action, will be prepared for each of the select banks. The customised programme will include the identified supervisory cycle for the bank, the intensity of supervision to be exercised and the mix of supervisory tools, including the RBS on-site inspection, to be applied for addressing the concerns identified in the risk profile.

2.39 The pilot RBS inspections of the select banks will be taken up independently after the annual financial inspections of these banks are completed under the present inspection system based on Capital Adequacy, Asset Quality, Management, Earnings, Liquidity and Systems (CAMELS) for the domestic banks, and an inspection system based on Capital Adequacy, Asset Quality, Liquidity, Compliance and Systems (CALCS) for the foreign banks. Under RBS, on-site inspections will be targeted to the areas of concern, which warrant on-location examination as revealed from the risk profile. On the basis of the experience gained in the pilot exercise the approach to RBS will be further fine-tuned and is likely to be extended to all banks in due course.

Changes in the Off-Site Monitoring and Surveillance System

2.40 After the introduction of Off-Site Monitoring and Surveillance (OSMOS) system in 1995, the scope and coverage of the off-site returns have been enhanced significantly. In view of the recent initiatives on consolidated supervision, country risk management and risk-based supervision, certain additional data needed to be collected through off-site returns. Accordingly, an upgraded OSMOS system, including new returns as well as enhancing the coverage of the existing ones, has been implemented from the quarter ended June 2003.

Supervisory Rating of Banks

2.41 Keeping in view the importance of monitoring and prevention of frauds, it was decided that compliance in this area should carry more weight while rating the banks. Accordingly, some changes were made in the system of rating banks under CAMELS / CALCS models wherein compliance regarding fraud monitoring and prevention would carry more weight.

Risk Based Internal Audit

2.42 The guidelines relating to risk-based internal audit systems were issued to banks in December 2002 wherein they were advised to immediately initiate necessary steps to review their current internal audit systems and prepare for the transition to a risk-based internal audit system in a phased manner, keeping in view their risk management practices, business requirements and manpower availability.

Prudential Norms

(a) Exposure Norms

Measurement of Credit Exposure on Derivative Products

2.43 Credit exposures on derivative products have important ramifications for banks. Consequently, it is crucial that these are measured appropriately. As per the instructions, prior to March 31, 2003, exposures by way of non-funded credit limits were captured at 50 per cent of such limits or outstandings, whichever is higher. Besides, the exposure of banks on derivative products, such as, Forward Rate Agreements (FRAs) and Interest Rate Swaps (IRS) was captured for computing exposure by applying the conversion factors to notional principal amounts as per the original exposure method. With effect from April 1, 2003, in addition to reckoning non-fund based limits at 100 per cent, banks have been advised to include forward contracts in foreign exchange and other derivative products at their replacement cost value in determining individual / group borrower exposure. As per the paper of the Basel Committee on Banking Supervision on International Convergence of Capital Measurement and Capital Standards, 1988, there are two methods to assess the exposure on account of credit risk in derivative products, *viz.*, (i) Original Exposure Method, and (ii) Current Exposure Method (Box II.2). Banks and FIs have been encouraged to follow the Current Exposure Method, which is more accurate in measuring credit exposure of a derivative product. In case a bank is not in a position to adopt the Current Exposure Method, it may follow the Original Exposure Method. However, banks have been advised that their endeavour should be to move over to the Current Exposure Method in course of time. Banks have been advised to adopt, effective from April 1, 2003, either of the above two methods, consistently for all derivative products, in determining individual / group borrower exposure. Banks would not be required to calculate potential credit exposure for single currency floating/floating interest rate swaps. The credit exposure on single currency floating / floating interest rate swaps are to be evaluated solely on the basis of their mark-to-market value.

Box II.2 : Measurement of Credit Risk Exposure of Derivative Products

There are two methods for measuring the credit risk exposure inherent in derivatives, as described below.

1. *The Original Exposure Method*

Under this method, the credit risk exposure of a derivative product is calculated at the beginning of the derivative transaction by multiplying the notional principal amount with the prescribed credit conversion factor. This method, however, does not take account of the ongoing market value of a derivative contract, which may vary over time. In order to arrive at the credit equivalent amount, a bank should apply the following credit conversion factors to the notional principal amounts of each instrument according to the nature of the instrument and its original maturity:

2. *The Current Exposure Method*

Under this method, the credit risk exposure / credit equivalent amount of the derivative products is computed periodically on the basis of the market value of the product to arrive at its current replacement cost. Thus, the credit equivalent of the off-balance sheet interest rate and exchange rate instruments would be the sum of the following two components:

(a) the total 'replacement cost' - obtained by marking-to-market all the contracts with positive value (*i.e.*, when the bank has to receive money from the counterparty); and

(b) an amount for 'potential future changes in credit exposure' - calculated by multiplying the total notional principal amount of the contract by the following credit conversion factors according to the residual maturity of the contract:

Original Maturity	Conversion Factor to be applied on Notional Maturity Principal Amount (per cent)		Residual Maturity	Conversion Factor to be applied on Notional Maturity Principal Amount (per cent)	
	Interest Rate Contract	Exchange Rate Contract		Interest Rate Contract	Exchange Rate Contract
Less than one year	0.5	2.0	Less than one year	Nil	1.0
One year and less than two years	1.0	5.0 (*i.e.*, 2+3)	One year and over	0.5	5.0
For each additional year	1.0	3.0			

Reference : Basel Committee on Banking Supervision (1988), *International Convergence of Capital Measurement and Capital Standards*, Bank for International Settlements, 2.44 In view of the critical importance of the infrastructure sector and high priority being accorded for development of various infrastructure services, infrastructure financing by banks was reviewed in consultation with Government of India and revised guidelines on financing of infrastructure projects were issued in February 2003. Accordingly, any credit facility in whatever form extended by lenders (*i.e.,*Basel. banks, FIs or NBFCs) to an infrastructure facility as broadly defined in the guidelines would be treated as 'infrastructure lending'. Specifically, a credit facility provided to a borrower company engaged in developing, or operating and maintaining, or developing, operating and maintaining any project in any of the following sectors would qualify as infrastructure facility:

- a road, including toll road, a bridge or a rail system;
- a highway project, including other activities being an integral part of the highway project;
- a port, airport, inland waterway or inland port;
- a water supply project, irrigation project, water treatment system, sanitation and sewerage system or solid waste management system;
- telecommunication services whether basic or cellular, including radio paging, domestic satellite service (*i.e.*, a satellite owned and operated by an Indian company for providing telecommunication service) and network of trunking, broadband network and internet services;
- an industrial park or special economic zone;
- generation or generation and distribution of power;
- transmission or distribution of power by laying a network of new transmission or distribution lines; and
- Any other infrastructure facility of similar nature.

2.45 In terms of the existing guidelines, credit exposure to borrowers belonging to a group may exceed the prudential exposure norm of 40 per cent of the bank's capital funds by an additional 10 per cent (*i.e.*, up to 50 per cent), provided the additional credit exposure is on account of extension of credit to infrastructure projects. In addition to the above, credit exposure to single borrower may exceed the prudential exposure norm of 15 per cent of the bank's capital funds by an additional 5 per cent (*i.e.*, up to 20 per cent) provided the additional credit exposure is on account of infrastructure lending. Banks may assign a concessional risk weight of 50 per cent for capital adequacy purposes on investment in securitised paper pertaining to an infrastructure facility which complies with certain conditions specified in the revised guidelines.

Norms for Foreign Banks

2.46 Effective March 31, 2002, foreign banks were brought on par with Indian banks for the purpose of computing the prudential credit exposure ceiling by broadening the concept of 'capital funds' as regulatory capital (*i.e.*, Tier I and Tier II capital) in India as defined under the capital adequacy standards. Consequent upon the adoption of the revised concept of capital funds, some foreign banks' exposures to individual / group borrowers exceeded the prudential exposure limits. Foreign banks are now not allowed to assume fresh exposure to single / group borrowers beyond the prudential credit exposure limits.

2.47 With a view to smoothening the transition to prudential exposure limits, relaxations were allowed in respect of the following:

- In case of merger / acquisition of different borrowing companies, foreign banks may continue with the excess group exposure till March 31, 2004 if their group exposure exceeds the prudential norm; and
- The existing fund and non-fund based facilities, such as, term loans, investments in bonds / debentures and performance guarantees, *etc*., exceeding the exposure ceilings, may continue till their expiry / maturity.

Underwriting by Merchant Banking Subsidiaries of Commercial Banks

2.48 Banks / subsidiaries were, hitherto, required to ensure that the funded and non-funded commitments, including investments and devolvements emanating from underwriting and other commitments (like stand-by facilities relating to a single legal person or entity) did not exceed 15 per cent of the net owned funds of the bank / subsidiary and the commitments under a single underwriting obligation did not exceed 15 per cent of an issue. These guidelines were reviewed and with a view to providing a level playing field to the merchant banking subsidiaries of banks, it was decided that the existing ceiling on underwriting commitments would not be applicable to them. The merchant banking subsidiaries of banks regulated by the SEBI would, consequently, be governed by the SEBI norms on various aspects of the underwriting exercise taken up by them. The prudential exposure ceiling on underwriting and similar commitments of banks, however, remained unchanged and would continue to be reckoned within the norms prescribed by the Reserve Bank earlier on overall borrower / issue size limits from time to time.

Advances to Self-Help Groups against Group Guarantee

2.49 At present, banks are required to limit their commitment by way of unsecured advances in such a manner that 20 per cent of the banks' outstanding unsecured guarantees together with a total of outstanding unsecured advances do not exceed 15 per cent of their total outstanding advances.

2.50 Banks generally lend to Self-Help Groups (SHGs) against group guarantees without insisting on any security. Considering the high recovery rate in respect of banks' advances to SHGs and that this programme helps the poor, banks were advised in November 2002 that unsecured advances given by them to SHGs against group guarantee would be excluded for the purpose of computation of the prudential norms on unsecured guarantees and advances until further notice. The matter would be reviewed after a year in the light of growth in aggregate unsecured advances, and the recovery performance of advances to SHGs.

(b) Capital Adequacy

Basel II Developments

2.51 The New Basel Capital Accord, popularly known as Basel II, is being operationalised sometime around end-2006. The Accord represents the convergence of research and practice in supervision as it attempts to apply state-of-the-art financial modelling techniques to the prescription of capital adequacy. The Third Consultative Paper (CP 3) of the Basel Committee on Banking Supervision (BCBS) was released in April 2003 for comments by interested parties and national central banks. The Reserve Bank forwarded its comments on CP3 to BCBS in July

2003 (Box II.3).

Box II.3: The Third Consultative Paper (CP3) on the New Basel Capital Accord and Comments of the Reserve Bank

The Basel Committee on Banking Supervision (BCBS) released the Third Consultative Paper (CP3) on the New Basel Capital Accord (Basel II) in July 2003. In view of the aim of BCBS to finalise Basel II by end of 2003 with operationalisation expected by end-2006, CP3 is an important development. The CP3 document is a culmination of the comments received from more than 40 countries on the third Quantitative Impact Study (QIS3) held in October 2002. In response to the comments received from QIS3 technical guidance, the following significant modifications have been proposed in the new Accord:

- Fully secured lending (by mortgages on residential property that is or will be occupied by the borrower) will now receive a 35 per cent risk weighting in the standardised approach instead of the earlier 40 per cent.
- If a bank estimates its own loss given defaults (LGDs), where those estimates are volatile over the economic cycle, LGDs that are appropriate for an economic downturn should be used. A minimum LGD value of 10 per cent is proposed for retail exposures secured by mortgages.
- As an alternative to standard or own estimate haircuts for repo style transactions the method of Value at Risk (VaR) has been confirmed. In this context, the methodology of Backtesting has now been developed.
- Advanced and Foundation Internal Rating-based (IRB) approaches are presently available for high volatility commercial real estate lending. These are similar to the general IRB approaches to corporate lending, except that a separate risk weight function is used.
- A revolving retail exposures risk weight curve has been recalibrated in the light of QIS3 results.
- An alternative standard operational risk approach has been developed.

The basic comments of the Reserve Bank on the CP3 are as follows:

- All banks with cross-border business exceeding 20 to 25 per cent of their total business may be defined as internationally active banks.

- The Basel Committee may consider prescribing a material limit (up to 10 per cent of the total capital) up to which cross-holdings of capital and other regulatory investments could be permitted and any excess investments above the limit would be deducted from total capital.
- Only those Export Credit Agencies (ECAs) would be eligible for use in assigning preferential risk weights which, (a) disclose publicly their risk scores, rating process and procedure, (b) subscribe to the publicly disclosed OECD methodology, and (c) are recognised by national supervisors.
- Risk weighting of banks should be de-linked from the credit rating of sovereigns in which they are incorporated.
- It would be difficult for supervisors to take a view as to whether the External Credit Assessment Institutions (ECAIs) are using unsolicited ratings to put pressure on entities to obtain solicited ratings. Supervisors are neither equipped nor competent to identify such behaviour of rating agencies.

- While internationally active banks in emerging economies may initially be required to follow the Standardised Approach, they may be allowed to use the internal ratings for assigning preferential risk weights on certain types of exposures, after validation of the internal rating systems by national supervisors.
- There is a strong case for revisiting the risk weights assigned to sovereign exposures when the exposures are aggregated as a portfolio which enjoy the benefits of diversification similar to the approach adopted for retail procedures.
- The capital charge for specific risk in the banking and trading books should be consistent to avoid regulatory arbitrages.

References:

Bank for International Settlements (2003), *Third Consultative Paper,* Basel.

Reserve Bank of India (2003), *Comments of the RBI on the Third Consultative Document of the New Basel Capital Accord*, Mumbai.

Investment Fluctuation Reserve

2.52 With a view to building up of adequate reserves to guard against any possible reversal in the interest rate environment in future due to unexpected developments, banks were advised to build up an Investment Fluctuation Reserve (IFR) of a minimum of 5 per cent of the investment held in the Available for Sale (AFS) and Held for Trading (HFT) categories of the investment portfolio within a period of five years commencing from the year ended March 31, 2002. As suggested by banks and to give further relaxation in building IFR, it was decided that while IFR would continue to be treated as Tier II capital, it would not be subject to the ceiling of 1.25 percent of the total risk-weighted assets. However, for the purpose of compliance with the capital adequacy norms, Tier II capital including IFR would be considered up to a maximum of 100 per cent of total Tier I capital. The above treatment would be effective from March 31, 2003 onwards.

(c) Income Recognition / Asset Classification

Projects under Implementation involving Time Overrun

2.53 Banks were advised in May 2002 that the projects under implementation would be grouped under the following three categories for determining the date when the project ought to be completed and the manner in which the asset classification of the underlying loan should be determined:

- Projects where financial closure had been achieved and formally documented may be treated as standard assets for a period not exceeding two years, beyond the date of completion of the project (as originally envisaged at the time of initial financial closure of the project).
- Projects sanctioned before 1997, with an original project cost of Rs.100 crore or more, where financial closure was not formally documented, and where the deemed date of completion of the project has been decided by an independent group of outside experts may be treated as a standard asset for a period not exceeding two years, beyond the deemed date of completion of the project, as decided by the Group.
- Projects sanctioned before 1997, with original project cost of less than Rs.100 crore where financial closure was not formally documented, may be treated as standard assets only for a

period not exceeding two years, beyond the date of completion of the project (as originally envisaged at the time of sanction).

- In February 2003, banks were allowed to recognise income on accrual basis in respect of the above three categories of projects under implementation which are classified as ‘standard’ in terms of the above guidelines.

Recovery of Agricultural Loans affected by Natural Calamities

2.54 The year 2002 witnessed one of the worst droughts. As part of relief measures, the Reserve Bank advised banks in November 2002 not to effect recovery of any amount either by way of principal or interest during that financial year in respect of *Kharif* crop loans in the districts affected by failure of the South-West monsoon as notified by the State Governments. Further, the principal amount of crop loans in such cases should be converted into term loans and will be recovered over a period of minimum five years in case of small and marginal farmers, and four years in case of other farmers. Interest due in financial year 2002-03 on crop loans should be deferred and no interest should be charged on the deferred interest.

2.55 Banks were advised that in such cases of conversion or re-scheduling of crop loans into term loans, the term loans may be treated as current dues and need not be classified as NPA. The asset classification of these loans would thereafter be governed by the revised terms and conditions and would be treated as NPA, if interest and / or instalment of principal remain unpaid for two harvest seasons, not exceeding two half years.

(d) Provisioning Norms

Inter-branch Accounts

2.56 Banks were advised to make 100 per cent provision from the year ended March 31, 1999 for the net debit position in their inter-branch accounts, arising out of the unreconciled debit and credit entries outstanding for more than three years as on March 31 every year. The period was reduced to two years from the year ended March 31, 2001 and further to one year from the year ended March 31, 2002. Banks are required to reconcile the entries in their inter-branch accounts within a period of six months. With this objective in view and in keeping with the best banking practices, it was decided that with effect from the year ending March 31, 2004, banks would be required to make 100 per cent provision for the net debit position in their inter-branch accounts in respect of entries which are un-reconciled and outstanding for more than six months.

2.57 With a view to reducing the level of long pending outstanding entries in the clearing adjustment accounts of banks, they have been allowed as a one-time measure, to net off the entries representing ‘clearing differences -receivable’ against entries representing ‘clearing differences - payable’ up to Rs.500 which are outstanding for more than three years as on March 31, 2003.

Accounting Standards

2.58 A Working Group (Chairman: Shri N.D. Gupta) was constituted to recommend steps to eliminate/reduce gaps in compliance by banks with Accounting Standards (AS) as issued by ICAI. The Working Group examined compliance by banks with the AS 1 to 22, which were already in force for the accounting period commencing from April 1, 2001, as also AS 23 to 28, which were to come into force for subsequent periods. The Working Group observed in its Report, that out of Accounting Standards which are already in force, *viz*., AS 1 to 22, banks in India are generally complying with most of the AS, except the following eight, leading to qualification in the financial statement. These pertain to AS 5 (net profit or loss for the period, prior period items and changes in accounting policies), AS 9 (revenue recognition), AS 11 (accounting for the effect of changes in foreign exchange rates), AS 15 (accounting for retirement benefits in the financial statements of employers), AS 17 (segment reporting), AS 18 (related-party disclosures), AS 21 (consolidated financial statements) and AS 22 (accounting for taxes on income).

2.59 In view of the above and also with a view to eliminating gaps in compliance with the AS, the Working Group made certain recommendations for compliance by banks with the concerned accounting standards. The Working Group has not made any recommendation on AS 11 (accounting for effects of changes in foreign exchange rates), since the ICAI was in the process of revising the concerned accounting standard. In March 2003, the Reserve Bank issued detailed guidelines on the basis of the Group's recommendations for the guidance of the banks.

Other Structural and Regulatory Changes

Setting up of New Private Sector Banks

2.60 With a view to impart greater competition in the banking system the Reserve Bank had set up a committee in January 1998 to review the licensing policy for setting up new private sector banks. Subsequently, the Reserve Bank issued guidelines for entry of new banks in the private sector in January 2001.

2.61 The applications received by the Reserve Bank within the stipulated period were scrutinised to ensure *prima facie* eligibility and thereafter referred to a High-Level Advisory Committee (Chairman: Dr.I.G. Patel) set up by the Reserve Bank. In their Report submitted to the Reserve Bank in June 2001, the Committee had recommended two applications as suitable for issue of 'in-principle' approvals for setting up new banks in private sector. The applications recommended were from Shri Ashok Kapur and two other banking professionals with Rabobank Netherlands, and Kotak Mahindra Finance Ltd., a non-banking financial company.

2.62 'In principle' approvals to the above two applicants, valid for one year, were issued on February 7, 2002. On being satisfied that the Kotak Mahindra Finance Ltd. complied with the requisite conditions laid down by the Reserve Bank as part of the 'in-principle' approval, they were granted a licence for commencement of banking business under Section 22 (1) of Banking Regulation Act, 1949 on February 6, 2003. The bank commenced operations with effect from March 22, 2003 and was included in the Second Schedule to the Reserve Bank of India Act, 1934 with effect from April 12, 2003. The other applicant has been granted extension of time till November 30, 2003 to complete all necessary formalities and to commence banking operations.

Foreign Direct Investment in the Banking Sector

2.63 The Finance Minister announced in the Union Budget 2003-04 that the limit for foreign direct investment in banking companies would be raised from 49 per cent to 74 per cent, to facilitate setting up of subsidiaries by foreign banks and for attracting investments in private sector banks. Accordingly, the Reserve Bank has proposed to the Government of India to lift the limit of voting rights. Even though comprehensive amendments to the Banking Regulation Act, 1949 are under active consideration of the Government and the Reserve Bank, an amendment to Section 12 of the Banking Regulation Act, 1949 (relating to voting rights of shareholders, among others) was suggested as an immediate measure to facilitate investment in private sector banks up to 74 per cent as envisaged in the Union Budget.

Setting Up of Off- Shore Banking Units

2.64 Following the announcement in the EXIM Policy 2002-07 by the Government of India, the Reserve Bank issued guidelines in November 2002 allowing banks operating in India to set up Off-Shore Banking Units (OBUs) in Special Economic Zones (SEZs) which would be virtually foreign branches of Indian banks located in India. The salient features of the scheme for setting up OBUs in SEZs are:

- All banks operating in India, authorised to deal in foreign exchange, are eligible to set up OBUs, with a preference for banks having overseas branches and experience of running OBUs.
- Banks would be required to obtain prior permission of the Reserve Bank for opening an OBU in a SEZ under Section 23(1)(a) of the Banking Regulation Act, 1949 (relating to opening of new place of business in India).
- Since OBUs would be branches of Indian banks, no separate assigned capital for such branches would be required. However, with a view to enabling them to start their operations, the parent bank would be required to provide a minimum of US $10 million to its OBU.
- The Reserve Bank would grant exemption from CRR requirements to the parent bank in respect of its OBU branch.
- The sources of raising foreign currency funds would only be external.
- The OBUs would be required to follow scrupulously 'Know Your Customer' and other anti-money laundering instructions issued by the Reserve Bank.
- The OBUs would be required to maintain separate *nostro* accounts with correspondent banks, which would be distinct from *nostro* accounts maintained by other branches of the same bank.
- Deposits of OBUs will not be covered by deposit insurance.
- The loans and advances of OBUs would not be reckoned as net bank credit for computing priority sector lending obligations.

Guidelines on Lenders' Liability Laws

2.65 Based on the recommendations of a Working Group constituted by the Government of India on Lenders' Liability Laws, banks and all-India FIs were advised on May 5, 2003 to adopt prescribed broad guidelines and frame the Fair Practices Code duly approved by their Board of Directors. The Fair Practices Code is expected to improve the quality of banking services to borrowers by making their own service obligations more transparent. The salient features of the guidelines are as follows:

- Loan application forms in respect of priority sector advances (up to Rs.2 lakh) should include information such as fees / charges payable for processing and pre-payment options.
- Banks and FIs should devise a system of giving acknowledgement for receipt for all loan applications.
- In case of rejection of applications of small borrowers seeking loans up to Rs.2 lakh, the main reason(s) for rejection should be conveyed in writing within the stipulated time.
- Lenders should ensure proper assessment of credit application by borrowers. The margin and security stipulation should not be used as a substitute for due diligence on creditworthiness of the borrower.
- Lenders should ensure timely disbursement of loans sanctioned in conformity with the terms and conditions governing such sanction, give notice of any change in the terms and conditions, including interest rates and service charges and ensure that changes in interest rates and charges are effected only prospectively.
- Post-disbursement supervision by lenders, particularly in respect of loan up to Rs.2 lakh, should be constructive with a view to taking care of any genuine difficulty that the borrower may face.
- Lenders should refrain from interference in the affairs of borrowers except for what is provided in the terms and conditions of the loan sanction documents.
- Consent or objection to a request for transfer of borrowal account, either from the borrower or from a bank / FI, should be conveyed within 21 days from the date of receipt of request.

4. Risk Management

2.66 In order to reap the benefits of financial market development and ensure financial sector stability, the risks introduced by each market need to be effectively managed before other markets are developed and more risks are injected into the financial system. The market development strategy, therefore, needs to accord priority to mitigate the risks introduced by more sophisticated financial markets and the risks to macroeconomic control from institutional reforms. The taxonomy of risks facing the four major financial markets: money, debt, equity and foreign exchange and the measures to mitigate them are delineated in Box II.4.

Bank Financing of Equities and Investment in Shares

2.67 In view of the increasing importance of efficiency of the risk management systems, banks were advised to review more specifically their risk management systems pertaining to capital market exposures and exposures to stock broking entities / market makers. The review, which is to be placed before the Board of Directors, should, *inter alia*, assess the efficiency of the risk management systems in place in the bank, assess the extent of compliance with the guidelines issued and identify the gaps in compliance for initiating appropriate steps immediately.

Guidelines on Country Risk Management

2.68 With a view to furthering compliance with the Core Principles for Effective Banking Supervision, released by the BIS in 1997, the Reserve Bank has framed guidelines on country risk management and provisioning. These guidelines were issued to banks on February 19, 2003 (Box II.5).

Management of Operational Risk

2.69 Operational risk covers a broad range of risks that are internal to the bank. Operational risk arises out of deficiencies in the internal systems, control systems failures and non-adherence to prescribed procedure. In recent years, size of operation of banks have increased manifold. Besides, banks are diversifying into various para-banking activities. Due to increased exposure of banks to various sectors and activities, the risks associated with them have also increased. Managing operational risk has, thus, gained importance with the change in the scale of banking operations. The nature and scope of operational risks has also received an added importance in view of the Basel II requirements (Box II.6).

Guidance Notes on Management of Credit and Market Risks

2.70 Guidelines on risk management systems were issued to banks in October 1999. These, together with the asset-liability management (ALM) guidelines issued earlier in February 1999, have been intended at providing a benchmark to the banks which were yet to establish integrated risk management systems. As a step towards enhancing and fine-tuning the existing risk management practices in banks, draft guidance notes on management of credit risk and market risk based on the recommendations of two Working Groups constituted in the Reserve Bank drawing experts from select banks and FIs were issued and also placed on the Reserve Bank's website for wider discussion by banks, FIs and other market participants during 2001-02.

2.71 With regard to credit risk, the guidance note covers areas pertaining to the policy framework, the types of credit risk models, managing credit risk in inter-bank and off-balance sheet exposures and implications for credit risk management arising from the New Capital Accord. With regard to market risk, the guidance note encompasses areas of liquidity, interest rate risk and foreign exchange risk management as well as the treatment of market risk in the proposed New Capital Accord. Issues like Value-at-Risk and stress-testing have also been dealt with in the guidance note. These draft guidance notes were subsequently revised in the light of the feedback received and the revised Guidance Notes issued to banks were placed on the website of the Reserve Bank in October

Box II.4: Necessary Measures for Mitigating Select Risks in Major Financial Markets

Source and Type of Risk	Money Market	Debt Securities Market	Equity Market	Foreign Exchange Market
Credit Risk	Detailed financial information disclosure on asset quality, capital adequacy and liquidity position. Enhance credit risk analysis.	Improve credit pricing ability by standardising bond contracts, requiring the use of rating agencies.	—	Conduct detailed credit analysis on borrowers, with a special focus on foreign currency earning and exchange risk hedging capacities. Apply high underwriting standards to foreign currency borrowers.

	Strengthen framework for repurchase agreements and collateral seizure.			
Liquidity Risk	Contain maturity mismatch and maintain minimum level of liquid assets.	Reduce fragmentation, develop benchmark securities and use primary dealers.	Accounting and auditing standards ensuring quality of financial disclosure.	Promote liquid market for foreign exchange transactions by fostering efficient and transparent trading and market conduct arrangements.
	Strengthen liquidity management skills and techniques.	Make available collateralised line of credit to support primary dealers.	Restrictions on exposure and concentration.	Establish limits against foreign currency mismatches.
Settlement risk	—	Dematerialise securities, Centralise depository, Automated settlement on real time basis.	Regulatory capital requirements, supervision of financial condition; early warning system. Membership restrictions in trading system / settlement system.	—
Interest rate Risk	— -	Comply with prudential requirements for risk management of portfolios. Achieve an adequate degree of transparency in large positions, Trading data.	—	—
Exchange rate Risk	—	—	—	Establish internal limits and monitoring mechanisms for foreign exchange exposure, including off-balance sheet items. Establish net open position limits. Set capital requirements against exchange rate risk. Develop instruments for hedging exchange rate risk.

Reference:

Karacadag, C., V. Sundarajan and J. Elliott (2003), "Managing Risks in Financial Market Development", *IMF Working Paper*, No.116, IMF, Washington D.C.

Box II.5: Guidelines on Country Risk Management

Country risk, which has an overarching effect on a bank's international activities, is the risk that economic, social and political conditions in a foreign country might adversely affect a bank's financial interests. Besides credit transactions, country risk includes investments in foreign subsidiaries, electronic banking agreements, electronic data processing servicing, and other outsourcing arrangements with foreign providers. It is, therefore, important that banks with significant international exposure have an effective country risk management process in place, commensurate with the volume and complexity of their international activities.

The Core Principles for Effective Banking Supervision, released in 1997, had observed that "banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring and controlling country risk and transfer risk in their international lending and investment activities and for maintaining reserves against such risks" (Principle XI). The assessment made by the Reserve Bank in 1999, regarding its compliance with the Core Principles revealed that country risk management (CRM) was one of the areas where there was an observed deficiency in India. Accordingly, after obtaining the views of banks on the draft guidelines, the Reserve Bank published the final guidelines on CRM in February 2003. These guidelines are applicable only in respect of countries where a bank has exposure of 2.0 per cent or more of its assets. The salient features of the guidelines may be grouped under the following seven heads: (a) policy and procedures, (b) scope, (c) ratings, (d) exposure limits, (e) monitoring, (f) provisioning, and (g) disclosures.

- **Policy and Procedures** – The CRM policy should address the issues of identifying, measuring, monitoring and controlling country exposure risks. The policy should specify the responsibility and accountability at various levels for the CRM decisions. The banks would need to institute appropriate systems and procedures, laid down with the approval of the Board, for dealing with country risk problems. Finally, the CRM policy should stipulate rigorous application of the 'Know Your Customer' (KYC) principle in international activities.

- **Scope** – Banks would need to reckon both funded (*e.g.*, cash and bank balances, deposit placements, investments, loans and advances) and non-funded (*e.g.*, letters of credit, guarantees, performance bonds, bid bonds, warranties, committed lines of credit) exposures from their domestic as well as foreign branches while identifying, measuring, monitoring and controlling country risks. Banks would also need to account for indirect country risk (exposures to a domestic commercial borrower with a large economic dependence on a certain country), which may be reckoned at 50 per cent of the exposure. Exposures would need to be computed on a net basis (*i.e.*, gross exposures *less* collaterals, guarantees, insurance, *etc*).

- **Ratings** – Banks need to institute appropriate systems to move over to internal assessment of country risks. Instead of relying solely on rating agencies or other external sources as the country risk monitoring tool, banks should also incorporate information from the relevant country managers of the foreign branches into their country risk assessments. The frequency of periodic reviews of country risk ratings should be at least once a year, with the provision for more frequent reviews in case of major events in the country where the bank exposure is high.

- **Exposure Limits** – The Boards of banks may set country exposure limits in relation to the bank's regulatory capital (tier-I *plus* tier-II) with sub-limits, if necessary, for products, branches, maturity, *etc.* In case of foreign banks, the regulatory capital would be the sum of tier-I and tier-II capital held in their Indian books.

- **Monitoring of Exposures** – Banks should switch over to real-time monitoring of country exposures by March 31, 2004. In the interim period, banks should monitor their country exposures on a weekly basis. Country risk exposures would need to be reviewed at quarterly intervals. The review should include progress in establishing internal country rating systems, compliance with regulatory norms, internal limits, stress tests and the exit options available to the banks in respect of countries in the 'high risk and above' categories.

- **Provisioning** – Banks would need to make provisions, with effect from the year ending March 31, 2003, on the net funded country exposures on a graded scale ranging from 0.25 per cent (in case of insignificant risk) to 100 per cent (in case of restricted / off-credit risks). While banks may not make any provision for 'home country' exposures (*i.e.*, exposure to India), they would need to include exposures of foreign branches of Indian banks to the host country. These provisions for country exposures would be allowed to be treated as tier-II capital, subject to a ceiling of 1.25 per cent of the risk-weighted assets.

- **Disclosures** – Banks would need to disclose as part of the 'Notes on Accounts' to the balance sheet as on March 31 every year, (a) the risk category-wise country exposures, and (b) the extent of aggregate provisions held thereagainst.

It was decided that a review of the guidelines would be undertaken after one year, taking into account the experience of banks in implementing the guidelines.

Reference:

Reserve Bank of India (2003), *Risk Management Systems in Banks – Guidelines on Country Risk Management*, RBI: Mumbai.

Box II.6: Operational Risk and New Capital Accord

The scope of operational risk is measured by the probability and impact of the unexpected losses stemming from the deficiency or failure of internal processes, people and systems, or from external events. A quantitative assessment requires such losses to be quantified as expected and assumes that probabilities and actual losses can be measured. Complete quantification is difficult in practice. The analysis of the probability and size of operational risks is also defeated by the lack of relevant data. One possible way out is to systematize operational risk and place them in the loss probability and size matrix (Table A).

Table A: Size and Probability of Unexpected Losses

Severity	Probability	
	Low	High
Low	C	B
High	D	A

For operational risk policy, the following rules result from an analysis of the size and probability of losses.

- Business areas with a high likelihood and high level of operational risk (Cell **A**) to be avoided.
- Areas with a low level but high probability of losses (Cell **B**) are often not perceived as “risk areas”, but merely “cost-intensive” or “low quality”. In such cases, problems are frequently to be found in process and system design.
- Small-scale losses with a low degree of probability (Cell **C**) should be accepted if the costs of prevention exceed the amount of reduction in the losses.
- The significant operational losses are mostly located where the probability is low, but the severity is high (Cell **D**). For such cases, preventive measures such as governance, internal control and management incentives are most important.

Given the fact that lack of adequate internal controls are behind many a major loss, the Basel Committee on Banking Supervision has in a recent study drafted several principles for executive management and boards of directors for monitoring by the banking supervisory authorities.

The new Basel Accord provides a menu of approaches towards measurement of operational risk. Three such approaches have been proposed: basic indicator approach, standardised approach and the advanced measurement approach. Under the first approach, operational risk capital allocation is based on a single indicator (*viz.*, Gross Income) as a proxy for operational risk exposure. Under the second approach, banks’ activities are divided into eight business lines (corporate finance, trading and sales, retail banking, commercial banking, payment and settlement, agency services, asset management, and retail brokerage). The capital charge for each business line is calculated by multiplying gross income by a factor (denoted as *beta*) assigned to that business line. Under the third approach, the regulatory capital requirement will equal the risk measure generated by the bank’s internal operational risk measurement using both qualitative and quantitative criteria. The qualitative criteria include independent operational risk management function, active involvement of board of directors / senior management in oversight of operational risk management process, regular reporting of operational risk exposure and loss experience and documentation of risk management system. Among the quantitative criteria are the demonstrated ability of the bank to capture potentially severe ‘tail’ loss events and sufficient ‘granularity’ in risk measurement systems to capture the major drivers of operational risk. In addition, the process of operational risk measurement would also need to include four key elements: tracking internal loss data, using relevant external data, employing scenario analysis to evaluate its exposure to high severity events and finally, capturing key business environment and internal control factors that can change the operational risk profile of the bank. These approaches are gradually increasing in the degree of sophistication and have built-in incentives to encourage banks to continuously improve their risk management and measurement capabilities and undertake more accurate assessment of regulatory capital.

Since operational risk is one of the important elements of the New Capital Accord, banks would be required to stress upon their internal control and systems, particularly towards clearing of backlog in balancing of books to ward off clearing differences and inter-branch and *nostro* accounts reconciliation. The progress made by banks in India in reconciliation of clearing differences as well as inter branch and *nostro* accounts, which are prone to frauds, should be closely monitored by banks. It is also imperative that banks make concerted efforts to build up appropriate systems to reduce the outstandings as early as possible and also to avoid incidence of fresh outstandings. In order to prevent fraud and mitigate operational risk arising out of it, banks would be required to strengthen their internal systems and procedures and take specific steps, particularly in the following areas: (a) strictly follow the principles of corporate governance; (b) adhere to the KYC principle; (c) build robust systems and procedures to prevent fraud; and (d) strengthen internal audit and control systems and put in place accountability process for audit and inspection staff.

References:

Basel Committee on Banking Supervision (1998),
Framework for Internal Control Systems in Banking Organisations, Basel.

Basel Committee on Banking Supervision (2003), *The New Basel Capital Accord (Third Consultative Document),* Basel.

Weigand, C. (2002), *Operational Risk in the New Basel Capital Accord,* presentation at Bank of Netherlands (available at www.dnb.nl).

2.72 Banks could use these guidance notes for upgrading their risk management systems. The design of risk management framework should be oriented towards the banks' own requirements dictated by the size and complexity of business, risk philosophy, market perception and the expected level of capital. The systems, procedures and tools prescribed in the guidance notes for effective management of credit risk and market risk are merely indicative in nature. The risk management systems in banks should, however, be adaptable to changes in business size, the market dynamics and the introduction of innovative products by banks in future.

5. NPA Management by Banks

One-Time Settlement / Compromise Schemes

2.73 The guidelines for compromise settlements of chronic NPAs up to Rs.5 crore were issued in July 2000. On a review and in consultation with the Government of India, it was decided to give one more opportunity to the borrowers to come forward for settlement of their outstanding dues. The revised guidelines applicable to public sector banks will cover NPAs (below the prescribed ceiling) relating to all sectors including the small sector. The guidelines will not, however, cover cases of wilful default, fraud and malfeasance. The revised guidelines issued on January 29, 2003 for compromise settlement of dues relating to NPAs of public sector banks in all sectors are as follows:

- Guidelines are applicable for compromise settlement of chronic NPAs up to Rs. 10 crore.
- The guidelines will cover all NPAs in all sectors irrespective of the nature of business, which have become doubtful or loss assets as on March 31, 2000 with outstanding balance of Rs. 10 crore and below on the cut off date.
- The guidelines will also cover NPAs classified as sub-standard assets as on March 31, 2000, which have subsequently become doubtful or loss assets.
- The guidelines will be applicable to cases in which the banks have initiated action under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002 and also cases pending before Courts / Debt Recovery Tribunals

(DRTs) / Board for Industrial and Financial Reconstruction (BIFR), subject to consent decree being obtained from the Courts / DRTs / BIFR.

- The last date for receipt of applications from borrowers under the scheme was September 30, 2003 and their processing should be completed by December 31, 2003.

2.74 Guidelines for special One-Time Settlement Scheme for loans up to Rs.50,000 to small and marginal farmers by PSBs which were issued in March 2002 were to be operational up to December 31, 2002. The Government and the Reserve Bank had received requests from banks for extending the time limit of the operation of the guidelines. In view of the above and keeping in view the drought / flood situation in different parts of the country, it was decided, in consultation with the Government of India, to extend the operation of the guidelines, for a further period of 3 months, *i.e.*, up to March 31, 2003.

Lok Adalats

2.75 The Reserve Bank has issued guidelines to commercial banks and FIs to enable them to make increasing use of *Lok Adalats*. They have been advised to participate in the *Lok Adalats* convened by various DRTs / Debt Recovery Appellate Tribunals (DRATs) for resolving cases involving Rs. 10 lakh and above to reduce the stock of NPAs. As on June 30, 2003, the number of cases filed by banks in *Lok Adalats* stood at 2,72,793 involving an amount of Rs.1,193.3 crore and amount recovered in 87,907 cases was Rs. 190.5 crore.

Debt Recovery Tribunals

2.76 The Government set up a Working Group (Chairman: Shri S. N. Aggarwal) to review the existing provisions of the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 and the rules framed thereunder in the light of the suggestions received from various quarters, such as, banks, FIs, DRTs and individuals as also to examine the adequacy of the infrastructure available to DRTs. The Working Group suggested amendments to the Act and Rules framed thereunder. The Government has substantially amended the Debts Recovery Tribunal (Procedure) Rules, 2003 to facilitate better administration of the Act including plural remedies for banks. As on June 30, 2003, out of 57,915 cases (involving Rs.82,266 crore) filed by banks to the DRTs, 22,163 cases (involving Rs.19,633 crore) have been adjudicated and the amount recovered so far stood at Rs. 5,787 crore.

The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002

2.77 The Government issued the SARFAESI Act, 2002 which, *inter alia,* provides, for enforcement of security interest for realisation of dues without the intervention of courts or tribunals. The Government has also notified the Security Interest (Enforcement) Rules, 2002 to enable secured creditors to authorise their officials to enforce the securities and recover the dues from the borrowers. The PSBs and FIs have been advised to take action under the Act and report compliance to the Reserve Bank.

2.78 The Act provides for sale of financial assets by banks / FIs to securitisation companies

(SCs) / reconstruction companies (RCs)[3]. Guidelines have been issued to ensure that the process of asset reconstruction proceeds on sound lines. These guidelines, *inter alia*, prescribe the financial assets which can be sold to SCs / RCs by banks / FIs, procedure for such sales, prudential norms for the sale transactions and related disclosures (Box II.7).

CDR Mechanism

2.79 A scheme of Corporate Debt Restructuring (CDR) was developed in India based on international experience and detailed guidelines on the same were issued for implementation by banks and FIs in 2001 (Box II.8). The objective of the framework has been to ensure timely and transparent mechanism for restructuring the corporate debts of viable entities, outside the purview of BIFR, DRTs and other legal proceedings.

2.80 Consequent upon the Union Budget announcements, 2002-2003, a High Level Group (Chairman: Shri Vepa Kamesam) was constituted in order to revamp the earlier CDR scheme. Based on the recommendations made by the High Level Group and in consultation with the Government, a revised scheme of CDR was finalised and forwarded to banks in February 2003. The progress made under CDR mechanism up to June 30, 2003 is as under:

Table II.1 : Progress under CDR Scheme

(Amount in Rs. crore)

Particulars	No. of cases	Amount involved
1	2	3
Cases referred to CDR forum	71	53,736
Final schemes approved	41	38,638
Rejected	18	7,252
Pending	12	7,846

Box II.7: Final Guidelines and Directions for SCs / RCs by the Reserve Bank

The Reserve Bank issued the final guidelines and directions to securitisation companies (SCs) and reconstruction companies (RCs) in April 2003. The guidelines have been finalised taking into account the feedback received from banks, FIs and others. The regulations would facilitate the smooth formation and functioning of SCs / RCs. The guidelines and directions cover the aspects concerning asset reconstruction and securitisation as also those relating to registration, owned funds, permissible business, operational structure for giving effect to the business of securitisation and asset reconstruction, deployment of surplus funds, internal control systems, prudential norms, and disclosure requirements for these companies.

In terms of the provisions of the SARFAESI Act, 2002, SCs are required to raise funds through the instrument of security receipts. The Reserve Bank has, however, clarified that the SCs / RCs can raise funds through the instrument of security receipts by the trust(s) set up by them.

In addition to the guidelines and directions, which are mandatory, the Reserve Bank has also issued guidance notes of recommendatory nature covering aspects relating to acquisition of assets, issue of security receipts, *etc.* The Reserve Bank is in the process of framing a set of standard guidelines in the matter of takeover of the management, sale or lease of whole or part of the business of the borrower. The SCs / RCs have been advised not to proceed against exercising the measures of takeover of management, sale or lease of the borrowers' business as provided for in Section 9 of the SARFAESI Act, 2002, until guidelines in this regard are notified by the Reserve Bank. As regards enforcement of security interest, SCs / RCs may follow the Security Interest (Enforcement) Rules, 2002 notified by the Government of India as also the relevant provisions in the SARFAESI Act, 2002.

Box II.8: Resolution of Corporate Distress: East Asian Experience

Both firm and country characteristics influence the way corporate financial distress is resolved. Firms differ in their capital and ownership structures, while country differences include variations in legal standards and regulatory framework. Besides the use of bankruptcy procedures, alternative means exist to deal with financial distress; these commonly include: out-of-court settlements with creditors and other stakeholders or re-scheduling or partial write-off of debt. In the aftermath of the Asian crisis, a large number of East Asian corporations experienced financial distress at the same time. Country experiences in East Asia on bankruptcy law, creditor rights and the efficiency of judicial systems suggests wide differences in prevailing practices after the crisis (Table A).

Table A: Main Features of Bankruptcy Codes in East Asia

Country	Timetable to render Judgement	Does Management stay in bankruptcy?	Is there automatic stay?	Do secured creditors get priority?
Indonesia	30 working days after a creditor's petition is registered (after August 1998)	No	No	Costs of proceedings are paid first, followed by claims on wages and secured creditors
Korea	120 working days after a creditor's petition is registered	No	No	Secured creditors paid first
Malaysia	180 working days after a creditor's petition is registered	No	No	Secured creditors paid first
Philippines	No timetable	Yes	Yes	Taxes are paid first, followed by wages, cost of proceedings and secured creditors
Thailand	No timetable	No	No	Costs of proceedings are paid first, followed by taxes, wage claims and secured creditors

Reference:

Claessens S., S. Djankor and L. Klapper (2003), 'Resolution of Corporate Distress in East Asia', *Journal of Empirical Finance*, Vol.10.

2.81 The salient features of the revised CDR scheme issued in February 2003 are as follows:

- It will cover multiple banking accounts / syndication / consortium accounts with outstanding exposure of Rs.20 crore and above.

- It will be a voluntary system based on Debtor-Creditor Agreement (DCA) and Inter-Creditor Agreement (ICA).
- CDR will have a three-tier structure consisting of : (a) CDR Standing Forum and its Core Group (the policy-making body), (b) CDR Empowered Group (the functional group deciding on the restructuring of cases referred to the CDR mechanism), and (c) the CDR Cell (the secretariat to the CDR system).
- The revised guidelines provide exit options for lenders who do not wish to commit additional financing or wish to sell their existing stake.
- 'Stand-still' agreement binding for 90 days or 180 days by debtors and creditors respectively, under which both sides commit themselves not to take recourse to any legal action during the 'stand-still' period.

Credit Information on Defaulters and Role of Credit Information Bureau

2.82 In order to alert banks and FIs and put them on guard against the defaulters to other lending institutions and help them in better management of their NPAs, the Reserve Bank has put in place a scheme on sharing credit data. The scheme aims at collecting from / disseminating to them details about borrowers with outstanding aggregating Rs.1 crore and above which are classified by them as 'doubtful' or 'loss' assets or where suits have been filed by them. Whereas information on non-suit filed accounts (*i.e.*, doubtful and loss accounts) is disseminated on half-yearly basis, *viz*., as on March 31 and September 30 (on floppy diskettes for their confidential use), the information on suit-filed accounts is published as on March 31 every year and is updated on quarterly basis. The information on suit-filed accounts is now published in a compact diskette (CD) form and is also available on the Reserve Bank website. The defaulters list (non – suit filed accounts) has been disseminated as on September 30, 2002; the defaulters list (suit filed accounts) as on March 31, 2002 has been published in CD form and is also placed on the Bank's website. Its quarterly updates up to December 31, 2002, have also been placed on the website.

2.83 Following the recommendations of Working Group on Wilful Defaulters (Chairman: Shri S.S. Kohli), with a view to making the scheme of wilful defaulters effective, the banks and FIs were advised on May 30, 2002, a revised definition of 'wilful default', including diversion and siphoning of funds by borrowers and penal measures to be initiated against wilful defaulters by them. In another step in this direction, the Reserve Bank set up a Working Group in response to observations made in the JPC Report regarding diversion of funds by borrowers with malafide intention and recommendation of criminal action against them in case of wrong certification on end-use of funds. The Group submitted its report in April 2003 and their recommendations are under consideration of the Reserve Bank. As a transparency measure, the banks / FIs were advised on July 29, 2003 to put in place a high-level grievances redressal mechanism for giving a hearing to representing borrowers that they have been wrongly classified as wilful defaulters.

2.84 Banks and FIs were advised on June 4, 2002 to submit periodic data on suit-filed accounts of Rs.1 crore and above, till December 2002 and suit filed accounts of wilful defaults of Rs.25 lakh and above, till the quarter ending December 2002 to the Reserve Bank as well as to Credit Information Bureau of India Ltd. (CIBIL) and thereafter to CIBIL only. However, the periodic data relating to non-suit filed accounts for their defaulters lists would continue to be submitted to the Reserve Bank only, as in the past. Furthermore, with a view to broad-base credit information / data with CIBIL, banks and FIs were advised on October 1, 2002 to furnish information in respect of suit-filed accounts between Rs.1 lakh and Rs.1 crore from the period ended March 2002 in a phased manner to CIBIL only. They were also advised on October 1, 2002 to obtain consent of their borrowers and their guarantors for disclosure of their names in case of default, in a phased manner, and submit the progress-returns thereon to CIBIL as per prescribed schedule. This would enable CIBIL to build up comprehensive credit information and a database on all (non-suit filed) borrowal accounts (performing as well as non-performing) and to share it with its members and also to take over credit information dissemination function in its entirety from the Reserve Bank. However, on a review of the position and considering the constraints expressed by banks in adhering to the time schedule for obtaining the consent clause, banks were advised, on February 10, 2003, that the revised schedule for obtaining the consent clause and submission of returns to CIBIL would be operative by September 2004 and December 2004, respectively.

6. Consultative Process in Policy Formulation

2.85 As part of the initiative to strengthen the consultative process to aid policy making, the Reserve Bank has initiated steps to enhance interaction with financial market participants. Periodical meetings are being held between Reserve Bank functionaries, representatives of select banks and experts to monitor the developments in money and credit markets, as also to discuss specific problems affecting the banking industry. These meetings are a step towards enhanced transparency and good governance in the conduct of monetary and financial policies.

Meetings with Bankers on Credit Deployment

2.86 In order to monitor closely credit conditions as also to get regular feedback on the direction of growth sectors and industries, since August 2001 monthly meetings with the executives of select banks (comprising public sector, private and foreign banks) along with IDBI are being held on fifteenth of every month. The number of participating banks was increased from 15 to 21 from February 2003, in view of the interest expressed by some banks in participating in these meetings. These meetings provide a platform to discuss likely credit flow to various industries, expectations on macroeconomic scenario and various policy issues impinging on the banking industry, so as to have the required inputs for formulation of the monetary policy.

Resource Management Discussions

2.87 The Resource Management Discussion meetings are held every year prior to the announcement of the annual Monetary and Credit Policy Statement with select banks. These meetings mainly focus on perception and outlook of the bankers on economy, liquidity condition, credit outflow, development of different markets and direction of interest rates along with their expectations from the policy and suggestions in this respect. During 2002-03 these meetings were conducted with 10 banks (including two foreign banks and two private sector banks) during the second and third week of March 2003. The feedback received from these meetings was taken into consideration while formulating the monetary and credit policy for 2003-04.

7. Credit Delivery

Priority Sector Lending

2.88 As a further step to improve the credit delivery mechanism by simplifying procedures, encouraging decentralised decision making and enhancing competition, the following measures were initiated during the year:

- The limit on advances granted to dealers in drip irrigation / sprinkler irrigation system / agricultural machinery was increased, irrespective of their location, from Rs.10 lakh to Rs.20 lakh, under priority sector lending for agriculture.
- The existing overall limit of Rs.10 lakh in respect of setting up of small business was increased to Rs.20 lakh without any ceiling for working capital. Further, banks are now free to fix individual limits for working capital depending upon the requirements of different activities.
- The individual credit limit to artisans, village and cottage industries was raised to Rs.50,000 from the existing limit of Rs.25,000. This will be under the overall limit of 25 per cent advances to weaker sections under priority sector or 10 per cent of net bank credit.
- In order to increase further credit flow to housing sector, the existing limit of housing loans for repairing damaged houses was increased from Rs.50,000 to Rs.one lakh in rural and semi-urban areas and to Rs.two lakh in urban areas. Further, in view of increasing demand for housing in rural and semi-urban areas and to improve financing to housing sector in these areas, it was decided that the banks, with the approval of their Boards, would be free to extend direct finance to the housing sector up to Rs.10 lakh in rural and semi-urban areas as part of priority sector lending.

Rural Credit

Relief for Drought-Affected Farmers

2.89 As alluded to earlier, the guidelines for relief measures by banks in the drought affected districts (as notified by the State Governments) were issued in November 2002.

2.90 In order to further mitigate the hardship of farmers in drought-affected states, the Government had decided in December 2002, as a one-time measure, to waive completely, the first year's deferred interest liability on *Kharif* loans in those States. There will be a cap on the amount to be waived as equivalent to 20 per cent of the total deferred liability of interest for the first year only. This instalment of deferred interest, which is to be waived by banks, would be reimbursed by the Government. No interest would be charged on the deferred interest, and the balance of the deferred interest would be recovered in reasonable instalments.

Working Group to suggest Amendments in the Regional Rural Banks Act, 1976

2.91 With a view to examining the various aspects of functioning of RRBs and to make recommendations that enable these banks to take care of the financial needs of the rural populace, the Government set up a Working Group (Chairman: Shri M.V.S. Chalapathy Rao) to suggest amendments in the Regional Rural Banks Act, 1976 (Box II.9).

Box II.9: Major Recommendations of the Working Group to suggest Amendments in

Regional Rural Banks Act, 1976

- The scope of financial services to be provided by RRBs, as per the amendments proposed in the preamble to Regional Rural Banks Act, 1976, needs to be widened.
- Capital adequacy norms, with due adaptation, needs to be introduced in RRBs in a phased manner along with RRB-specific amount of equity based on their risk-weighted asset ratio.
- Based on financial health of RRBs, differentiated ownership structures should be allowed.
- Prescribed minimum level of shareholding should be at 51 per cent for sponsor institutions.
- The area of operation of RRBs need to be extended to cover all districts.
- Keeping in view the regional character and distinct socio-economic identity of issues, RRBs falling in one socio-economic zone may be amalgamated so as to create one or a few RRBs in each State.
- RRBs may have a minimum of five and a maximum of eleven Board members, including the Chairman. The number of Directors may not be fixed uniformly for all RRBs as at present.
- As part of consolidation process, some sponsor banks may be eased out and some FIs and other strategic managing partners may take over as sponsor institutions.
- The regulatory framework for RRBs must be on the lines of those for commercial banks with provision for such bank-specific relaxations as may be necessary for specific time period. RRBs may also be subjected to the statutory norms of licensing and each RRB should be required to obtain a license from the Reserve Bank under the provisions of the Banking Regulation Act, 1949 within a specific time period.
- Half-yearly financial audit may be introduced in the RRBs.
- In order to strengthen the RRBs to cater to the needs of the rural economy for all kinds of financial services, diversification of their business needs to be encouraged without losing focus on fulfilling the financial needs of the rural poor.
- RRBs may avail of all the services of their sponsor banks / institution or other established and authorised public sector portfolio management service providers based on their own judgement of costs and benefits for professionalisation of the investment function for achieving optional returns on the bank's resources.
- Various IT-based innovations may be adopted by RRBs at different stages of their development for providing competitive customer services in a cost-effective manner.
- The induction of technology in RRBs may be monitored by a national-level Standing Committee that may guide RRBs on various issues arising out of the implementation of computerisation plans by various RRBs.

Rural Infrastructure Development Fund

2.92 Both public and private sector banks that have shortfalls in lending to the priority sector or to agriculture have to contribute specified allocations to the Rural Infrastructure Development Fund (RIDF). The RIDF was established with NABARD for assisting State Governments/ State-owned corporations in quick completion of on-going projects relating to medium and minor irrigation, soil conservation, watershed management and other forms of rural infrastructure. The IXth *tranche* of RIDF has been set up during the year 2003-04 in NABARD with a *corpus* of Rs. 5,500 crore.

2.93 In the case of RIDF-I to VI, the rate of interest on deposits placed in the Fund was uniform for all banks irrespective of the extent of their shortfall. Effective from RIDF-VII, it was decided to link the rate of interest on RIDF deposits to the banks' performance in lending to agriculture. Accordingly, effective from RIDF-VII, banks are receiving interest at rates inversely proportional to their shortfall in agricultural lending. In the case of RIDF-IX, interest rate on loans out of RIDF have been linked to the Bank Rate and fixed at 2.0 percentage points above the Bank Rate.

Review Group on the Working of Local Area Banks

2.94 Guidelines for establishment of Local Area Banks (LABs) were announced in 1996. Since no comprehensive review of the LAB had been undertaken, a Review Group (Chairman: Shri G. Ramchandran) was appointed by the Reserve Bank in July 2002 with outside experts to study and make recommendations on the LAB scheme. The major recommendations of the Group accepted by the Reserve Bank are as under:

- There should be no licensing of new LABs till measures to strengthen the existing LABs were put through and the existing LABs are placed on a sound footing.
- The existing LABs should be asked to reach net worth of at least Rs.25 crore over a period of five years for attaining viability.
- LABs should maintain a minimum capital adequacy of 15 per cent, and
- LABs need to be treated like any other commercial bank and therefore, regulation and supervision should be entrusted to the same wing of the Reserve Bank which is responsible for regulation and supervision of commercial banks.

Credit to SSIs

2.95 To give the benefit of the soft interest rate policy of the Reserve Bank to small-scale industry (SSI), banks have been advised to set the interest rate on advances to SSI units keeping in view general southward movement in interest rates. Further, as per the announcement made in the Union Budget 2003-04, the Indian Banks Association has already advised the banks to adopt the interest rate band of two per cent above and below its PLR for secured advances. To mitigate the problem of delayed payment, banks have been advised to fix sub-limits within the overall working capital limits to the large borrowers specifically for meeting the payment obligation in respect of purchases from SSI. To make available timely credit to the sector a time frame has been fixed for disposal of loan applications. In the recently announced Mid-term Review of Monetary and Credit Policy for 2003-04 banks have been allowed to increase the loan limit from Rs. 15 lakh to Rs. 25 lakh (with the approval of their Boards) for dispensation of collateral requirement, on the basis of good track record and the financial position of the SSI units. Moreover, all new loans granted by banks to NBFCs for the purpose of on-lending to SSI sector would also be reckoned under priority sector lending.

8. Money and Government Securities Markets

Money Market

Reliance on Call Notice / Money Market

2.96 The Monetary and Credit Policy for 2002-03 stipulated prudential limits in a symmetric way on both borrowing and lending of banks in the call/notice money market. This was done to preserve the integrity of the financial system and to facilitate the development of the term money market as well as the repo market. Accordingly, after consultation with banks, prudential limits in respect of both borrowing and lending came into effect in two stages, effective October 5, 2002 and December 14, 2002. At present, in the second stage, with effect from the fortnight beginning December 14, 2002, lending of SCBs, on a fortnightly average basis, should not exceed 25 per cent of their owned funds. Banks are, however, allowed to lend a maximum of 50 per cent on any day during a fortnight. Similarly, borrowings by SCBs should not exceed 100 per cent of their owned funds or 2 per cent of aggregate deposits, whichever is higher. Banks are, however, allowed to borrow a maximum of 125 per cent of their owned funds on a particular day during a fortnight.

2.97 In order to ensure smooth adjustment to this stipulation without any disruption in asset-liability management (ALM), banks were advised to unwind their position as borrowers and/or lenders in the call/notice money market in excess of the prudential limit, as specified for the first stage, by October 4, 2002. The Reserve Bank may, however, consider allowing temporary access to the call/notice money market in excess of the stipulated limit to any bank facing mismatches, on request. Increased access over stipulated norms may also be permitted by the Reserve Bank for a longer period for banks with fully functional ALM system to the satisfaction of the Reserve Bank.

2.98 With effect from October 5, 2002, Primary Dealers (PDs) are free to lend up to 25 per cent of their net owned funds (NOF) on average basis, during a reporting fortnight. So far as borrowing by PDs in call/notice money market is concerned, in stages I and II, PDs would be allowed to borrow up to 200 per cent and 100 per cent, respectively, of their NOF as at end-March of the preceding financial year. These phases will be effective contingent upon certain developments in the repo market.

Progress Towards Pure-Inter-Bank Call Money Market

2.99 With a view to moving towards a pure inter-bank call/notice money market, non-bank participants are allowed in the second stage to lend, with effect from June 14, 2003, on average in a reporting fortnight, up to 75 per cent of their average daily lending in the call/notice market during 2000-01. The Mid-term Review of Monetary and Credit Policy for 2003-04 has proposed that with effect from fortnight beginning December 27, 2003, non-bank participants would be allowed to lend, on average in a reporting fortnight to 60 per cent of their average daily lending in call / notice money market during 2000-01. The time-table for further phasing out of non-bank participation will be announced in consultation with market participants.

Borrowings by Co-operative Banks from Money Market

2.100 Consequent upon developments relating to co-operative banks during early part of 2001 and in order to reduce excessive reliance of some urban co-operative banks (UCBs) in call / notice money market, it was stipulated on April 19, 2001 that borrowings by UCBs in the call /

notice money market on a daily basis should not exceed 2.0 per cent of their aggregate deposits as at end March of the previous financial year. Subsequently, the same stipulation was extended to State Co-operative Banks (StCBs) and District Central Co-operative Banks (DCCBs) on April 29, 2002.

Certificates of Deposit (CDs) Market

2.101 In order to impart transparency and flexibility and encourage secondary market transactions in the financial market, it was stipulated that banks and FIs should issue CDs without prejudice to the Depositories Act, 1996, in dematerialised form effective June 30, 2002. Existing outstandings of CDs in physical form were to be converted into demat form by October 2002.

2.102 In order to increase the investor base, minimum size of issues of CDs by banks and FIs was reduced to Rs.1 lakh in June 2002. The Fixed Income Money Market and Derivatives Association of India (FIMMDA) also issued a standardised procedure, documentation and operational guidelines for issue of CDs in both physical and demat form on June 20, 2002. Further, with a view to providing more flexibility to pricing of CDs and giving additional choice to both investors and issuers, CDs are now permitted to be issued as a coupon-bearing instrument as well and banks may issue CDs on a floating rate basis, provided the methodology of computing the floating rate is objective, transparent and market based. The standardised procedures and documentations in this regard would be issued by FIMMDA in consultation with market participants.

Interest Rate Derivatives

2.103 Following the announcement in the mid-term Review for the year 2002-03, the Reserve Bank had constituted a Working Group on Rupee Derivatives (Chairman: Shri Jaspal Bindra) in November 2002 with appropriate representations from banks, primary dealers, mutual funds and the Reserve Bank. The scope of the Group was expanded to cover the issues relating to exchange-traded interest rate derivatives - in addition to the issues on OTC interest rate derivatives - on the recommendations of the High Level Coordination Committee on Financial and Capital Markets. The Group submitted its Report in January 2003. The major recommendations of the Group are as follows:

- Less complex interest rate options to be permitted in the first phase may include vanilla caps, floors and collars, European Swaptions, call and put options on fixed income instruments / benchmark rates and unleveraged structured swaps based on overnight indexed swaps and Forward Rate Agreements (FRAs) where the risk profile of such structure is similar to that of the building blocks.
- SCBs, FIs and PDs should be allowed to both buy and sell options; corporates may sell options initially without being the net receivers of premium. Mutual funds and insurance companies may also write options as and when their respective regulators allow them.
- Four contracts, *viz*., a) short-term Mumbai Inter-Bank Offer Rate (MIBOR) Futures Contract, b) MIFOR Futures Contract, c) Bond Futures Contract, and d) Long-Term Bond Index Futures Contract, could be considered for trading on exchanges at the present stage.
- The market regulator should lay down only broad eligibility criteria and the exchanges should be free to decide on the underlying stocks and indices on which futures and options

could be permitted.

- Netting should be allowed on intra-day basis at client-level positions.
- ICAI could be requested to develop guidelines for accounting of exchange-based transactions on interest rate derivatives.
- The Reserve Bank may consider mandatory anonymous disclosure of deals done in a standardised manner on the negotiated dealing system platform.
- Brokers accredited by the FIMMDA may be permitted in the OTC derivatives market.
- SEBI may consider issuing guidelines in regard to derivative products that mutual funds can trade in. The IRDA should come out with guidelines for participation of insurance companies in derivatives markets.
- To make the OTC derivatives contracts legally enforceable, amendment to Section 18A of the Securities Contract and Regulation Act, 1956 may be followed up vigorously by the Reserve Bank with the Ministry of Finance. To clarify the status of derivatives contracts in India undertaken by banks / FIs / PDs, the Banking Regulation Act, 1949 may be amended.
- Derivative dealers can choose the pricing and valuation model for interest rate options according to their opinion on the suitability of the models.
- A common minimum information framework and a public disclosure system may be adopted by market participants.

2.104 Meanwhile, guidelines for enabling regulated entities to participate in exchange-traded interest rate derivatives (IRDs) were finalised by the Reserve Bank in consultation with the Government and SEBI. Accordingly, it has been decided to allow SCBs (excluding RRBs and LABs), PDs and specified all-India FIs to deal in exchange-traded IRDs in a phased manner. In the first phase, the SEBI has decided to introduce anonymous order driven system for trading in IRDs on The Stock Exchange, Mumbai (BSE) and National Stock Exchange (NSE). In the first phase, such entities can transact only in interest rate futures on notional bonds and T-Bills for the limited purpose of hedging the risk in their underlying investment portfolio. PDs are, however, allowed to hold trading positions in IRDs subject to some prudential regulations. Allowing transactions in a wider range of products, as also market making for entities other than PDs will be considered in the next stage on the basis of the experience gained.

2.105 For the present, only the interest rate risk inherent in the Government securities classified under the AFS and HFT categories have been allowed to be hedged.

2.106 Interest rate derivative transactions undertaken on the exchanges shall be deemed as hedge transactions, if and only if, a) the hedge is clearly identified with the underlying Government securities in the AFS and HFT categories, b) the effectiveness of the hedge can be reliably measured, and c) the hedge is assessed on an ongoing basis and is 'highly effective' throughout the period.

2.107 The existing norm of 5 per cent of total transactions undertaken during a year as the aggregate upper limit for contract for each of the approved brokers should be observed by SCBs and all-India FIs who participate through approved Futures and Options members of the exchanges.

2.108 It is required that the regulated entities should seek approval of their Board of Directors for formulating the policy framework and appropriate risk control measures before trading in interest rate futures on the stock exchanges. the Reserve Bank is in the process of harmonising the regulatory and prudential norms for OTC and exchange-traded derivatives.

Collateralised Borrowing and Lending Obligation (CBLO)

2.109 The mid-term review of Monetary and Credit Policy for 2002-03 had announced the proposal to promote collateralised borrowing/ lending operations by market participants through Collateralised Borrowing and Lending Obligations (CBLO) to reduce their reliance on the call/notice money market. The CBLO has been operationalised as a money market instrument through the Clearing Corporation of India Limited (CCIL) on January 20, 2003. The CBLO may have original maturity between one day and up to one year. The regulatory provisions and accounting treatment for CBLO are the same as those applicable to other money market instruments. However, in order to develop CBLO as a money market instrument, it has been exempted from CRR stipulations subject to bank maintaining minimum CRR of 3 per cent. Securities lodged in the gilts account of the bank maintained with CCIL under Constituents' Subsidiary General Ledger (CSGL) facility remaining unencumbered at the end of any day can be reckoned for SLR purposes by the concerned bank.

Discounting / Rediscounting Of Bills By Banks

2.110 In December 1999, the Reserve Bank had constituted a Working Group on Discounting of Bills by Banks (Chairman: Shri K.R. Ramamoorthy). The Working Group had examined the suggestions of various banks, FIs and NBFCs in respect of granting freedom to banks in discounting of bills. After considering the recommendations of the Working Group, revised guidelines were issued to banks on January 24, 2003 in supercession of the earlier instructions and banks were advised to adhere to the new guidelines while purchasing/ discounting/negotiating/rediscounting of genuine commercial/trade bills. The important features of the revised guidelines are:

- Banks are presently required to open letters of credit (LCs) and purchase/ discount/negotiate bills under LCs only in respect of genuine commercial and trade transactions of their borrower constituents who have been sanctioned regular credit facilities by them. Accommodation bills should not be purchased/discounted/negotiated by banks.
- The practice of drawing bills of exchange claused 'without recourse' and issuing letters of credit bearing the legend 'without recourse' should be discouraged because such notations deprive the negotiating bank of the right of recourse it has against the drawer under the Negotiable Instruments Act.
- Bills rediscounting should be restricted to usance bills held by other banks. Banks should not rediscount bills earlier discounted by non-banking financial companies (NBFCs) except in respect of bills arising from sale of light commercial vehicles and two / three wheelers.
- While discounting bills of services sector, banks should ensure that actual services are rendered and accommodation bills are not discounted. Services sector bills should not be eligible for rediscounting and,
- Banks should not enter into repo transactions using bills discounted / rediscounted as collateral.

Government Securities Market

Separate Trading for Registered Interest and Principal of Securities (STRIPS)

2.111 Operational arrangements, including software development on separate trading for registered interest and principal of securities are being formulated. Dates for consolidation of coupon strips (March 25 / September 25 and May 30 / November 30) would be aligned with coupon payment dates in future issuances. The coupon payment dates of 6.01 per cent Government Stock 2028, issued on August 7, 2003, were aligned to March 25 / September 25. PDs, which meet certain laid down financial criteria, would be authorised to undertake stripping and reconstitution of securities. The Public Debt Office of the Reserve Bank would act as a registry of stripped bonds.

Debt Buy Back Scheme of Government of India

2.112 The Union Budget 2003-04 observed that a large proportion of the banks' holding of Central Government domestic debt, contracted under the high interest rate regime of the past, is thinly traded. Such loans should ordinarily command a premium over their face value with the softening of interest rates. However, owing to limited liquidity, banks are often unable to encash the same. In view of this, the Government proposed to buy back such loans from banks, on a voluntary basis, that are in need of liquidity by offering a premium that was to be set on a transparent basis. If banks declare the premium received as business income, for income tax purposes, it was decided that they would be allowed additional deduction to the extent that such income is used for provisioning of their NPAs.

2.113 After completion of the necessary modalities, on July 19, 2003, the buy back auction of 19 high coupon, relatively illiquid Government securities was conducted by the Reserve Bank. The debt buy back auction was conducted through an interactive platform developed by Clearing Corporation of India Limited (CCIL), where the participants were allowed to revise their bids in a live interactive mode. The details of the auction are given below.

- A total of 131 offers, amounting to a total of Rs. 14,434 crore (face value), were received. The entire amount was accepted as these were at or above the minimum discount of 7.5 per cent stipulated by the Government. The market value of these securities bought back amounted to Rs. 19,394 crore.
- The net cash outflow for the Government amounted to Rs. 2,539 crore after accounting for the outflows due to premium (Rs. 3,472 crore) and accrued interest on securities bought back (Rs. 500 crore), and inflows on securities reissued by way of premium received (Rs. 1,120 crore) and accrued interest (Rs. 313 crore).
- In exchange of the securities bought back, the Government reissued four securities of equal face value (Rs. 14,434 crore), in a pre-announced manner.

Trading of Government Securities on Stock Exchanges

2.114 With a view to encouraging wider participation of all classes of investors, including retail investors in Government securities, it was decided to introduce trading in Government securities through a nation-wide, anonymous, order-driven, screen-based trading system in the stock exchanges in the same manner in which trading takes place in equities. This facility of trading of Government securities on the stock exchanges would be available to banks in addition to the present Negotiated Dealing System of the Reserve Bank, which will continue to remain in place. Accordingly, with effect from January 16, 2003, trading of Government of India dated securities in dematerialised form is being allowed on automated order driven system of the NSE, BSE and Over-the-Counter Exchange of India (OTCEI). The scheme will subsequently be extended to Government of India Treasury Bills and State Government securities.

Guidelines for Uniform Accounting for Repo / Reverse Repo Transactions

2.115 On a review of the accounting practices followed by all Reserve Bank regulated entities for accounting repo / reverse repo transactions, it emerged that there were divergent practices prevailing among them. In order to ensure uniform accounting treatment and impart an element of transparency, guidelines for uniform accounting for repo / reverse repo transactions was finalised in consultation with the FIMMDA. The uniform accounting will be applicable from the financial year 2003-04. The uniform accounting principles for the present would not apply to repo / reverse repo transactions under the Liquidity Adjustment Facility (LAF) with the Reserve Bank.

2.116 The legal character of repo under the current law, as outright purchase and outright sale transactions is kept intact by ensuring that the securities sold are excluded from the Investment Account of the seller of securities and are included in the Investment Account of the buyer of securities. The buyer of the securities can reckon the approved securities acquired for the purpose of Statutory Liquidity Ratio. The securities bought would have to be marked-to-market as per the investment classification guidelines. In case of entities not following any investment valuation norms, the valuation of securities acquired will be in accordance with the norms followed by them in respect of securities of similar nature. Banks are required to make disclosures on the securities sold under repo and purchased under reverse repo in the 'Notes on Accounts' to the balance sheet.

9. Legal Reforms in the Banking Sector

2.117 The Committee on Banking Sector Reforms (Chairman: Shri M.Narasimham) in 1998 observed that a legal framework that clearly defined the rights and liabilities of parties to contracts and provides for speedy resolution of disputes is a *sine qua non* for efficient trade and commerce, especially for financial intermediation. Keeping this in view, several legislative initiatives have been undertaken in the banking and financial sector over the past several years (Box II.10).

2.118 A revised Banking Ombudsman Scheme, 2002 was brought into force by the Reserve Bank in the place of Banking Ombudsman Scheme, 1995 with effect from June 2002. The new Scheme provides for review of an award passed by the Banking Ombudsman. The Scheme also empowers the Ombudsman to act as an arbitrator for resolving disputes between a bank and its constituent as well as between one bank and another bank through the process of conciliation, mediation and arbitration.

Box II.10: Legal Reforms in Banking

A. Laws Enacted

- The Negotiable Instruments (Amendments and Miscellaneous Provisions) Act, 2002, effective from February 6, 2003, introduces the concepts of 'electronic cheque' and 'cheque truncation' by expanding the definition of 'cheque' as given in the extant Act. It also enhances the punishment for dishonour of cheques from one year to two years, excludes the nominee directors from prosecution and provides for speedy and time-bound disposal of criminal complaints by summary trial, day-to-day hearing and complainant's evidence through affidavit.
- The Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interest (SARFAESI) Act, 2002, effective from the date of promulgation of the first Ordinance, *i.e.*, June 21, 2002, has been extended to cover co-operative banks by a notification dated January 28, 2003.
- The Prevention of Money Laundering Act, 2002, notified by the Government of India in January 2003, intends to combat menace of crime-related money and provides the enabling legal framework.
- The Multi-state Co-operative Societies Act, 2002, which came into force with effect from August 2002 in replacement of the Act of 1984, empowers the Central Government to give directions to the multi-state cooperative societies in the public interest or to supersede their Board only with respect to those multi-state co-operative societies in which not less than 51 per cent of the paid-up share capital or of the total shares is held by the Central Government.

B. Bills introduced in the Parliament

- The Financial Companies Regulation Bill, 2000, introduced in Parliament in December 2000, proposes compulsory registration of all financial companies with the Reserve Bank, prior approval of the Reserve Bank for any substantial change in the management, stipulation for minimum requirement of net-owned funds and prohibiting all unincorporated bodies from issuing advertisement in any manner for soliciting public deposits.
- The Banking Regulation (Amendment) Bill, 2003, has been introduced in Parliament in April 2003. The Bill provides for the removal of the extant restriction that no person holding shares in the banking company is entitled, in respect of any shares held by him, to exercise voting rights on poll in excess of 10 per cent of total voting rights of all the shareholders of that banking company. This amendment is expected to encourage foreign banks to set up their subsidiaries and attract foreign investors.
- The Banking Regulation (Amendment) and Miscellaneous Provisions Bill, 2003, proposes amending the definition of 'approved securities', 'banking', and 'banking policy'; providing for banking company to undertake the business of insurance, derivatives, securitisation transactions, credit, debit and other cards issued by the banks; criminal liability for use of words "bank", 'banker" and "banking" by any company other than banking company without the approval of the Reserve Bank; prohibition on connected lending and advances to associate companies of the banks; prohibition on acquisition of more than five per cent in the share capital of the banking companies without the approval of the Reserve Bank and empowering the Reserve Bank to supersede the Board of Directors of a banking company in

certain circumstances.

C. Bills submitted to the Government

- The Payment and Settlement Systems Bill, 2002, based on the recommendation of the Committee on Payment Systems (Chairman: Dr. R.H. Patil), constituted by the Reserve Bank, calls for the enactment of a separate statute for regulation and supervision of the payment and settlement systems in the country.
- The Amendments to the Reserve Bank of India Act, 1934 propose separation of the debt management of the Government from monetary management, disclosure of credit information to other central banks or monetary authority outside India on reciprocal basis and other regulatory authorities in India, streamlining the cash reserve ratio by removing the prescribed limit to accord professional flexibility in the management of monetary policy and empowering the Reserve Bank for electronic transfer of fund and multiple payment system.
- The Bank Deposit Insurance Corporation Bill, based on the recommendations of the Joint Team of the Finance Ministry, the Reserve Bank and the Deposit Insurance and Credit Guarantee Corporation (DICGC), envisages a pro-active role by DICGC requiring power to cancel registration in case of default in payment of premium, sharing of information by the Bank as to the health of the bank, *etc.*

10. Technological Developments

Payment and Settlement System

2.119 Payment and settlement systems play an important role to ensure that funds move safely, quickly and in a timely manner. Settlement systems in the country have traditionally been Deferred Net Settlement (DNS) systems. The Committee on Payment and Settlement Systems (CPSS) of the Bank for International Settlements (BIS) have come out with a set of Core Principles for Systemically Important Payment Systems. These principles are the current international standards and codes for the deferred net settlement systems in any country. The status of compliance with these principles in the Indian context is detailed in Box II.11.

Retail Funds Transfer System

2.120 The growth in usage of non-conventional modes of retail funds transfer system has been substantial. Electronic Funds Transfer (EFT) using the RBI-EFT scheme has shown the highest jump with a ten-fold rise both in terms of volume and value during 2002-03 as compared with the previous year. ECS (Credit Clearing) grew by 26 per cent in terms of volume, while ECS (Debit Clearing) showed a marked rise of 62 per cent in terms of number of transactions during 2002-03 over the previous year. A new product, the Special EFT (SEFT) covering about 127 centres with more than 2,300 designated branches of banks was introduced during the year to provide quicker transfer of funds in a safe and secure electronic mode. Large-scale usage of cards was also witnessed during the year. While the number of debit cards issued grew at a rate faster than that of credit cards, smart-card based products have just been making their foray in the Indian scenario. The year also witnessed a significant change from individual bank-owned Automated Teller Machines (ATMs) to shared ATMs, where ATMs are shared across many banks and the services are outsourced.

Reports of Committees

Committee on Payment System

2.121 In order to examine various issues relating to the payments system, a Committee on Payment Systems (Chairman: Dr. R.H.Patil) was set up with broad-based representation from the banking industry. The Committee examined the relevant aspects of regulation and supervision of payment and settlement systems. The major recommendations of the Committee were, among others, enactment of a separate statute for regulation and supervision of the payment system in the country. The draft provides legal base for netting, finality of settlement and powers to formulate regulations. The Report of the Committee along with the draft bill has been forwarded to the Government for further action.

Working Group on Cheque Truncation

2.122 With the passage of amendments to the Negotiable Instruments Act, 1881 the Reserve Bank constituted a Working Group on cheque truncation and e-cheques (Chairman: Dr. R.B. Barman). The Working Group in its Report, submitted in July 2003, has recommended, *inter alia* (i) truncation of physical cheques at the place of first deposit (presenting bank) and settlement on basis of the current structure of MICR fields and (ii) targeting the four metro centres in the first phase including all banks and all clearings at a centre from a cut-off date. A pilot project is also recommended to be implemented within a period of one year at a metro centre and covering two nearby smaller towns so that the impact on inter-city clearing could also be evaluated.

Working Group on Critical Infrastructure in the Financial Sector

2.123 As part of the efforts to have plans for protecting critical computer infrastructure and representing the concerns of the financial sector, a Working Group (Chairman: Shri R. Gandhi) analysed the various issues and submitted its Report to the Government as part of the Working Group on Critical Information Systems Protection set up by the Government. The group has indicated the types of systems which form part of the critical infrastructure, as part of the requirements of the banking and financial sector.

Developments in Technology in Banking

2.124 A number of banks commenced the process of setting up core banking solutions, which are at various stages of implementation. While the new private banks, foreign banks and a few old private sector banks have already such systems in place, the PSBs are also rapidly moving towards the attainment of this requirement. Computerisation of the business of banks has been receiving high importance. While all PSBs have already crossed the 70 per cent level of computerisation of their business, the advice from the Central Vigilance Commission (CVC) to achieve 100 per cent computerisation – has resulted in renewed vigour in these banks to attain this requirement.

Box II.11: Status of Compliance with Core Principles for Systemically Important Payment Systems

	Principle	Observation
1.	The system should have a well-founded legal basis under all relevant jurisdictions.	The existing deferred net settlement systems are all based on contractual agreements between the participant banks and the manager of the clearing house.
2.	System's rules and procedures should enable participants to have a clear understanding of the system's impact on each of the financial risks they incur.	The rules and procedures for clearing exist in the form of the model Uniform Rules and Regulations (URR) which are adopted by all clearing houses. These elucidate the duties and responsibilities of all the participants. For electronic based systems, such as, the ECS-Credit and Debit, and EFT-Procedural Guidelines clearly define the rights and obligations of all the participants in the respective systems.
3.	System should have clearly defined procedures for management of credit risks and liquidity risks.	Well laid out procedures for management of any situation arising out of such risks exist. The Rule 11 of the model URR provides the facility of partial unwind. The clearing is carried out by withdrawing all instruments drawn on the defaulting bank as though it did not participate in the clearing, thus resulting in the risk not materalising.
4.	System should provide prompt final settlement on day of value, preferably during the day and at a minimum, at the end of the day.	All clearings of the major centres of the country, which account for more than 85 per cent of the clearing value perform the accounting of the clearing settlements on the same day itself. The system ensures settlement being accounted for at different time zones, and at the latest, by the end of the day. This includes Delivery *versus* Payment (DvP) transactions (Government securities), inter-bank clearing and high value clearing also. In case of low-value MICR clearing, the existence of a 'return clearing' for unpaid cheques as well as the statutory need for the drawee bank branch to physically verify the payment instrument, require a longer time for settlement finality, which is by the end of the day.
5.	System in which multilateral netting takes place should, at a minimum, be able to ensure timely completion of daily settlements if participant with the largest single settlement obligation cannot settle.	Settlement risk is addressed through a system of partial unwind. There has not been a single instance of failure to settle on a daily basis in all systemically important payment systems till date.
6.	Assets used for settlement should preferably be a claim on the central bank; where other assets are used, they should carry little or less credit risk.	The final settlement occurs across the books of the Reserve Bank in the major centres and across the books of public sector banks (mainly the SBI) at other centres.
7.	System should ensure a high degree of security and operational reliability and should have contingent arrangements for timely completion of daily processing.	High degree of security and reliability is achieved with the state- of-the-art cheque processing system for cheque clearing; other settlements for systemically important systems take place on robust, reliable and secure computer systems.

8. The system should provide a means of making payments which is practical for its users and efficient for the economy.	The existing systems are all the result of many years of their operation and thus are tuned to meet the requirements of the participants as also meet the overall requirements for the economy as a whole. The Reserve Bank as the overseer of the payment system has also taken several initiatives to increase efficiency of the system by inducting newer technology and bringing about changes in procedures.
9. System should have objective and publicly disclosed criteria for participation, which permit fair and open access.	The access criteria laid down for becoming members of the clearing house are explicit and are disclosed. Constituents have to be banks fulfilling certain other minimum criteria (not applicable in case of post offices). For other players such as PDs and mutual funds, explicit rules of eligibility have been laid down by the central bank. The model URR for clearing houses provide for orderly removal of a member from the clearing house in case its continuance may cause dislocation / risk to the smooth functioning of the system.
10. Governance arrangements should be effective, accountable and transparent.	The clearing house is an association of member banks governed by URR. It has a Standing Committee for day-to-day governance and a general body where all major decisions are discussed and approved by the members. The members enter into contracts with the bank managing the clearing house wherein the duties and responsibilities are clearly spelt out.

2.125 Networking in banks is also an important activity which has been receiving focused attention. As part of the Indian Financial Network (INFINET), the number of Very Small Aperture Terminals (VSATs) rose from 924 at end-March 2002 to more than 2000 at end-June 2003. The notification of the Institute for Development and Research in Banking Technology (IDRBT) as the Certification Authority and the establishment of Registration Authorities in various banks during the year would lead to exchange of secured electronic message using digital signatures and Public Key Infrastructure (PKI)-based encryption.

Integration of IT Strategy and Business Strategies of Banks

2.126 The World Bank had sanctioned a Modernisation and Institutional Development Loan (MIDL) of US $ 83.7 million in 1995 under the Financial Sector Development Project to six participating banks (PBs). The financial assistance is intended to help the PBs to build financial strength and long-term competitiveness in a more liberalised business and banking environment.

2.127 During its visit in February 2001, the World Bank Review Team had observed that the computerisation efforts of the PBs had largely gone into house keeping areas like book-keeping and reconciliation. The IT infrastructure was found to be driven by technology and not by business and customer needs. The impact of the computerisation was characterised by a focus on "hardware" installation and was not fully reflected in productivity. They further observed that the progress in networking was not very satisfactory. There was an absence of integration of IT strategies with business strategy of PBs. As a result, even where proper infrastructure had been set up, it was not used by the customers to the extent necessary to break even and hence the consequential benefits were not accruing to banks. The World Bank suggested that the Reserve Bank could take a lead role and issue guidelines to banks, helping them integrate their IT strategy with business strategies. It was, therefore, decided to engage the services of the National Institute of Bank Management (NIBM) to conduct a study on integration of IT strategy with strategic business plans of banks. The purpose of the study is not to analyse the performance of the six participating banks but to consider these banks as case studies. The NIBM forwarded a detailed project report on the subject on May 30, 2003 which is being processed for issue of suitable guidelines to the banks.

11. Other Developments

Immediate Credit for Cheques

2.128 Based on the recommendation of the Indian Banks' Association (IBA), it has been decided that the present ceiling of Rs.7,500 should be enhanced to Rs.15,000 for immediate credit of outstation / local cheques subject to the existing guidelines issued by the Reserve Bank. These guidelines mainly relate to extension of such facility to all individual depositors without laying any stipulation for minimum balance for the purpose, proper conduct of account of customer, charging of interest for the period the bank is out of funds in the event of cheque being returned unpaid and publicity of availability of such facilities at branches.

Savings Bank Accounts

2.129 Banks have been advised that they should inform customers regarding the requirement of minimum balance at the time of opening the savings bank account and also any subsequent changes in this regard to the account holders in a transparent manner as deemed fit by them.
2.130 Banks have been allowed to open savings bank accounts in the names of State Government departments / bodies / agencies in respect of grants / subsidies released for implementation of various programmes / schemes sponsored by State Governments on production of an authorisation to the bank from the respective Government departments certifying that the concerned Government department or body has been permitted to open savings bank account. An amended directive has been issued to the banks in this regard in December 2002.

Dishonour of Cheques - Streamlining of Procedure

2.131 On January 28, 1992, banks were advised to implement the recommendation of the Goiporia Committee relating to return / despatch of dishonoured instruments to the customer within 24 hours. However, in light of the recommendations of the JPC on the Stock Market Scam and Matters Relating Thereto, the extant instructions relating to return of all dishonoured cheques have been reviewed. It has been suggested that in addition to the existing instructions in respect of dishonoured instruments for want of funds, banks may follow the additional instructions laid down in the circular dated June 26, 2003 which could cover all cheques dishonoured on account of insufficient funds and not only those relating to settlement transactions of Stock Exchanges. These instructions, *inter alia*, cover procedure for return / despatch of dishonoured cheques, banks' MIS on such cheques and procedure for dealing with cases of frequent dishonour of cheques.

2.132 Banks have also been advised to adopt, with the approval of their respective Boards, appropriate procedure for dealing with dishonoured cheques with inherent preventive measures, lay down requisite internal guidelines for their officers and staff and ensure strict compliance thereof.

Zero per cent Interest Finance Schemes for Consumer Durables

2.133 Banks were advised to charge interest on loans for purchase of consumer durables without reference to their PLR regardless of size of the loan amount. It was observed that some of the banks were providing low / zero per cent interest rates on consumer durables advances to borrowers through adjustment of discount available from manufacturers / dealers of consumer goods. Some of the banks promote such schemes by releasing advertisement in different newspapers and media indicating that they were promoting / financing consumers under such schemes. Since such loan schemes lack transparency in operations and distort pricing mechanism of loan products, banks were advised to refrain from offering such products.

Credit Facilities to Indian Joint Ventures / Wholly-owned Subsidiaries Abroad

2.134 The existing exchange control regulations permit Authorised Dealers to undertake investments in overseas markets subject to limits approved by their respective Boards. In view of the above, it was decided to revise the existing ceiling from 5 per cent of their unimpaired Tier - I capital to 10 per cent of unimpaired capital funds (Tier I and Tier II capital) for banks to offer credit / non-credit facilities to Indian joint ventures / wholly owned subsidiaries abroad, subject to the prescribed conditions. This facility has been permitted to banks to provide additional avenues for deployment of funds held in Foreign Currency Non-Resident (Bank) Deposit (FCNR(B)), Exchange Earners Foreign Currency (EEFC) and Resident Foreign Currency (RFC) accounts. The position would be reviewed after one year.

'Know Your Customer' – Identification of Depositors

2.135 As part of the 'Know Your Customer' (KYC) principle, the Reserve Bank has issued several guidelines relating to identification of depositors and advised the banks to put in place systems and procedures to control financial frauds, identify money laundering and suspicious activities and scrutinize / monitor large-value cash transactions. They have also been advised from time to time to be vigilant while opening accounts for new customers to prevent misuse of the banking system for perpetration of frauds. Taking into account recent developments, both domestic and international, it was decided to reiterate, reinforce and consolidate the extant instructions on KYC norms and cash transactions with a view to safeguarding banks from being unwittingly used for the transfer or deposit of funds derived from criminal activity (both in respect of deposit and borrowal accounts), or for financing of terrorism.

Bank Finance for PSU Disinvestment Programme of Government of India

2.136 Disinvestment in public sector undertakings (PSUs) has relevance for the economic reform process of the country and availability of bank finance to the bidders would help in the successful completion of the disinvestment programme. Banks were, therefore, allowed to extend finance to the successful bidders for acquisition of shares of PSUs under the Government of India's disinvestment programme. It was, however, specified initially that shares pledged to the bank should be marketable without lock-in period. The guidelines were subsequently relaxed allowing banks to extend finance to the successful bidders even though the shares of the disinvested company acquired / to be acquired by the successful bidder are subjected to a lock-in period / other such restrictions which affect their liquidity, subject to fulfillment of certain conditions.

2.137 Banks are precluded from financing investments of NBFCs in other companies and inter-corporate loans / deposits to / in other companies. The position was reviewed and banks are advised that Special Purpose Vehicles (SPVs) which comply with the certain conditions would not be treated as investment companies and therefore would not be considered as NBFCs, and such SPVs would be eligible for bank finance for PSU disinvestment by the Government of India.

12. Implementation of Recommendations of Joint Parliamentary Committee

2.138 The Parliament constituted a Joint Committee on 'Stock Market Scam and Matters Relating Thereto' (Chairman: Shri P. M. Tripathi) on April 27, 2001 with Members of Parliament as members. The terms of reference of the JPC were:

- To go into the irregularities and manipulations in all their ramifications in all transactions, including insider trading, relating to shares and other financial instruments and the role of the banks, brokers and promoters, stock exchanges, FIs, corporate entities and regulatory authorities;
- to fix the responsibility of the persons, institutions or authorities in respect of such transactions;
- to identify the misuse, if any, of and failures / inadequacies in the control and supervisory mechanism;
- to make recommendations for safeguards and improvements in the systems to prevent recurrence of such failures;
- to suggest measures to protect small investors; and
- to suggest deterrent measures against those found guilty of violating the regulations.

2.139 After several rounds of deliberations with various agencies and others, the Committee submitted its Report to Parliament on December 19, 2002. The JPC made in all 275 observations / recommendations; about one-third of which pertain to the Reserve Bank. These observations / irregularities mainly concern violations of the Reserve Bank norms / guidelines on banking transactions by a few commercial / co-operative banks particularly in collusion with certain stock brokers, laxity in follow-up of inspection reports, diversion of funds by borrowers, lack of coordination / effective monitoring / prompt action on the part of various regulators to check the scam, *etc.* The Committee, *inter alia,* recommended strengthening of supervision / monitoring systems of banking and financial sectors, legislative reforms to strengthen the supervision system, action against officials / borrowers involved in scam-related transactions, anticipation and pre-emptive action in a coordinated manner by regulators, insurance cover for depositors of NBFCs and corporate governance in banks.

2.140 The implementation of the recommendations of the JPC on Stock Market Scam and matters relating thereto has been taken up on an urgent basis to remove certain irregularities that have occurred in the transitional phase (Box II.12).

Box II.12: Progress Report on the Recommendations of the Joint Parliamentary Committee (JPC) on the Stock Market Scam and Matters Relating Thereto

The Reserve Bank has taken the following major measures on the recommendations of JPC:

(a) Urban Co-operative Banks (UCBs)

(i) UCBs have been advised to designate a senior official as compliance officer who should ensure to furnish compliance to the observations made in the inspection report to the Reserve Bank within the prescribed time limit.

(ii) UCBs have been advised to furnish important findings of the inspection of UCBs to the Chief Secretary of the State concerned.

(iii) Concurrent audit has been introduced for all UCBs. (iv) Instructions have been introduced to the UCBs making it obligatory on the part of Audit Committee to monitor implementation of the Reserve Bank guidelines. (v) UCBs have been advised that they should rectify the deficiencies / irregularities observed during the inspection in all respects for specific compliance in each case within a maximum period for four months from the date of inspection.

(vi) The UCBs have been advised to co-opt two professional directors with experience in banking and related areas with a view to improving the governance standards in the banks.

(vii) The Reserve Bank has also initiated steps to strengthen off-site surveillance of UCBs. With this end in view, an Off-Site Surveillance Division (OSS) has been set up in the Reserve Bank to detect early warning signals which will facilitate initiation of immediate corrective action.

(viii) The Reserve Bank has also initiated a Technical Assistance Programme (TAP) to strengthen the Management Information System (MIS) in UCBs in collaboration with external training institutions like the National Institute of Bank Management (NIBM), Pune, so as to ensure a robust MIS in UCBs as a support for decision making and regulatory compliance.

(ix) With effect from June 2002, an asset-liability management system has been introduced in scheduled UCBs under which the UCBs are required to manage their asset-liability mismatches within acceptable tolerance levels.

(x) The Regional Offices of the Reserve Bank have been advised to monitor the credit-deposit (CD) ratio of all UCBs to ensure that the high level of CD ratio is not being achieved by violating the statutory requirements on maintenance of cash reserve and liquid assets.

(xi) Instructions have been issued to UCBs regarding the ban on granting of loans and advances to the directors and their relatives on concerns in which they have interest.

(b) Commercial Banks

(i) Banks have been advised to put in place appropriate risk management systems to identify, measure, monitor and control the various risks to which they are exposed and also apprise their Boards in regard to the robustness of risk management systems and their compliance with RBI guidelines.

(ii) The effectiveness of risk management system would be examined specifically during the Annual Financial Inspection of the bank.

(iii) Detailed guidelines have been issued for uniform compliance with accounting standards.

(iv) Adoption of the prescribed system and risk control procedures for capital market exposures within the limits prescribed by the Reserve Bank in its circular of May 11, 2001 has been reiterated.
(v) Detailed instructions have been issued regarding the procedure to be followed by banks in respect of dishonoured cheques.

(c) Overseas Corporate Bodies (OCBs)

(i) Investments under the portfolio investment scheme by OCBs were banned with effect from November 29, 2001. Subsequently, with effect from September 16, 2003, OCBs are not permitted to make fresh investment under FDI scheme (including automatic route) and in other investments / deposits / loans under the various routes / schemes available to the non-residents under the extant Exchange Control Regulations. Further, the facility of opening and maintaining fresh Non-Resident (External) Accounts (NRE) (Savings, Current, Recurring or Fixed), Foreign Currency (Non-Resident) Accounts (Banks) [FCNR(B)] and Non-Resident Ordinary (NRO) Accounts with Authorised Dealers (ADs) in India by OCBs, stands withdrawn.

(ii) A floppy-based system for collection of sale / purchase statistics in respect of NRIs / OCBs (only sales in case of OCBs) from banks has since been introduced. A software has since been developed to receive the data by e-mail. In respect of Foreign Institutional Investors also, where data collection is through floppy-based system, it is proposed to convert this procedure to enable receipt of data through the e-mail module and the revised procedure is expected to be introduced shortly. The process of monitoring would be improved further once the Integrated Foreign Exchange Management System (IFMS) facilitated web-based reporting is operationalised.

(d) Other Measures

(i) The Reserve Bank has constituted various Working Groups to look into the systemic areas, *e.g.*, penal measures and criminal action against the borrowers who divert the funds with malafide intention, preparation of pilot policy statement on take over / merger of banks, identifying existing constraints in laws relating to regulation of financial markets, examination of existing system of supervision over UCBs, *etc.* Their recommendations are under examination / finalisation.

(ii) The Reserve Bank has forwarded to the Government of India amendments relating to Banking Regulation Act, in areas like enhancement of penal provision for false returns, non-compliance with the Reserve Bank instructions / directives and role of Nominee Directors.

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* The primary focus of the Chapter is on policy developments during 2002-03; nevertheless, wherever necessary, references are made to the recent policy developments.
1 While the policy measures are discussed in this Chapter with respect to fiscal 2002-03 (April-March) and 2003-04 (so far), the supervisory details are discussed over the period covering July 2002-June 2003, since the Reserve Bank's accounting year spans over July-June.
2 The categories are as follows: 1. Business Strategy; 2. Long-term Information System (IS) Strategy; 3. Short-term IS Strategy; 4. IS Security Policy; 5. Implementation of Security Policy; 6. IS Audit Guidelines; 7. Acquisition and Implementation of Packaged Software; 8. Development of software - in-house and outsourced; 9. Physical Access Controls; 10. Checklist for Operating System; 11. General Checklist for Application Systems Controls; 12. Database Controls; 13. Checklist for Network Management; 14. Maintenance related; and 15. Internet Banking.

3 Chapter VI looks into the details of the SC / RCs.