Chapter II

Policy Developments in Commercial Banking*

2.1 As financial institutions expand and become increasingly complex under the impact of deregulation, innovations and technological upgradation, the role of supervision and regulation becomes critical for the stability of the system. The choices before the financial institutions and their regulators are changing dramatically, with the need for supervisory rules and guidelines to evolve with the changing financial conditions, as also with the changing risk appetite and risk management approaches. The most important challenge before the supervisors is developing an approach to regulation that would work in a world of plurality, diversity and dynamism. During the past decade, the process of financial transformation in India has also been marked by wide-ranging changes in the policy environment.

2.2 Management of the financial sector over the years has been oriented towards maintaining a balance between efficiency and stability, while pursuing gradual economic integration with the rest of the world. In India, financial sector reforms have sought to strengthen the regulatory and supervisory framework and to bring it at par with international best practices, along with suitable country-specific adaptations. This has also been the guiding principle in the approach to the New Basel Accord. During 2003-04, 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 so as to enhance efficiency of the financial system.

2.3 Against this backdrop, the present Chapter provides an overview of the policy initiatives in the Indian commercial banking sector during 2003-04 and in 2004-05 so far (up to October 2004). The changes in the overall thrust of monetary and credit policy are presented first in Section 2. This also includes a discussion on steps for improvement in credit delivery. Section 3 presents a review of the measures initiated in the area of prudential regulation, followed by Section 4 on developments regarding management of non-performing assets. Section 5 deals with developments in supervision and supervisory policy, which is followed in Section 6 by a discussion on the evolving consultative approach to policy formulation. Changes in money, Government securities and foreign exchange markets, technological developments and upgradation of legal infrastructure are presented in the subsequent Sections of 7, 8 and 9, respectively.

2. Monetary and Credit Policy

2.4 The policy statements of the Reserve Bank, announced twice during a year, were known as the *Credit Policy Statements* till 1992 - the year which marked the initiation of financial sector reforms. With the move towards a more market oriented financial system and operating procedures for monetary policy, the policy was renamed as the *Monetary and Credit Policy* so as to highlight the growing linkages between the two. Apart from credit pricing and credit delivery, regulatory policies were also recognised to be important for channelling the flow of credit. In the succeeding years, the Reserve Bank policy statements became increasingly comprehensive discerning the links between monetary policy, credit policy and regulatory regime in a dynamic situation involving overall structural transformation of the real sector, the financial sector and the opening of the economy. Recognising the overall interplay of these factors, the Reserve Bank policy statement since 2004-05 has been renamed as the *Annual Policy Statement.*

* The primary focus of the Chapter is on policy developments during 2003-04; nevertheless, wherever necessary, references are made to the recent policy developments.

2.5 Although the policy objectives of the Reserve Bank have remained broadly unchanged over the years, there is some change in emphasis from time to time. In addition to the traditional objectives of growth and price stability, a third objective that has been gaining importance in the post reform period is that of financial stability. While in the short run, there may exist some trade-offs between the stated objectives, in the long run, the complementarities among them become more pronounced.

2.6 The focus on growth and stability continued to be reflected in the overall stance of monetary policy in recent years. The overall stance of monetary policy for 2003-04 and reiterated in the mid-term review of monetary and credit policy 2003-04 included: (i) 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; and (ii) to continue with the stance of a preference for a soft and flexible interest rate environment within the framework of macroeconomic stability. But monetary management in 2003-04 was confronted with an increase in the volatility of inflation rate as well as a continued abundance of liquidity. Recognising these, as well as factoring in the prospects for the real sector, inflationary expectations and international developments, especially the hardening of oil and commodity prices, the policy stance for 2004-05 was fine-tuned: (i) to provide adequate liquidity to meet credit growth and support investment and export demand in the economy while keeping a very close watch on the movements in the price level; and (ii) while continuing with the *status quo,* to pursue an interest rate environment that is conducive to maintaining the momentum of growth, and macroeconomic and price stability. The annual policy Statement of 2004-05 emphasised, barring the emergence of any adverse and unexpected developments in the various sectors of the economy and assuming that the underlying inflationary situation does not turn adverse, the above-mentioned stance would be maintained. Though monetary management in the first half of 2004-05 was conducted broadly in conformity with the monetary policy stance announced in the annual policy Statement of 2004-05, monetary management faced severe challenges on two counts: (i) overhang of liquidity; and (ii) acceleration in headline WPI inflation beyond the anticipated level with implications for inflationary expectations. While capital inflows were not at the level of the previous year, the carry forward of liquidity into the current fiscal year was over Rs.81,000 crore. The liquidity balance was complicated further by a sharp increase in reserve money in the previous year emanating largely from build-up of excess cash balances by commercial banks towards the close of the year, in fact in the last week of March 2004. As the overall assessment of the inflation scenario revealed that it was largely supply induced, it was necessary to balance the pros and cons of using monetary policy instruments as a means for stabilising inflationary expectations. Given the large informal sector and the fact that the vast majority of population is not hedged against inflation, determined efforts were needed to contain inflationary expectations while carefully assessing the facts and reasons on an ongoing basis for appropriate policy responses and communicating the assessments and policy responses from time to time. Subsequent to the announcement of the annual policy Statement of 2004-05 in May 2004, a number of calibrated responses were taken to moderate inflationary expectations and reiterate the importance of stability in financial market conditions, while ensuring that appropriate liquidity is maintained in the system. Consistent with the developments during the first half of 2004-05, barring the emergence of any adverse and unexpected developments in the various sectors of the economy and keeping in view the inflationary situation, the overall stance of monetary policy for the second half of 2004-05 was formulated as: provision of appropriate liquidity to meet credit growth and support investment and export demand in the economy while placing equal emphasis on price stability; consistent with the above, to pursue an interest rate environment that is conducive to macroeconomic and price stability, and maintaining the momentum of growth; and to consider measures in a calibrated manner, in response to evolving circumstances with a view to stabilising inflationary expectations.

2.7 The policy statements as well as mid-term reviews of the Reserve Bank have been focusing on the structural and regulatory measures to strengthen the financial system. The policy 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, and developing technological and institutional infrastructure.

With a paradigm shift from micro-regulation to prudential regulation and macro-management, the monetary and credit policy 2003-04 placed emphasis on promoting financial stability through developing sound risk management systems and enhancing transparency and accountability while continuing the stance stated earlier. The annual policy Statement of 2004-05 in particular has placed greater emphasis on the need to enhance the integration of various segments of the financial market, improve credit delivery system, nurture the conducive credit culture and improve the quality of financial services. In view of the above, structural and regulatory measures aimed at increasing the operational effectiveness of monetary policy, redefining the regulatory role of the Reserve Bank, strengthening the prudential and supervisory norms and developing the institutional infrastructure have gained prominence. The Reserve Bank is continuously working towards consolidating the gains of financial sector reforms by further broadening the consultative process. While the emphasis, at this stage, is on reinforcing corporate governance within financial institutions, the focus is also on enhancing the credit delivery mechanism and facilitating ease of transactions by the common person.

Statutory Pre-emptions

2.8 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. Consequently, a phased reduction in Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) has taken place since 1991, thereby releasing the resources pre-empted earlier by reserve requirements.

Cash Reserve Ratio

2.9 The CRR of scheduled commercial banks (SCBs) which was 15 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. On a review of the macroeconomic situation, the CRR was increased by one-half of one percentage point of the NDTL in two stages - to 4.75 per cent effective September 18, 2004 and further to 5.0 per cent effective October 2, 2004. Also in line with the recommendations of the Internal Group on Liquidity Adjustment Facility (LAF) (December 2003), the remuneration on eligible cash balances under CRR has been delinked from the Bank Rate and placed at a rate lower than the repo rate, at 3.5 per cent effective September 18, 2004. However, the Reserve Bank would continue to pursue its medium-term objective of reducing CRR to its statutory minimum of three per cent. The Reserve Bank chose to increase the CRR, partly for absorbing liquidity in the system, but more importantly for signalling the Reserve Bank's concern at the unacceptable levels of inflation so that inflationary expectations are moderated while reiterating the importance of stability in financial market conditions.

Statutory Liquidity Ratio

2.10 The Statutory Liquidity Ratio has been progressively brought down from the peak rate of 38.5 per cent in February 1992 to the statutory minimum of 25.0 per cent in October 1997. Commercial banks, however, hold SLR securities well in excess of the statutory prescription in response to attractive risk-free yields. The banking system held SLR securities to the extent of 41.3 per cent of its NDTL as at end-March 2004.

Interest Rate Structure

2.11 Prior to the reforms, direct monetary controls coupled with administered lending and deposit rates created distortions in both supply and demand for credit. The structure of administered interest rates has since been almost totally dismantled. Banks now have sufficient flexibility to decide their deposit and lending rate structures and manage their assets and liabilities accordingly. At present apart from savings account and NRE deposits on the deposit side and export credit and small loans on the lending side, all other interest rates are deregulated.

Bank Rate and Repo Rate

2.12 With the gradual liberalisation of interest rates by the mid-1990s, the Reserve Bank was able to reactivate the Bank Rate as a signalling device in April 1997 by linking rates on various standing facilities to the same. Bank Rate was used to signal the stance of policy in association with other supporting instruments. In the recent period, given

the surplus liquidity conditions in the financial market, coupled with the fact that discretionary liquidity was being provided at the reverse repo rate[1] as and when required, the importance of the Bank Rate as a signalling rate declined. It is desirable that the liquidity injections take place at a single rate. Accordingly, the Internal Group on LAF suggested that the Bank Rate, under normal circumstances, be aligned to the reverse repo rate, and accordingly the entire liquidity support including refinance could be made available at the reverse repo rate/Bank Rate. The Bank Rate/reverse repo rate would, therefore, provide the upper bound to the interest rate corridor. The Group also suggested that the Reserve Bank may continue to announce the Bank Rate independently. On a review of macroeconomic developments, the Bank Rate, which was reduced from 6.25 per cent to 6.0 per cent on April 29, 2003, was left unchanged in the mid-term Review of the annual policy for 2004-05.

2.13 The LAF, which has been increasingly emerging as the principal operating instrument of monetary policy, allows the Reserve Bank to manage market liquidity on a daily basis while helping the short-term money market interest rates to move within a corridor thereby imparting stability and facilitating the emergence of a short-term rupee yield curve. Taking into account recommendations of the Internal Group on LAF and the suggestions from the market participants and experts, the revised LAF scheme came into effect from March 29, 2004. The scheme outlined: (i) 7-day fixed rate repo to be conducted daily in place of daily LAF auctions and (ii) overnight fixed rate reverse repo to be conducted daily, on weekdays. Also the 14-day repo, which was reintroduced through an announcement made on November 5, 2001, conducted at fortnightly intervals, was being continued for some time in order to enable market participants to meet their prior commitments. With a view to enhancing further the effectiveness of LAF and to facilitate liquidity management in a flexible manner, the mid-term Review of annual policy for 2004-05 proposed that the LAF scheme would be operated with overnight fixed rate repo and reverse repo with effect from November 1, 2004, and accordingly, auctions of 7-day and 14-day repo (reverse repo in international parlance) have been discontinued from November 1, 2004. With effect from October 29, 2004, it has been decided to adopt the international usage of 'Repo' and 'Reverse Repo' terms under LAF operations. Accordingly, absorption of liquidity by the Reserve Bank in the LAF window is being termed as 'reverse repo' and injection of liquidity as 'repo'.

2.14 Under the revised LAF Scheme, the Reserve Bank continues to have the discretion to conduct overnight repo/longer term repo/reverse repo auctions at fixed rate or at variable rates, and has the discretion to change the spread between the repo rate and the reverse repo rate as and when appropriate keeping in view the market conditions and other related factors. On an assessment of the prevailing situation, overnight fixed rate repo at 4.5 per cent under LAF has been introduced in addition to the existing overnight fixed rate reverse repo at 6.0 per cent with effect from August 16, 2004. In view of the current macroeconomic and overall monetary conditions, it has been decided to increase the fixed repo rate by 25 basis points from 4.50 per cent to 4.75 per cent effective from October 27, 2004. The spread between the repo rate and the reverse repo rate, which was reduced by 50 basis points from 200 basis points to 150 basis points with effect from March 29, 2004, has further been reduced by 25 basis points from 150 basis points to 125 basis points with effect from October 27, 2004. Accordingly, the fixed reverse repo rate under LAF continues to remain at 6.0 per cent.

Deposit Rates

2.15 Prescriptions of interest rates on all term deposits, including conditions of premature withdrawal, and offering of the uniform rate irrespective of size of deposits have been dispensed with. At present, on the deposit side, only savings deposit rate (which is at 3.5 per cent per annum currently) and NRI deposit rate are being prescribed by the Reserve Bank. Banks are otherwise free to offer interest rates on deposits of any maturity above 15 days for regular deposits and 7 days for wholesale deposits (over Rs.15 lakh) from residents. In the

[1] In the international parlance, while 'repo' denotes injection of liquidity by the central bank against eligible collateral, 'reverse repo' denotes absorption of liquidity by the central bank against eligible collateral. On the contrary, in the Indian context 'repo' denotes liquidity absorption by the Reserve Bank and 'reverse repo' denotes liquidity injection.

mid-term Review of annual policy for 2004-05 banks have been allowed to reduce the minimum tenor of retail domestic term deposits (under Rs.15 lakh) from 15 days to 7 days, at their discretion. Banks, however, would continue to have the freedom to offer differential rates of interest on wholesale domestic term deposits of Rs.15 lakh and above as earlier. There are, however, interest rate ceilings prescribed for foreign currency denominated deposits and rupee deposits from non-resident Indians (NRIs), and such ceilings will have to continue as part of managing external debt flows, especially the short-term flows.

2.16 In view of the implications for the interest rate structure and the high fiscal cost of the small savings schemes, the Union Government constituted an Advisory Committee to advise on the Administered Interest Rates and Rationalisation of Saving Instruments (Chairman: Dr. Rakesh Mohan)[2] on January 24, 2004. While the Committee was in favour of continuing with most of the small saving schemes, given their popularity in the rural and semi-urban areas, it recommended discontinuance of a few saving instruments offered by the Government where investments are primarily motivated by tax benefits available under Section 88 and Section 10 of the Income Tax Act. The Committee, however, preferred to continue with the PPF Scheme in its present form. After considering alternative benchmarks and a fixed illiquidity premium of 50 basis points, the Committee decided to continue with average yields on Government securities as the most suitable benchmark in line with the suggestion made by the Reddy Committee[3]. A few recommendations of the Committee in respect of introduction of a Senior Citizens' Savings Scheme and discontinuation of the Deposit Scheme for Retiring Employees and 6.5 per cent Saving Bonds 2003 (non-taxable) have already been implemented by the Central Government with certain modifications.

2.17 Since banks have been given freedom to determine interest rates on deposits and advances and the extant guidelines cover only certain operational matters, there have been requests from various quarters for rationalisation of the operational guidelines relating to deposits. A Working Group was constituted to review the whole range of the regulations, instructions and guidelines governing the interest rate structure, (Chairman : Shri H. N. Sinor), with representation from select banks, Indian Banks' Association (IBA) and the Reserve Bank. The Group's Report was examined by the Reserve Bank and based on its recommendations, instructions were issued to banks on February 13, 2004 effecting the following changes in the extant guidelines: (i) all aspects concerning renewal of overdue deposits to be decided by individual banks subject to their Boards laying down a transparent, non-discretionary and non-discriminatory policy in this regard and (ii) decisions on margin on advances against term deposits and interest payable on maturity proceeds of deposit accounts of deceased depositors also to be left to the discretion of individual banks subject to their Boards laying down a transparent policy in this regard.

NRI Deposit Scheme

2.18 The deposit schemes available to the NRIs have been streamlined and currently three schemes, *viz.*, Foreign Currency (Non-Resident) Account (Banks) [FCNR(B)] Scheme, Non-Resident (External) Rupee [NRE] Account Scheme and the Non-Resident (Ordinary) [NRO] Account Scheme are under operation (Box II.1). Fresh deposits under Non-Resident (Non-Repatriable) Rupee [NRNR] Account Scheme or the Non-Resident (Special) Rupee [NRSR] Account Scheme were discontinued with effect from April 1, 2002, and existing deposits were to continue only up to the date of maturity. On maturity of the existing deposits under the NRNR Account Scheme and NRSR Account Scheme, the maturity proceeds would be credited to the account holder's NRE Account and NRO Account, respectively.

2.19 Banks in India were offering FCNR(B) deposits in foreign currency and NRE deposits in domestic currency to the NRIs. While the interest rates on the former were linked to LIBOR/SWAP rates, interest rates on the latter were at par with domestic deposit rates. Given the fact that NRE deposits are fully repatriable, in order to provide consistency in the interest rates offered to NRIs,

[2] Government of India (2004), 'Report of the Advisory Committee to Advise on the Administered Interest Rates and Rationalisation of Savings Instruments', *Reserve Bank of India Bulletin*, August.

[3] Government of India (2001), 'Report of the Expert Committee to Review the System of Administered Interest Rates and other Related Issues', September 17.

Box II.1: Features of Various Deposit Schemes Available to NRIs

Particulars	FCNR(B) Account	NRE Account	NRO Account
Type of Account	Term Deposits only	Savings, Current, Recurring, Fixed Deposits	Savings, Current, Recurring, Fixed Deposits
Eligibility	NRIs (Individuals/entities of Bangladesh/Pakistan nationality/ownership require prior approval of the Reserve Bank)	NRIs (Individuals/entities of Bangladesh/Pakistan nationality/ownership require prior approval of the Reserve Bank)	Any person resident outside India (other than a person resident in Nepal and Bhutan) (Individuals/entities of Bangladesh/Pakistan nationality /ownership as well as erstwhile OCBs require prior approval of the Reserve Bank)
Currency in which account is denominated	Pound Sterling, US Dollar, Japanese Yen and Euro	Indian Rupees	Indian Rupees
Rate of Interest	Subject to cap: LIBOR minus 25 basis points except in case of Japanese Yen where the cap would be based on the prevailing LIBOR rates	Subject to cap: **Fixed Deposits**: Should not exceed LIBOR/SWAP rates for US Dollar of corresponding maturity plus 50 basis points. **Savings Bank accounts**: Should not exceed LIBOR/ SWAP rate for six months maturity on US Dollar deposits plus 50 basis points.	**Fixed Deposits**: Banks are free to determine interest rates. **Savings Bank accounts**: Same as domestic savings bank accounts of resident Indians.
Repatriability	Repatriable	Repatriable	Not repatriable except for the following in the accounts: 1. Current income. 2. Up to US $ 1 million per calendar year for any bonafide purpose out of the balances in NRO account/sales proceeds of assets. Immovable property should have been held for a period not less than ten years. 3. If the immovable property acquired out of rupee funds is sold after being held for less than ten years, remittance can be made, if the sale proceeds were held for the balance period in NRO account (Savings/Term Deposit) or in any other eligible investment, provided such investment is traced to the sale proceeds of the immovable property.

Notes:
1. When a person resident in India leaves India for Nepal and Bhutan for taking up employment or for carrying on business or vocation or for any other purposes indicating his intention to stay in Nepal and Bhutan for an uncertain period, his existing account will continue as a resident account. Such account should not be designated as Non-resident (Ordinary) Rupee Account (NRO).
2. ADs may open and maintain NRE/FCNR(B) accounts of persons resident in Nepal and Bhutan who are citizens of India or of Indian origin, provided the funds for opening these accounts are remitted in freely convertible foreign exchange. Interest earned in NRE/FCNR (B) accounts can be remitted only in Indian Rupees to NRIs and Person of Indian Origin (PIO) resident in Nepal and Bhutan.
3. In terms of Regulation 4(4) of the Notification No.FEMA 5/2000-RB dated May 3, 2000, ADs may open and maintain Rupee accounts for a person resident in Nepal/Bhutan.

an interest rate ceiling linked to the LIBOR/SWAP rates was prescribed on NRE deposits in stages during 2003-04. The ceiling on interest rates on fresh (and renewals of) term deposits for one to three years under the NRE scheme was placed at 250 basis points above the LIBOR/SWAP rates for the US dollar of corresponding maturity, effective July 17, 2003. The spread over LIBOR/ SWAP rates was reduced to 100 basis points, effective September 15, 2003 and further to 25 basis points effective October 18, 2003. NRE deposit rates were placed at LIBOR/SWAP rates

effective April 17, 2004 in pursuance of the recommendations of the Internal Group on External Liabilities of Scheduled Commercial Banks which proposed alignment of NRE term deposit rates with international rates. Further, the NRE savings deposit rate was capped at a maximum of LIBOR/SWAP rates for six months' maturity on US dollar deposits effective April 17, 2004. No lien of any type, direct or indirect, is permitted against the balances in NRE savings accounts. In the mid-term Review of annual policy for 2004-05, the ceiling on NRE interest rates was raised to LIBOR/SWAP rates of US dollar of corresponding maturities plus 50 basis points. However, the ceiling on FCNR(B) deposit rates continue to be at LIBOR/SWAP rates of corresponding maturities minus 25 basis points. With a view to bringing NRE accounts at par with the domestic deposits, the Union Budget 2004-05 proposed the withdrawal of tax exemptions on interest earned from a NRE account and interest paid by banks to a non-resident or to a not-ordinarily resident on deposits in foreign currency with effect from April 1, 2005.

2.20 As part of the ongoing liberalisation of foreign exchange payments, supported by the steady accumulation of foreign exchange reserves in the face of strong capital inflows, a number of measures were undertaken in 2003-04 to further liberalise the payments regime for individuals (Box II.2).

Box II.2: Channels of Remittance to India

While bulk of the inward remittances to India takes place through banking channels, two schemes, *viz.*, Money Transfer Service Scheme (MTSS) and Rupee Drawing Arrangements (RDA), have recently gained momentum on account of their speed and ease of operation.

MTSS is an approved method of transferring remittances from abroad to beneficiaries in India. Only personal remittances such as remittances towards family maintenance and remittances favouring foreign tourists visiting India are permissible. The system envisages a tie-up between reputed money transfer companies abroad and agents in India who have to be an Authorised Dealer, Full Fledged Money Changer, registered NBFC or International Air Transport Association (IATA) approved travel agent with a minimum net worth of Rs.25 lakh. The Indian agent requires the Reserve Bank approval to enter into such an arrangement. Remittances up to Rs.50,000 can be paid in cash, while any amounts in excess of this amount have to be necessarily paid by cheque/demand draft. The system does not envisage the repatriation of such inward remittances. Currently, there are 14 overseas principals who have tie-ups with 39 Indian entities. Collateral equal to 3 days' drawings or US $ 50,000 (whichever is higher) is placed by the overseas principals to indemnify the Indian agents against possible defaults. Limits have been placed on the maximum amount permissible per remittance as well as the number of remittances allowed to be received by each beneficiary. The agents have to maintain clear audit trails of all transactions undertaken by them. An amount of US $ 837 million was received through this arrangement during January-December 2003 as against US $ 555 million during 2002, an increase of 51 per cent.

Rupee Drawing Arrangements (RDA) are entered into by banks in India with Private Exchange Houses in the Gulf Region, Singapore and HongKong for channelising inward remittances. Authorised Dealers need the prior approval of the Reserve Bank to enter into RDA with Exchange Houses and open vostro accounts in their name. Inward remittances under the scheme are normally personal remittances from NRIs in the above countries. Trade remittances up to Rs.2 lakh per transaction can also be funded through these arrangements. Under RDA, banks may enter into arrangements under Designated Depository Agency (DDA), Non-Designated Depository Agency, or Speed Remittance procedures.

Under DDA procedure, the Exchange House issues rupee drafts to the beneficiary and at the end of each day arrives at the total drawings and deposits their daily collections on the next working day in the DDA account (this account is a designated account opened in the name of the drawee bank by the Exchange House with a bank acceptable to the drawee bank at a centre mutually agreed upon). Auditors are appointed by the bank to ensure that daily drawings are deposited by the Exchange House in the DDA account on the next working day. The funds so deposited are transferred to the nostro account of the bank within the float period. Interest earned on the funds till the date of transfer to the nostro account accrues to the Exchange House. No collateral security is to be placed by the Exchange House under this kind of arrangement in the normal course.

Under Non-DDA procedure, the Exchange House directly credits the nostro account of the bank with the total of daily drawings. As no auditors are appointed to oversee the transfers to the nostro accounts, collateral deposits equivalent to one month projected drawings are insisted upon (15 days cash and 15 days bank guarantee).

Under Speed Remittance, the Exchange House sends instructions electronically to the bank with complete details of the beneficiary and funds their rupee account through the bank's nostro account well in advance before issuing payment instructions. On verification of data and availability of balance in the vostro account, the bank issues drafts in favour of the beneficiary or directly credits the beneficiary's account. No payments are made unless clear funds are available in the account. A collateral deposit equivalent to 15 days' drawings is prescribed for operation of this arrangement.

Currently, there are 29 banks which have entered into 188 Rupee Drawing Arrangements with Exchange Houses. Remittances received through these arrangements have increased by 14.3 per cent from US $ 4,670 million in 2002 (January-December) to US $ 5,337 million in 2003.

2.21 Under the Liberalised Remittance Scheme for resident individuals as a part of liberalisation, general powers have been granted to resident individuals to freely remit up to US $ 25,000 per calendar year for any permissible current or capital account transactions or a combination of both. They are free to acquire and hold immovable property or share or any other asset outside India without prior approval of the Reserve Bank. Individuals can also open, maintain and hold foreign currency accounts with a bank outside India for making remittances under the Scheme without prior approval of the Reserve Bank. The foreign currency accounts may be used for putting through all transactions connected with or arising from remittances eligible under this Scheme.

Facilities to Non-Resident Indians

2.22 Students going abroad for higher studies have been treated as non-residents for availing facilities towards release of foreign exchange. Residents were also allowed greater flexibility towards resource mobilisation from overseas through the NRI channel. General permission has been granted to resident individuals to borrow amounts not exceeding US $ 250,000 or its equivalent from close relatives abroad. The loan should be interest-free and have a minimum maturity period of one year.

2.23 Moreover, a number of measures were undertaken to achieve greater integration between current and capital account transactions in respect of NRIs. Authorised Dealers (ADs) are now permitted to grant rupee loans to NRIs as per policy laid down by the bank's Board of Directors, other than for purpose of (a) the business of chit fund, or (b) Nidhi Company, or (c) agricultural or plantation activities or in real estate business, or construction of farm houses, or (d) trading in Transferable Development Rights (TDRs), or (e) investment in capital market including margin trading and derivatives.

2.24 The close relatives (as defined under Section 6 of the Companies Act, 1956) of the NRI borrower in India are allowed to repay the instalment of housing loans, interest and other charges if any, through their bank account directly to the borrower's loan account with the authorised dealer/housing finance institution.

2.25 Deposits by NRIs with persons other than authorised dealers/authorised banks out of inward remittances from overseas or by debit to NRE/FCNR(B) Accounts shall henceforth not be permissible.

Lending Rates

2.26 Lending rates were deregulated in October 1994 and banks were required to announce a prime lending rate (PLR), taking into account the cost of funds and transaction cost with the approval of their Boards. Further, the system of tenor linked prime lending rates (TPLRs) was introduced in April 1999 to provide more operational flexibility to banks. However, lending rates across banks tended to vary widely with banks charging higher spreads over their PLRs to non-prime borrowers. Despite a fall in deposit rates and lowering of the cost of funds, the range of PLRs of public sector banks remained sticky downwards. In addition, multiplicity of PLRs imparted additional complexities to pricing of loans. In the interest of customer protection and to have greater degree of transparency in regard to actual interest rates charged to borrowers, banks were advised to provide information on maximum and minimum interest rates charged alongside their PLRs which were placed on the Reserve Bank website on a quarterly basis effective from June 2002. In order to address the downward stickiness of PLRs and wide disparity in charging interest to different category of borrowers, a scheme of Benchmark PLR (BPLR) was mooted by the Reserve Bank in the monetary and credit policy 2003-04 for ensuring transparency in banks' lending rates as also to reduce the complexity involved in pricing of loans. While arriving at their BPLR, banks were advised to take into account: (i) actual cost of funds, (ii) operating expenses and (iii) a minimum margin to cover regulatory requirements of provisioning/capital charge and profit margin. As all lending rates could be determined with reference to the BPLR, taking into account term premia and/or risk premia, the system of tenor-linked PLR was proposed to be discontinued.

2.27 The issues relating to the implementation of the system of BPLR were discussed with select banks and the IBA. It was clarified that since lending rates for working capital and term loans could be determined with reference to the BPLR by taking into account term premia and/or risk premia, a need for multiple PLRs might not be compelling. It was also clarified that banks have

the freedom to price their loan products based on time-varying term premia and relevant transaction costs. Banks could price floating rate products by using market benchmarks in a transparent manner. For smooth implementation of the new system by banks, the IBA issued a circular on November 25, 2003 to its member banks outlining broad parameters to be followed by banks for the computation of BPLR.

2.28 Almost all commercial banks have adopted the new system of BPLR and the rates have been lower in the range of 25-200 basis points from their earlier levels of PLRs[4]. Banks have also been advised to align the pricing of credit to assessment of credit risk so as to improve credit delivery and institutionalise a credit culture.

2.29 The only lending rates that are being regulated are those pertaining to exports, small loans of up to Rs.2 lakh, and the differential rate of interest (DRI) scheme (Box II.3).

Credit Delivery

2.30 The Reserve Bank has initiated a number of measures to improve the credit delivery system particularly for agriculture, exports, small-scale industry (SSI) and infrastructure. Selective credit controls have been dispensed with and micro-regulation of credit delivery has been discontinued. There is greater freedom to both banks and borrowers in matters relating to credit. There exists, however, concern on two areas of credit delivery, *viz.*, the priority sector lending and flow of credit to the needy and deserving on a timely basis.

2.31 The widening of the scope of priority sector lending alongwith interest rate deregulation has made priority sector lending far more flexible than before. There is a general consensus that the real issue in credit-delivery is timely availability of credit rather than its cost.

2.32 Regional rural banks (RRBs) are an important instrument for purveying rural credit. In order to strengthen RRBs, weak RRBs were recapitalised, lending to non-target group was relaxed, deposit and lending rates were deregulated. The Reserve Bank has constituted Empowered Committees in its Regional Offices with members drawn from NABARD, sponsor banks, conveners of State Level Bankers' Committees (SLBCs) and State Governments to ensure that the RRBs adhere to good governance and comply with prudential regulations. The Committees would also focus on operational issues and provide clarifications on regulatory issues. State Governments are being requested to remove discrimination between RRBs and co-operative banks in matters of stamp duty, mortgage fee, *etc*. State Governments are also being requested to accord approval for merger of RRBs within the State, sponsored by the same bank, as and when approached with such proposals. Sponsor banks are advised to provide support to their RRBs in matters relating to efficient management, training of staff, computerisation and networking of their activities.

Priority Sector Lending

2.33 A target of 40 per cent of net bank credit has been stipulated for lending to the priority sector by domestic scheduled commercial banks, both in the public and private sectors. Within this, sub-targets of 18 per cent and 10 per cent of net bank credit, respectively, have been stipulated for lending to agriculture and weaker sections of the population. A target of 32 per cent of net bank credit has been stipulated for lending to the priority sector by foreign banks. Of this, the aggregate credit to SSI sector should not be less than 10 per cent of the net bank credit and that to the export sector should not be less than 12 per cent of the net bank credit. A few changes were announced in the mid-term Review of annual policy for 2004-05 relating to priority sector lending by SCBs (Box II.4). The limit on advances under priority sector for dealers in agricultural machinery has been increased from Rs.20 lakh to Rs.30 lakh and for distribution of inputs for allied activities from Rs.25 lakh to Rs.40 lakh. All private sector banks have been urged to formulate special agricultural credit plans from the year 2005-06, targeting an annual growth rate of at least 20-25 per cent of credit disbursements to agriculture. The composite loan limit for SSI entrepreneurs has been enhanced from Rs.50 lakh to Rs.1 crore. In order to encourage securitisation of loans to SSI sector, investment by banks in securitised assets pertaining to SSI sector to be treated as their direct lending to SSI sector under priority sector, provided the pooled assets represent loans to SSI sector which are reckoned under priority sector and the securitised loans are originated by banks/FIs. At present, banks' direct finance for housing up to Rs.10 lakh

[4] Also see Table III.34 of the Report.

Box II.3: Interest Rate Structure for All Rupee Advances Including Term Loans of Commercial Banks

Types of Advances	Rate of Interest (Per cent per annum)
I. (a) Up to and inclusive of Rs.2 lakh	Not exceeding Benchmark Prime Lending Rate (BPLR)
(b) Over Rs.2 lakh	Banks are free to determine interest rates subject to BPLR and spread guidelines. Banks may, however, offer loans at below BPLR to exporters or other creditworthy borrowers including public enterprises based on a transparent and objective policy approved by their Boards.
II. Export Credit*	
1. Pre-shipment Credit	
(a) (i) Up to 180 days	Not exceeding BPLR minus 2.5 percentage points
(ii) Beyond 180 days and up to 270 days	Banks are free to determine rates of interest subject to BPLR and spread guidelines.
(b) Against incentives receivable from Government covered by ECGC Guarantee (up to 90 days)	Not exceeding BPLR minus 2.5 percentage points
2. Post-shipment Credit	
(a) On demand bills for transit period (as specified by FEDAI)	Not exceeding BPLR minus 2.5 percentage points
(b) Usance Bills (for total period comprising usance period of export bills, transit period as specified by FEDAI and grace period wherever applicable)	Not exceeding BPLR minus 2.5 percentage points
(i) Up to 90 days (may be extended for a maximum period of 365 days for eligible exporters under the Gold Card Scheme)	Not exceeding BPLR minus 2.5 percentage points
(ii) Beyond 90 days and up to 6 months from the date of shipment	Banks are free to determine interest rates subject to BPLR and spread guidelines.
(c) Against incentives receivable from Government, covered by ECGC Guarantee (up to 90 days)	Not exceeding BPLR minus 2.5 percentage points
(d) Against undrawn balances (up to 90 days)	Not exceeding BPLR minus 2.5 percentage points
(e) Against retention money (for supplies portion only) payable within one year from the date of shipment (up to 90 days)	Not exceeding BPLR minus 2.5 percentage points
III. Deferred credit for the period beyond 180 days	Banks are free to determine rates of interest subject to BPLR and spread guidelines.
IV. Export Credit not otherwise specified (ECNOS)	
(a) Pre-shipment credit	Banks are free to determine rates of interest subject to BPLR and spread guidelines.
(b) Post-shipment credit	Banks are free to determine rates of interest subject to BPLR and spread guidelines.
V. DRI Advances	4.0 per cent
VI. Loans covered by participation in refinancing schemes of term lending institutions	Free to charge interest rates as per stipulations of the refinancing agencies without reference to BPLR

VII. Banks are free to determine the rates of interest without reference to BPLR and regardless of the size in respect of following loans:

(a) Loans for purchase of consumer durables;
(b) Loans to individuals against shares and debentures/bonds;
(c) Other non-priority sector personal loans;
(d) Advances/overdrafts against domestic/NRE/FCNR(B) deposits with the bank, provided that the deposit/s stands/stand either in the name(s) of the borrower himself/borrowers themselves, or in the names of the borrower jointly with another person;
(e) Finance granted to intermediary agencies (excluding those of housing) for on lending to ultimate beneficiaries and agencies providing input support;
(f) Finance granted to housing finance intermediary agencies for on lending to ultimate beneficiaries;
(g) Discounting of Bills;
(h) Loans/Advances/Cash Credit/Overdrafts against commodities subject to Selective Credit Control.

* Effective from May 1, 2004 to April 30, 2005. Since these are ceiling rates, banks are free to charge any rate below the ceiling rates.

Box II.4: Major Policy Announcements in the Mid-Term Review of Annual Policy for the year 2004-05

1. Monetary Measures

- Bank Rate was kept unchanged at 6.0 per cent; the repo rate was increased by 25 basis points to 4.75 per cent from 4.50 per cent effective October 27, 2004. The fixed reverse repo rate under LAF continues to remain at 6.0 per cent.
- Revised LAF was made operative with overnight fixed rate repo and reverse repo, and accordingly, auctions of 7-day and 14-day repo (reverse repo in international parlance) were discontinued from November 1, 2004.

2. Interest Rate Policy

- Ceiling interest rates on NRE deposits was raised by 50 basis points from the existing level of US dollar LIBOR/SWAP rates of corresponding maturities.
- Banks to fix the ceiling on interest rates on FCNR(B) deposits on monthly basis.
- Minimum tenor of retail domestic term deposits (under Rs.15 lakh) can be reduced from 15 days to 7 days at the discretion of the banks.

3. Credit Delivery Mechanism

- The restrictive provisions of service area approach dispensed with, except for Government sponsored programme.
- The limit on advances under priority sector for dealers in agricultural machinery and for distribution of inputs for allied activities were enhanced from Rs.20 lakh to Rs.30 lakh and from Rs.25 lakh to Rs.40 lakh, respectively.
- Banks advised to make efforts to increase their disbursements to small and marginal farmers to 40 per cent of their direct advances under special agricultural credit plans (SACP) by March 2007.
- Private sector banks urged to formulate SACPs from the year 2005-06.
- The composite loan limit for SSI entrepreneurs enhanced from Rs.50 lakh to Rs.1 crore.
- Investment by banks in securitised assets pertaining to SSI sector to be treated as their direct lending to SSI sector under the priority sector, subject to conditons.
- Banks with the approval of their Boards, allowed to extend direct finance to housing sector up to Rs.15 lakh under priority sector lending.
- Banks enabled to finance distressed urban poor to prepay their debt to non-institutional lenders, against appropriate collateral or group security.
- In view of the expertise gained by NBFCs in the area, bank could extend finance to NBFCs against second hand assets financed by them.

4. Money Market

- With effect from the fortnight beginning January 8, 2005, non-bank participants would be allowed to lend, on average in a reporting fortnight, up to 30 per cent of their average daily lending in call/notice money market during 2000-01.
- The minimum maturity period of CP reduced from 15 days to 7 days with immediate effect, issuing and paying agents to report issuance of CP on the NDS by the end of the day effective from a future date, and a Group to be constituted to suggest rationalisation and standardisation of processing, settlement and documentation of CP issuance.

5. Government Securities Market

- Capital Indexed Bonds to be introduced during the year 2005-06 in consultation with the Government.
- To reduce the counter party risk, settlement of OTC derivatives through CCIL to be operationalised by March 2005.

6. Foreign Exchange Market

- General permission was given to ADs to issue guarantees/letters of comfort and letters of undertaking up to US $ 20 million per transaction for a period up to one year for import of all non-capital goods permissible under Foreign Trade Policy (except gold) and up to three years for import of capital goods, subject to prudential guidelines.
- 100 per cent Export Oriented Units (EOUs) and units set up under EHTPs, STPs and BTPs schemes to be permitted to repatriate the full value of export proceeds within a period of twelve months.
- The limit for outstanding forward contracts booked by importers/exporters increased, based on their past performance, from 50 per cent to 100 per cent of their eligible limit. However, the contracts booked in excess of 25 per cent of the eligible limits would be on deliverable basis.

7. Prudential Measures

- The risk weight in the case of housing loans and consumer credit increased from 50 per cent to 75 per cent and from 100 per cent to 125 per cent, respectively.
- Effective, March 31, 2005, an asset in respect of FIs would be classified as doubtful, if it remained in the sub-standard category for 12 months. FIs are permitted to phase out the consequent additional provisioning over a four-year period.
- Banks have been urged to make persistent efforts in obtaining consent from all their borrowers in order to establish an efficient credit information system.
- To constitute a Working Group on avoidance of conflicts of interest.
- To constitute a Working Group for evolving a framework for participation of banks in commodity futures market and examine the role of banks in providing loans against warehouse receipts.
- On the basis of the recommendation of the Working Group on Development Finance Institutions, approach for supervision of DFIs and large NBFCs proposed.
- With a view to smoothening the process of transition of RNBCs an approach to comply with Reserve Bank's direction on their investment portfolio proposed.

8. Payment and Settlement System

- The national settlement system (NSS) would be introduced in a phased manner and is expected to be operationalised in early 2005.
- The per transaction limits existing for Electronic Clearing System (ECS) and Electronic Fund Transfer (EFT) would be dispensed with, effective November 1, 2004.
- Central Board of Direct Taxes would grant refunds up to Rs.25,000 through ECS facility at select centres.
- High Powered Committee constituted for streamlining the systems and procedures in regard to transmission of data pertaining to excise duty and service tax.

in rural and semi-urban areas is treated as priority sector lending. In order to further improve flow of credit to the housing sector, banks, with the approval of their Boards, may extend direct finance to housing sector up to Rs.15 lakh, irrespective of location, as part of their priority sector lending. With a view to bringing in urban poor into formal financial system, banks were enabled to advance loans to distressed urban poor to prepay their debt to non-institutional lenders, against appropriate collateral or group security.

2.34 Domestic scheduled commercial banks, that have shortfalls in the priority sector or agricultural lending targets, are allocated amounts for contribution to Rural Infrastructure Development Fund (RIDF) established with NABARD. However, in the event of failure to attain the stipulated targets and sub-targets by foreign banks, they are required to make good the shortfall by depositing for a period of one year, an equivalent amount with the Small Industries Development Bank of India (SIDBI) at rate of interest as may be decided by the Reserve Bank from time to time. The details regarding operationalisation of the RIDF such as the amounts to be deposited by banks, interest rates payable on these deposits, period of deposits, *etc.*, are decided every year after the announcements in the Union Budget (Box II.5).

Credit to Agriculture

2.35 The declining share of agriculture in capital formation relative to its share in real GDP in recent years has been a cause of concern exacerbated by the declining credit-deposit ratio of the rural branches of SCBs. Additionally, several SCBs have been reporting shortfalls in lending to the priority sector including agriculture.

Box II.5: Rural Infrastructure Development Fund (RIDF)

The RIDF was established with NABARD in 1995-96 for assisting the State Governments and State-owned Corporations in expeditious completion of on-going projects relating to minor and medium irrigation, soil conservation, watershed management and other forms of rural infrastructure (such as rural roads and bridges, market yards, *etc.*). Subsequently, the RIDF was extended on a year-to-year basis by announcements in the Union Budget. In the Interim budget 2004-05, it was decided to set up a new fund in place of the RIDF to be named as Lok Nayak Jai Prakash Narayan Fund (LNJPNF). The LNJPNF set up with a corpus of Rs.50,000 spread over three years and comprising of three components *viz.,* finance for infrastructure development through State Governments, refinance for investments in agriculture, commercial infrastructure and selective cofinancing, and development measures and risk management, would replace the RIDF. However, the Union budget 2004-05 announced the revival of RIDF with revised guidelines.

The domestic scheduled commercial banks having shortfall in lending to the priority sector/agriculture targets are allocated amounts for contribution to RIDF.

The Fund has completed its ninth year of operation. Initially, irrigation projects were given a major thrust, while rural roads and bridges received priority from RIDF II onwards. Since then, many other activities such as rural drinking water schemes, soil conservation, rural market yards, rural health centres and primary schools, mini hydel plants, Shishu Shiksha Kendras, Anganwadis, system improvement under power sector, *etc.* were added to the list of eligible activities under RIDF. From RIDF V onwards, the ambit of RIDF was also extended to projects undertaken by Panchayat Raj Institutions and projects in social sector covering primary education, health and drinking water.

With a view to encouraging the flow of credit to agriculture, since RIDF VII, the interest rate on banks' contributions to RIDF has been linked inversely to the extent of shortfall in the agricultural lending *vis-à-vis* the stipulated target of 18 per cent. As regards interest received on loans granted out of RIDF VII, RIDF VIII and RIDF IX, NABARD retains a margin of 0.5 per cent and the balance interest spread earned is credited to the Watershed Development Fund.

In terms of the announcement made in the Union Budget for 2004-05, RIDF X has been established with NABARD with a corpus of Rs.8,000 crore[5]. The domestic scheduled commercial banks, (public and private sector banks) which reported shortfall in lending to the priority sector (40 per cent target) and/or agricultural sector (18 per cent target) as on the last reporting Friday of March 2004 have been advised to contribute for the corpus of RIDF X.

The banks will be paid interest on their contribution to the RIDF X at rates of interest inversely related to the shortfall in agricultural lending *vis-à-vis* the target of 18 per cent, as given in the table below.

Sr. No.	Shortfall in lending to agriculture in terms of percentage to Net Bank Credit	Rate of interest on the deposit (Per cent per annum)
1	Less than 2 percentage points	Bank Rate* (6 per cent at present)
2	2 and above, but less than 5 percentage points	Bank Rate minus 1 per cent
3	5 and above, but less than 9 percentage points	Bank Rate minus 2 per cent
4	9 percentage points and above	Bank Rate minus 3 per cent

*Bank Rate prevailing at the time of sanction of loans to State Governments by NABARD.

[5] For details of loans sanctioned and disbursed under RIDF, also see Table IV.25.

2.36 The Reserve Bank constituted an Advisory Committee on Flow of Credit to Agriculture and Related Activities from the Banking System (Chairman: Shri V.S. Vyas), which submitted its Report in June 2004.[6] The recommendations made by the Committee are important in the context of expanding outreach of banks and improving flow of credit to the agriculture sector. While some of the recommendations of the Committee are being examined, other recommendations have been accepted for immediate implementation by banks (Box II.6).

Box II.6: Advisory Committee on Flow of Credit to Agriculture and Related Activities from the Banking System: Recommendations and Action Taken

The recommendations of the Committee that have been accepted by the Reserve Bank and advised to the banks for implementation are as under:

- Banks may waive margin/security requirements for agricultural loans up to Rs.50,000 and in the case of agri-business and agri-clinics for loans up to Rs.5 lakh.
- Investment by banks in securitised assets representing direct (indirect) lending to agriculture may be treated as their direct (indirect) lending to agriculture under the priority sector.
- Loans to storage units, including cold storage units, which are designed to store agricultural produce/products, irrespective of their location, would be treated as indirect agricultural finance under the priority sector.
- Non-performing asset (NPA) norms for all direct agricultural advances, including direct agricultural term loans, may be modified with a view to aligning the repayment dates with the harvesting of crops.
- Micro-finance institutions (MFIs) would not be permitted to accept public deposits unless they comply with the extant regulatory framework of the Reserve Bank.
- Banks may explore the possibilities like entering into tie-ups with major tractor and farm machinery manufacturers for financing the agriculturists in a cost-effective manner.
- The controlling authorities of banks may review the lapses, if any, in implementing the recommendations of the R. V. Gupta Committee relating to simplification of documentation, delegation of more powers to the branch managers, *etc.*, and take steps to rectify the situation.
- Banks should pay attention to their systems and procedures to make their lending cost-effective and also consider measures to save the borrower of avoidable expenses for getting a loan sanctioned.
- Banks may provide a separate flexible revolving credit limit to small borrowers of production and investment loans for meeting temporary shortfalls in family cash flows and also to evolve suitable credit products/packages.
- Banks may adopt measures to reduce the information gap about procedures. Application forms for loan products should contain a comprehensive checklist of documents/ information to be furnished as also procedural requirements to be complied with for availing of loans.
- Banks may explore financing of oral leessees on the basis of Joint Liability Group and SHG approach models through pilot projects until such time the State Governments address issues of legalising tenancy.
- Banks may address various issues such as delays/refusal to open savings account of SHGs, large number of branch visits required to access credit, inadequate credit support extended by banks, delays in renewal of credit limits and impounding of SHG savings as collateral for loans, *etc.* to make the access to financial services smooth and client-friendly.
- Banks may work in consort with the State Governments and finance various agronomic and water management development projects, wherever feasible.
- Banks may consider posting technical staff at their head/ controlling offices, placing top level executives in charge of rural credit and effecting rural posting of officers for a minimum of three to five years, absorbing more agricultural graduates for staffing rural branches of commercial banks.
- Banks may explore the possibilities of routing credit through post offices, outsourcing loan appraisal and monitoring *etc.*, to facilitators, subject to guidelines approved by their Boards of Directors.
- Banks may, based on their commercial judgement and the policies adopted by them, consider financing good working PACS.
- Banks may consider using low cost ATMs running on diesel generator sets for cash dispensation in rural areas. Wherever volume of business justifies it, computers in rural bank branches may be networked for a free flow of intra-branch and inter-bank information. Banks must formulate a time-bound programme for using IT in rural branches.
- Banks may design, with the approval of their Boards, an appropriate incentive structure for prompt repayment of their dues. Further, they may review and revise their project appraisal procedures to overcome some of the supply side factors contributing to non-recovery of loans.
- Banks may increasingly consider associating with contract farming, subject to availability of proper legal and regulatory framework in different states.
- The system of Special Agricultural Credit Plans (SACP) may be continued and may also be made applicable to private sector banks.
- The restrictive provisions of Service Area Approach may be dispensed with for lendings outside Government-sponsored schemes.
- Banks may raise credit to small and marginal farmers to 40 per cent of disbursements under SACP by the end of the Tenth Plan period.
- Ceilings on lending to dealers of agricultural machinery, cattle and poultry feeds and inputs of production may be reviewed in view of the need to enhance the availability of agricultural machinery, implements, inputs, *etc.*

Certain other recommendations of the Advisory Committee are being examined by the Reserve Bank in consultation with NABARD, IBA, Government of India and other concerned agencies.

[6] The Report is available on the Reserve Bank website.

2.37 The Government announced a package of measures on June 18, 2004 aimed at doubling agricultural credit in three years with a credit growth of 30 per cent for 2004-05. Pursuant to the announcement, the Reserve Bank and the IBA issued guidelines to commercial banks, while NABARD issued similar guidelines to co-operative banks and the RRBs. These guidelines include: (i) debt restructuring and provision of fresh loans to farmers affected by natural calamities; (ii) one-time settlement for small and marginal farmers; (iii) fresh finance for farmers whose earlier debts have been settled through compromise or write-offs; and (iv) relief measures for farmers indebted to non-institutional lenders. While the progress so far has been encouraging, banks have been urged to keep up the momentum.

Credit to Small-Scale Industries

2.38 Credit to SSIs is crucial from the point of view of the contributions made by small industries to GDP, to exports and to employment generation. Realising the critical role of small industries in the economy, the Reserve Bank has been addressing the issue of adequate supply of credit to this sector. The Reserve Bank Working Group on Flow of Credit to the SSI Sector (Chairman: Dr. A.S. Ganguly) submitted its Report in April 2004. A list of recommendations of the Group together with responses thereto has been put in the public domain (Box II.7). In order to enable banks to determine appropriate pricing of loans to small and medium enterprises (SMEs), Credit Information Bureau of India Ltd. (CIBIL) would work out a mechanism, in consultation with the Reserve Bank, SIDBI and IBA, for developing a system of proper credit records.

2.39 Following the announcement made in the annual policy Statement of 2004-05, a Special Group was constituted by the Reserve Bank (Chairman: Shri G. Srinivasan) to formulate a mechanism for restructuring of debt of medium enterprises on the lines of the Corporate Debt Restructuring (CDR) Scheme for large industries. The Group comprises representatives from SIDBI and commercial banks, and is expected to submit its Report shortly.

Export Credit

2.40 The Reserve Bank's initiatives towards simplification of procedures for export credit delivery were well accepted by the market as reflected in the survey on exporters' satisfaction conducted with the help of National Council of Applied Economic Research (NCAER) during 2001-02.

2.41 The Government (Ministry of Commerce and Industry) in consultation with the Reserve Bank, had indicated in the Exim Policy 2003-04 that a Gold Card Scheme would be worked out by the Reserve Bank for creditworthy exporters with good track record for easy availability of export credit on best terms. Accordingly, in consultation with select banks and exporters, a Gold Card Scheme has been drawn up. The salient features of the Scheme are: (i) all creditworthy exporters, including those in small and medium sectors with good track record would be eligible for issue of Gold Card by individual banks as per the criteria laid down by the latter; (ii) banks would clearly specify the benefits they would be offering to Gold Card holders; (iii) requests from card holders would be processed quickly by banks within a prescribed time-frame; (iv) 'in-principle' limits would be set for a period of 3 years with a provision for stand-by limit of 20 per cent to meet urgent credit needs; (v) card holders would be given preference in the matter of granting of pre-shipment credit in foreign currency; and (vi) banks would consider the waiver of collaterals and exemption from ECGC guarantee schemes on the basis of card holder's creditworthiness and track record. As indicated in the annual policy Statement of 2004-05, guidelines on Gold Card Scheme for creditworthy exporters with good track record, for easy availability of export credit, were issued to banks. Most of the public sector banks and many private sector and foreign banks have since announced such schemes.

Infrastructure Lending

2.42 An area where banks and FIs play an important role is that of infrastructure financing (Box II.8). Financing of infrastructure projects is characterised by large capital outlays, long gestation periods and high leverage ratios. In order to facilitate the free flow of credit to infrastructure projects, several policy measures have been taken by the Reserve Bank. In April 1999, the Reserve Bank introduced new guidelines relating to the financing of infrastructure projects, such as, the criteria for

Box II.7: Working Group on Flow of Credit to Small-Scale Industries Sector

The recommendations of the Working Group on Flow of Credit to Small-Scale Industries (SSI) Sector were examined by the Reserve Bank and on September 4, 2004, the Reserve Bank put out a list of recommendations which have been classified further as (i) those accepted with immediate effect, (ii) requiring further examination and (iii) which pertain to Government of India and other institutions.

The following recommendations have been accepted with immediate effect:

- A full-service approach to cater to the diverse needs of the SME sector may be achieved through extending banking services to recognised SME clusters by adopting a 4-C approach *viz.*, Customer focus, Cost control, Cross sell and Contain risk. A cluster based approach to lending may be more beneficial for: (i) dealing with well-defined and recognised groups; (ii) availability of appropriate information for risk assessment and (iii) monitoring by the lending institutions.
- Corporate-linked SME cluster models need to be actively promoted by banks and FIs. Banks linked to large corporate houses can play a catalytic role in promoting this model. Financing of SMEs linked to large corporates, covering suppliers, ancillary units, dealers, *etc.* would also enhance competitiveness of the corporates as well as the SME participants.
- Successful micro credit management models should be made use of by SIDBI and Lead Banks with a view to encourage the adoption of their work practices in other States.
- New instruments need to be explored for promoting rural industry and improve the flow of credit to rural artisans, industries and rural entrepreneurs.
- Higher working capital limits need to be taken into account while extending credit to such units located in hilly terrain and frequent flood areas with poor transportation system.

The recommendations of the Working Group that need further examination include:

- The need to have a dedicated National level SME Development Fund to play a catalytic role in the advancement of the SME sector. SIDBI may promote a NBFC (non-public deposit taking) exclusively for undertaking venture and other development financing activities for SMEs. Banks could also contribute to the corpus created by SIDBI (on risk sharing basis) or alternatively, set up their own venture financing instruments.
- The traditional sources of credit flow to the SME sectors (through public sector banks, Specialised SSI Branches, *etc.*) are unlikely to improve their services, at least, in the short and medium term. While public sector banks have inherent problems in extending credit to many SMEs due to historical reasons, it is necessary to explore ways to overcome such traditional problems:

a. Banks could promote and finance Special Purpose Vehicles (SPVs) in the form of micro credit agencies dedicated to servicing SME clusters. Banks could extend wholesale financial assistance to Non-Governmental Organisations (NGOs)/Micro Finance Intermediaries (MFIs) and work out innovative models for securitisation of the MFI receivable portfolio on the pattern of models in vogue in USA and other countries. Such SPVs may be extended necessary support through various fiscal/taxation measures by the Government.

b. Such micro credit intermediaries as in the form of NBFCs (funded by individual or a group of banks but not permitted to accept public deposits) could credit-rate and risk assess, and serve as instruments for extending quick credit to SME clusters, accredited to them.

c. Large banks can directly extend credit and banking services to (i) SMEs linked to large corporates and (ii) to identified SME clusters which are credit-rated. The micro credit intermediary (SME-specific NBFC) funded by banks (individually or in groups) could be an alternate source to speed up credit access to stand alone clusters of product/service specific SMEs. Recognising the acute problems faced by SMEs, for tiny and village industry sectors, particularly in the North Eastern region of the country, special instruments, besides NBFCs, *etc.* need to be tailored, dedicated and funded.

- A uniform target in priority sector lending (including SSI) at 40 per cent of net bank credit for all domestic and foreign banks has been recommended with a view to providing a level playing field for all banks. To ensure active participation in the faster development of the priority sector, the following suggestions were made:

a. The tenure of the deposits representing shortfall in lending to the priority sector by foreign banks with SIDBI, be increased to a period of three years in order to enable SIDBI to better manage disbursal to SME sector.

b. Risk sharing mechanisms between foreign banks and SIDBI needs to be worked out: (i) on credit extended to the SME sector by SIDBI and (ii) interest rate payable by SIDBI to foreign banks on priority sector lending shortfall deposits, may be pegged at a rate which does not act as an incentive for the foreign banks to keep the deposit with SIDBI, rather than directly meeting the credit needs of the SME sector.

The third list comprises recommendations such as those relating to definition of SME sector, role of Credit Guarantee Fund Trust for Small Industry (CGTSI), repealing of State Finance Corporation (SFC) Act and privatisation of SFCs, rating mechanism for industrial clusters, conversion of Technology Bureau of Small Enterprises into an independent Technology Bank are under consideration of the Ministry of Small Scale Industries (MoSSI), Government of India and other agencies such as SIDBI, CGTSI, CIBIL and IBA.

Box II.8: Financing Infrastructure: The Role of Banks and Financial Institutions

Governments, donors and the private sector including commercial lenders are the major source of funding for infrastructure. For the Government, the source of funds comprise of own-revenues and borrowings. In the case of developing countries, the creditworthiness of the State and local Governments and the low level of efficiency of the entities delivering infrastructure services are the major issues in their ability to access the capital markets. Some countries in which the credit markets are not well developed, or in which local Governments have limited access to credit, infrastructure banks have been created to allow local Governments to finance infrastructure investments.

Donors constitute the next major group for financing infrastructure. It has been estimated that US $ 4 billion of housing and infrastructure is financed by donors in developing countries each year which forms roughly 3-4 per cent of the total investment financing. For developing countries, the Government and donors need to work together to ensure a selection of economically efficient projects and technologies.

Private equity financing takes place when the private sector has ownership or partnership interest in the infrastructure. This can involve some kind of build-operate-transfer (BOT) arrangement, in which the private sector builds and then operates for some period, after which the facility is transferred to the Government. BOT arrangement has been tried in India in financing construction and maintenance of roads and bridges. An alternative to BOT arrangement is concessions, where a private firm contracts with the Government to operate or expand an existing component of the infrastructure. Concessions have been more common than BOT arrangements, and perhaps, offer much greater potential. The advantages of private equity financing include: (i) access to resources that otherwise would be unavailable; (ii) lowering the public sector's risk of making bad investments; (iii) innovations, *viz.*, service delivery agency.

The main consideration for banks and FIs in financing infrastructure projects lies in the creditworthiness of the borrowing entities and the viability of projects. Poor creditworthiness of local Government institutions/public sector undertakings entrusted with the responsibility for creating and maintaining infrastructure services, and inadequate user charges/taxes, make it difficult for the banks and FIs to fund the infrastructure especially in the developing countries. The credit enhancement of infrastructure projects by Governments through full guarantees has been resorted to in many countries. However, credit enhancement should not be used as a substitute for due diligence. Fiscal incentives in the form of tax-exemptions and regulatory relaxations provided to banks and other financial institutions by Central Banks may act as a catalyst to encourage flow of credit to the infrastructure sector. This should be combined with creation of an enabling lending environment by the Government by undertaking critical reforms in the infrastructure sector.

Financing mechanisms need to provide appropriate incentives and support for reforms to ensure long-term sustainability of investments and improve efficiency of resource utilisation. The mechanisms also need to use limited public resources to help leverage additional resources from the private sector and community. Innovative financing structures including credit enhancement techniques can reduce the cost of funding infrastructure services and mitigate the risks by distributing them across various stakeholders.

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Reserve Bank of India (1999), *Guidelines on Infrastructure Financing*.

financing, the types of financing, the appraisal, the regulatory compliance/concerns, the administrative arrangements and the inter-institutional guarantees.

2.43 In view of the critical importance of the infrastructure sector as also the high priority being accorded to this sector, certain relaxations relating to regulatory and prudential aspects were allowed to banks since 1999-2000 to boost credit flow to this sector. These measures, *inter alia*, included: (i) enhancing the scope of definition of infrastructure lending, (ii) relaxing the prudential single borrower exposure limit from 15 per cent to 20 per cent of capital funds in respect of infrastructure companies providing infrastructure facilities, (iii) assigning a concessional risk weight of 50 per cent on investment in securitised paper satisfying certain conditions pertaining to an infrastructure facility, (iv) permitting lending to SPVs in the private sector, registered under Companies Act, for directly undertaking viable infrastructure projects subject to certain conditions and (v) lending to promoters, with certain safeguards and where appropriate, for acquiring a controlling stake in existing infrastructure companies.

2.44 In the annual policy Statement of 2004-05, it was proposed to further expand the scope of definition of infrastructure lending by including the following projects/sectors relating to

Box II.9: Definition of Infrastructure Lending

Any credit facility in whatever form extended by lenders (*i.e.*, banks, FIs or NBFCs) to an infrastructure facility as specified below falls within the definition of 'infrastructure lending'. In other words, it is a credit facility provided to a borrower company engaged in developing or operating and maintaining, any infrastructure facility that is a project in any of the following sectors, or any infrastructure facility of a similar nature:

(i) a road, including toll road, a bridge or a rail system;

(ii) a highway project including other activities being an integral part of the highway project;

(iii) a port, airport, inland waterway or inland port;

(iv) a water supply project, irrigation project, water treatment system, sanitation and sewerage system or solid waste management system;

(v) 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), network of trunking, broadband network and internet services;

(vi) an industrial park or special economic zone;

(vii) generation or generation and distribution of power;

(viii) transmission or distribution of power by laying a network of new transmission or distribution lines;

(ix) construction relating to projects involving agro-processing and supply of inputs to agriculture;

(x) construction for preservation and storage of processed agro-products, perishable goods such as fruits, vegetables and flowers including testing facilities for quality;

(xi) construction of educational institutions and hospitals.

agricultural sector and social infrastructure: (i) construction relating to projects involving agro-processing and supply of inputs to agriculture; (ii) construction for preservation and storage of processed agro-products, perishable goods such as fruits, vegetables and flowers including testing facilities for quality; and (iii) construction of educational institutions and hospitals (Box II.9). With a view to providing a boost to infrastructure lending, as per the guidelines issued on June 11, 2004, banks have been allowed to raise long-term bonds with a minimum maturity of five years to the extent of their exposure of residual maturity of more than five years to the infrastructure sector. It is intended that banks should have first provided assistance to such infrastructure projects before raising resources through bonds. Keeping in view the importance of infrastructure financing at the State level, in consultation with the State Finance Secretaries, a Working Group on Credit Enhancement by State Governments for Financing Infrastructure has been constituted with members drawn from the Central Government, State Governments, select banks, FIs and the Reserve Bank. The Group is examining the instruments of credit enhancement which the State Governments could offer to improve the rating/borrower capability of State PSUs/SPVs in order to attract institutional financing for infrastructure projects.

2.45 In view of the expertise gained by NBFCs in financing second hand assets and to encourage credit dispensation, in the mid-term Review of annual policy for 2004-05, banks were allowed to extend finance to NBFCs against second hand assets financed by them, provided suitable loan policies duly approved by the banks' Boards are put in place.

2.46 With a view to further developing the corporate debt market, a Group was constituted with members from the Reserve Bank, Securities and Exchange Board of India (SEBI) and other market participants. The Group *inter alia,* would examine the issues relating to primary issuance as well as growth of secondary market; regulatory aspects for the development of Asset Backed Securities (ABS) and Mortgage Backed Securities (MBS); and trading, settlement and accounting of corporate debt securities. The Group is expected to submit its Report in January 2005.

3. Prudential Regulation

2.47 Regulation of financial institutions, particularly of banks, is important from the point of view of financial system stability, which not only helps the institutions to perform better but also improves the overall performance of the economy (Box II.10). A key element of the ongoing financial sector reforms has been strengthening of the prudential and supervisory framework, which has been done on an ongoing basis through developing sound risk management systems and enhancing transparency and accountability. With a paradigm shift from micro-regulation to

Box II.10: Special Nature of Banks

Over the last two decades, the theory of finance has offered significant contributions to the understanding of banks and identifying the specific aspects that qualify them as special financial intermediaries. Banks have historically developed comparative advantage *vis-à-vis* other types of intermediaries over different functions (such as liquidity and payment services, credit supply, and information provision). Banks are 'special' as they not only accept and deploy large amounts of uncollateralised public funds in a fiduciary capacity, but also leverage such funds through credit creation. Banks thus, have a fiduciary responsibility. The deployment of funds mobilized through deposits involves banks in financing economic activity and providing the lifeline for the payments system. The banking system is something that is central to a nation's economy; and that applies whether the banks are local-based or foreign-owned. A World Bank study examines the way banking and non-banking finance interact during different stages of economic development, producing various efficiency/ stability configurations.

The owners or shareholders of the banks have only a minor stake and the considerable leveraging capacity of banks (more than ten to one) puts them in control of very large volume of public funds inspite of their own stake being very small. In a sense, therefore, the owners act as trustees and as such must be fit and proper for the deployment of funds entrusted to them. The sustained stable and continuing operations depend on the public confidence in individual banks and the banking system. The speed with which a bank under a run can collapse is incomparable with any other organisation. For a developing economy, there is much less tolerance for downside risks among depositors many of whom place their life savings in the banks. Hence from a moral, social, political and human angle, there is an onerous responsibility on the regulator. Concentrated shareholding in banks controlling huge public funds does pose issues related to the risk of concentration of ownership because of the moral hazard problem and linkages of owners with businesses. Hence diversification of ownership is desirable as also ensuring fit and proper status of such owners and directors. However, with diversified ownership, there is, perhaps, an even greater concern over corporate governance and professional management in order to safeguard depositors' interest and ensure systemic stability. The regulatory and supervisory framework therefore has to ensure that banks have adequate capital to cushion risks that are inevitable in their operations, follow prudent and transparent accounting practices and are managed in accordance with the best practices for risk management. Banks are, thus, regarded as special type of financial intermediaries that need a differentiated treatment by regulatory authorities including special protective measures from competition in the risk of failure.

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prudential regulation and macro-management, the emphasis is on strengthening prudential norms by the adoption of appropriate international benchmarks. A review of the progress made on the implementation of the recommendations of the Reports of the 11 Advisory/Technical Groups constituted by the Standing Committee on International Financial Standards and Codes was considered by a panel of advisers. Taking into account the suggestions of the panel, a revised draft report is being placed in the public domain. The important elements of prudential supervision of Indian banks are discussed below.

Ownership and Governance of Banks

2.48 The largest banks in India are still in the public sector, and these control over 75 per cent of the total banking sector assets. Competition has been infused by allowing new private sector banks, a more liberal entry of foreign banks and a gradual deregulation of the banking sector. A number of initiatives have been taken relating to ownership and governance of banks.

2.49 The guidelines issued in February 3, 2004 on acknowledgement of transfer/allotment of shares in private sector banks would be applicable for any acquisition of shares of five per cent and above of the paid-up capital of a private bank. The objective is to put in place a mechanism which ensures that shareholders whose aggregate holdings above the specified thresholds meet the fitness and propriety tests before grant of acknowledgement of transfer of shares. In determining whether the applicant

(including all entities connected with the applicant) is 'fit and proper' to hold the position of a shareholder at the lowest threshold of five per cent and above, the Reserve Bank takes into account all relevant factors, including among other criteria, the applicant's integrity, reputation and track record in financial matters and compliance with tax laws, which are necessary to protect the interests of the depositors and integrity of the financial system.

2.50 The underlying principles of the draft comprehensive policy framework for ownership and governance in private sector banks which was put in the public domain on July 2, 2004 for discussion and feedback *inter alia* were to ensure that the ultimate ownership and control of private sector banks is well diversified, important shareholders (*i.e.*, shareholding of five per cent and above) are 'fit and proper' as laid down in the guidelines dated February 3, 2004, and the directors and the CEO who manage the affairs of the bank are 'fit and proper' as laid down in the circular dated June 25, 2004, and observe sound corporate governance principles. The draft policy on ownership and governance of private banks is in line with the international best practices. Based on the responses received and dialogues with various stakeholders, a second draft on the policy framework has been finalised and would be placed in public domain shortly.

Foreign Direct Investment (FDI) in Banking

2.51 Foreign investment in banking is governed by the FDI policy of Government of India. In case of a nationalised bank, a ceiling of 20 per cent on all types of foreign investment in the paid up capital has been stipulated in terms of the provisions of Banking Companies (Acquisition & Transfer of Undertakings) Acts, 1970/80. In respect of investment by NRIs in the private sector banks, the policy restricted NRI investments to 40 per cent and FDI to 20 per cent, subject to the condition that the combination of NRI investment and FDI should also be within the overall prescribed ceiling of 40 per cent foreign equity in the sector. Foreign Institutional Investors (FIIs) were allowed to acquire 24 per cent in addition to the 40 per cent limit.

2.52 With liberalisation of the FDI regime, FDI in the banking sector was brought under the automatic route. In terms of the Government of India announcement dated May 21, 2001, FDI up to 49 per cent from all sources was permitted in private sector banks under the automatic route, subject to conformity with the guidelines issued by the Reserve Bank from time to time. The foreign investment includes, *inter alia,* shares issued in IPOs, private placements, ADRs/GDRs and acquisition of shares from existing shareholders with Foreign Investment Promotion Board (FIPB) approval. Issue of shares under automatic route is not available to those foreign investors who have financial or technical collaboration in the same or allied field; such cases in fact require FIPB approval.

2.53 With a view to further liberalising foreign investment in the banking sector, the Government announced an increase in the FDI limit in private sector banks from 49 per cent to 74 per cent under automatic route including investment by FIIs subject to guidelines issued by the Reserve Bank from time to time (March 5, 2004). Foreign investment in private sector banks from all sources would be permissible up to a composite ceiling of 74 per cent of the paid-up capital of the bank. This would include FDI, investments under Portfolio Investment Scheme (PIS) by FIIs, NRIs and shares acquired prior to September 16, 2003 by OCBs, IPOs, private placements, GDRs/ADRs and acquisition of shares from existing shareholders. However, the FII investment limit cannot exceed 49 per cent, within the aggregate foreign investment ceiling of 74 per cent of the paid up capital and at all times, at least 26 per cent of the paid up capital would have to be held by residents. Detailed guidelines in this regard are under consideration of the Reserve Bank.

Exposure Norms

2.54 The Reserve Bank has prescribed regulatory limits on banks' exposure to individual and group borrowers in India to avoid concentration of credit, and has advised the banks to fix limits on their exposure to specific industries or sectors (real estate, capital market, *etc.*) for ensuring better risk management. In addition, banks were also required to observe certain statutory and regulatory exposure limits in respect of advances against investments in shares, debentures and bonds.

Credit Exposures to Individual /Group Borrowers

2.55 Taking into account the international best practices, it has been decided to adopt the concept of capital funds as defined under capital adequacy standards for determining exposure ceiling

uniformly by both domestic and foreign banks, effective from March 31, 2002. Banks have been allowed to assume single/group borrower credit exposure up to 15 per cent and 40 per cent of capital funds, respectively, with respective additional allowance of 5 per cent and 10 per cent of capital funds for exposure to the infrastructure sector. In addition, it has been decided in June 2004 that banks may, in exceptional circumstances, with the approval of their Boards, consider enhancement of the exposure to a borrower up to a further five per cent of capital funds (*i.e.*, 20 per cent for single borrower and 45 per cent for group borrowers). In respect of exposure to infrastructure, banks could consider additional sanctions up to five per cent and 10 per cent as indicated above, over and above the limits of 20 per cent and 45 per cent, respectively. The exposure limits will be applicable even in case of lending under consortium arrangements, wherever formalised. While computing the extent of above-stated borrower exposures *vis-à-vis* respective limits, the exemptions allowed pertain to: (i) credit facilities (including funding of interest and irregularities) granted to weak/sick industrial units under rehabilitation packages; (ii) borrowers to whom limits are allocated directly by the Reserve Bank, for food credit; (iii) principal and interest that are fully guaranteed by the Government of India and (iv) loans and advances granted against the security of bank's own term deposits.

Unhedged Foreign Currency Exposure of Corporates

2.56 To ensure a policy that explicitly recognises and takes account of risks faced by banks arising out of foreign exchange exposure of their clients, foreign currency loans above US $ 10 million (or such lower limits as may be deemed appropriate *vis-à-vis* the banks' portfolios of such exposures), would be extended only on the basis of a well laid out policy with regard to hedging of such foreign currency loans. Further, the policy for hedging framed by the bank's Boards could exclude the following: (i) forex loans that are extended to finance exports, provided the customers have uncovered receivables to cover the loan amount and (ii) forex loans that are extended for meeting forex expenditure. A recent study of select banks revealed that though most banks have adopted policies mandated by their Boards, banks often rely on 'natural hedge' available with their customers. Further, information on the total exposure of the corporate clients was also not readily available with banks. In view of the systemic risk, banks are being encouraged to obtain information from their large borrowers on their unhedged forex exposures, so that the banks, in turn, can assess the risk of their own exposure to such corporates on an on-going basis.

Margin on Advances against Shares/Issue of Guarantees

2.57 With effect from January 3, 2004, the margin requirement on all advances/financing of IPOs/issue of guarantees by banks has been raised from 40 per cent to 50 per cent. Further, banks have been advised to maintain a minimum cash margin of 25 per cent (within the overall margin of 50 per cent) in respect of guarantees issued by banks. However, with effect from May 18, 2004, when the equity market slipped sharply, the margins have been restored *status quo ante* and margin requirement on all advances against shares/financing of IPOs/issue of guarantees has been reduced to 40 per cent. In respect of guarantees issued by banks for capital market operations, banks have been advised to maintain a minimum cash margin of 20 per cent (within the overall margin of 40 per cent).

Bank Finance to Employees to buy Shares of their Own Companies

2.58 The instruction that banks could provide finance up to Rs.50,000 or six months' salary, whichever is less, to assist employees to buy shares of their own companies has been reviewed in view of several companies offering Employee Stock Options (ESOPs) and employee quota in their IPOs as also introduction of robust system of assessing risks in many banks. Banks have been advised on February 6, 2004 that while extending finance to employees for purchasing shares of their own companies either under ESOP or IPO, they may take their own decision subject to extant regulations including margin requirement on IPO financing. However, all such financing should be treated as part of the banks' exposure to capital market within the overall ceiling of 5 per cent of banks' total outstanding advances, as on March 31 of the previous year. Further, these instructions would not be applicable to banks extending financial assistance to their own employees for acquisition of shares under ESOP/IPO. The issue of declaration of dividends by banks has also been revisited (Box II.11).

Box II.11: Declaration of Dividend by Banks

The policy approach adopted with regard to payment of dividends by banks has been reviewed by the Reserve Bank and it was decided in April 2004 that the regulatory focus on payment of dividend should shift from 'dividend rate' to 'dividend payout ratio'. The criteria for declaration of dividend was revised by the Reserve Bank and as per the revised guidelines, banks are required to fulfil certain criteria for becoming eligible for the declaration of dividend *viz.*, the bank should have CRAR of at least 11 per cent in preceding two completed years and the accounting year for which it proposes to declare dividend, and carrying net NPA less than 3 per cent. In addition, the bank should comply with the provisions of Sections 15 and 17 of the Banking Regulation Act, 1949, the prevailing regulations/guidelines issued by the Reserve Bank, including creating adequate provisions for impairment of assets and staff retirement benefits, transfer of profits to Statutory Reserves and Investment Fluctuation Reserves.

Banks, which qualify to declare dividend are eligible to pay dividend without obtaining the prior approval of the Reserve Bank, subject to compliance with the following: (i) the dividend payout ratio does not exceed 33.33 per cent, (ii) the proposed dividend should be payable out of the current year's profit, (iii) dividend payout ratio is calculated as a percentage of 'dividend payable in a year' (excluding dividend tax) to 'net profit during the year', (iv) in case the profit for the relevant period includes any extra-ordinary profits/income, the payout ratio shall be computed after excluding such extra-ordinary items for reckoning compliance with the prudential payout ratio ceiling of 33.33 per cent; and (v) the financial statements pertaining to the financial year for which the bank is declaring a dividend be free of any qualifications by the statutory auditors, which have an adverse bearing on the profits during the year. In case of any qualification to that effect, the net profit should be suitably adjusted while computing the dividend payout ratio.

Banks, which comply with all the above conditions but desire to declare dividend higher than 33.33 per cent are required to obtain prior approval of the Reserve Bank for declaration of such higher dividend and such requests would be considered by the Reserve Bank on a case-to-case basis. Banks satisfying the above criteria are also eligible to declare interim dividend out of the relevant accounting period's profit without prior approval of the Reserve Bank. However, the cumulative interim dividend(s) should be within the prudential cap on dividend payout ratio (*viz.*, 33.33 per cent) computed for the relevant accounting period. For declaration and payment of interim dividends beyond the prescribed ceiling, the Reserve Bank's prior approval has to be sought.

In case any bank does not meet the criteria prescribed, it should obtain the prior approval of the Reserve Bank before declaring any dividend. The requests received from these banks would be considered by the Reserve Bank on a case-to-case basis.

All banks declaring dividends should report details of dividend declared during the accounting year as per the prescribed proforma. The revised guidelines have been made applicable from the accounting year ended March 31, 2004 onwards.

Limits on Exposure to Unsecured Guarantees and Unsecured Advances

2.59 The instruction that banks have to limit their commitment by way of unsecured guarantees in such a manner that 20 per cent of the bank's outstanding unsecured guarantees plus the total of outstanding unsecured advances do not exceed 15 per cent of total outstanding advances has been withdrawn to enable banks' Boards to formulate their own policies on unsecured exposures. Simultaneously, all exemptions allowed for computation of unsecured exposures stand withdrawn. However, with a view to ensuring uniformity in approach and implementation, the expression 'unsecured exposure' is defined as an exposure where the realisable value of the security is not more than 10 per cent, *ab-initio,* of the outstanding exposure and the term 'security' means tangible security properly charged to the bank. Further, the unsecured 'substandard' assets would attract additional provision of 10 per cent, *i.e.*, a total of 20 per cent on the outstanding balance; however, the provisioning requirement for unsecured 'doubtful' assets would remain unchanged at 100 per cent.

Guidelines on KYC Norms for Existing Accounts

2.60 Banks have been advised to complete the KYC procedures in respect of all existing accounts in a phased manner by December 2004. In order to ensure timely completion of the procedures, it has been decided in June 2004 that banks may limit the application of KYC procedures to existing accounts where the credit or debit summation for the financial year ended March 31, 2003 is more than Rs.10 lakh or where unusual transactions are suspected. They may, however, ensure that KYC procedures are applied to all existing accounts of trusts, companies/firms, religious/charitable organizations and other institutions or where the accounts are opened through a mandate or power of attorney.