Consolidated Accounting and Supervision

2.61 In terms of guidelines for consolidated accounting and other quantitative methods to facilitate consolidated supervision, banks have *inter alia* been advised that as a prudential measure aimed at better risk management and avoidance of concentration of credit risks, in addition to adherence to prudential limits on exposures assumed by banks, banks should also adhere to the following prudential limits on single and group borrower exposures: capital market exposures (not to exceed 2 per cent of its total on-balance-sheet assets, excluding intangible assets and accumulated losses, as on March 31 of the previous year); within the total limit, investment in shares, convertible bonds and debentures and units of equity oriented mutual funds should not exceed 10 per cent of consolidated bank's net worth and exposures by way of unsecured guarantees and unsecured advances (as formulated by the Boards of the banks).

Inter-Regulatory Working Group on Financial Conglomerates

2.62 An analysis of consolidated prudential returns for the half-year ended March 31, 2003 revealed that banks complied with regulatory requirements both on an individual basis and on a group-wide basis. In this context, the Reserve Bank constituted a Working Group to examine the framework for the complementary supervision of financial conglomerates. The major recommendations of the Working Group on Financial Conglomerates include: (i) identifying financial conglomerates for focused regulatory oversight; (ii) capturing intra-group transactions and exposures amongst 'group entities' within the identified financial conglomerates and large exposures of the group to outside counter parties; (iii) identifying a designated entity within each group to furnish group data to the principal regulator for the group; and (iv) formalising a mechanism for inter-regulatory exchange of information. The Working Group further recommended that segments under the jurisdiction of the Reserve Bank, SEBI, IRDA and NHB would be subjected to complementary regulation. The framework could later be extended to the segment covered by the Pension Fund Regulatory and Development Authority consequent upon its formation. The new reporting framework would track: (i) any unusual movement in respect of intra-group transactions manifested in major markets; (ii) build up of any disproportionate exposure (both fund based and non-fund based) of any entity to other group entities; (iii) any group-level concentration of exposure to various financial market segments and outside counterparties; and (iv) direct/indirect cross-linkages amongst group entities. Individual intra-group transactions beyond threshold levels (Rs.1 crore for fund based transactions and Rs.10 crore for others) would be included in the reporting format, supplemented by including exposure ceilings in respect of intra-group exposures. Pending the evolution of a legal framework for inter-regulatory coordination, three regulators, *viz.*, the Reserve Bank, SEBI and IRDA could sign a Memorandum of Understanding (MoU) to provide sanctity to the proposed framework. The Report of the Group was placed on the Reserve Bank website, and following actions were initiated: (i) twenty four conglomerates have been identified and the first report based on the format recommended by the Group is under compilation; (ii) a nodal cell has been established at the Reserve Bank for smooth implementation of the framework. A Technical Committee with representatives from all three regulators has been interacting and addressing issues arising out of the reporting requirements.

Working Group on Conflicts of Interest in the Indian Financial Services Sector

2.63 There is increasing concern internationally about the impact of the conflicts of interest in the financial sector. Legislative and regulatory measures have been adopted by different countries to ensure that conflicts of interest are not allowed to compromise the interest of stakeholders and public at large. These measures are intended to have positive impact on investor confidence, efficacy of the regulatory framework and, above all, the credibility of those associated with the financial services. Accordingly, in consultation with Chairman, SEBI and Chairman, IRDA, a Working Group on avoidance of conflicts of interest has been constituted with a view to identify the sources and nature of potential conflicts of interest, the international practices to mitigate this problem, the existing mechanisms prevalent in India, and make recommendations for avoidance of such conflicts of interest. The Group would submit its Report by February 2005.

Capital Adequacy/Risk Weights

2.64 In view of the management of cross border capital flows following oil-crisis and international debt crisis, the 1988 Basel Accord prescribed a common minimum capital standard to banking industry of Group of Ten (G-10) to be achieved by 1992. With a view to adopting the Basle Committee framework on capital adequacy norms which takes into account the elements of risk in various types of assets in the balance sheet as well as off-balance sheet business and also to strengthen the capital base of banks, the Reserve Bank decided in April 1992 to introduce a Risk Asset Ratio system for banks (including foreign banks) in India as a capital adequacy measure. Essentially, under the above system the balance sheet assets, non-funded items and other off-balance sheet exposures are assigned weights according to the prescribed risk weights and banks have to maintain unimpaired minimum capital funds equivalent to the prescribed ratio on the aggregate of the risk weighted assets and other exposures on an ongoing basis.

Basel II Developments

2.65 The Basel Committee on Banking Supervision (BCBS) released the International Convergence of Capital Measurement and Capital Standards on June 26, 2004 which is expected to be implemented by the end of 2006 (Box II.12). The main objective for revision in the 1988 Accord was to develop a framework that would further strengthen the soundness and stability of the international banking system by promoting adoption of stronger risk management practices by the banking industry. Since well-established risk management system is a pre-requisite for implementation of advanced approaches under Basel II, banks have been advised to undertake a self-assessment of the existing risk management systems, and to concurrently initiate appropriate measures to upgrade them to match up to the minimum standards prescribed under Basel II. Further, in view of the complexities involved in migrating to Basel II, a Steering Committee comprising members from banks, IBA and the Reserve Bank has been constituted. The Steering Committee would form sub-groups for purposes of assisting it on various matters. On the basis of the inputs received from the Steering Committee, the Reserve Bank would prepare draft guidelines for implementation of Basel II norms and place them in public domain.

2.66 In the annual policy Statement of April 2002, banks have been advised to adopt the Basel norm for capital charge for market risk. As a further step in this direction, the Reserve Bank issued draft guidelines on computing capital charge for market risk to select banks seeking their comments. With a view to ensuring smooth transition to Basel II norms, it was proposed in the annual policy Statement of 2004-05 to phase the implementation of capital charge for market risk over a two-year period (Box II.13).

Investment Fluctuation Reserve

2.67 In order to be better positioned to meet the interest rate risk, banks have been advised in May 2002 to build up an Investment Fluctuation Reserve (IFR) within five years which should be a minimum of 5 per cent of their investments in 'Held for Trading' (HFT) and 'Available for Sale' (AFS) categories. Banks have been urged, in December 2003, to achieve the stipulated five per cent of their investment portfolio within a period of five years. Banks are also free to build up a higher percentage of IFR up to 10 per cent of their AFS and HFT investments. As at end-March 2004, banks had built up IFR up to 3.0 per cent.

2.68 In view of representations received from banks to review the existing guidelines of classification of investments to bringing them in alignment with international practices and current state of risk management practices in India, an Internal Group to review the existing guidelines is being set up by the Reserve Bank. With the recent trends in interest rates, some of the risks have crystallised. However, there has been some cushion for banks given the conservative accounting norms which do not permit banks to recognise unrealised gains in their portfolio, while requiring them to provide for any known depreciation in their value. On September 2, 2004, banks have been permitted to exceed the present limit of 25 per cent of total investments under Held to Maturity (HTM) category provided the excess comprised only of SLR securities, and the total SLR securities held in the HTM category was not more than 25 per cent of their Demand and Time Liabilities (DTL) as on the last Friday of the second preceding fortnight. To enable the above, as a one-time

Box II.12: Basel II: A Revised Framework

Central bank governors and the heads of bank supervisory authorities in the G-10 countries endorsed the revised new capital adequacy framework commonly known as Basel II. The Committee's first round of proposals for revising the capital adequacy framework came out in June 1999, which was followed by additional proposals for consultation in January 2001 and April 2003 and quantitative impact studies related to its proposals. The Committee expects its members to move forward with the appropriate adoption procedures in their respective countries, so that the revised framework is available for implementation as on year-end 2006.

Although the framework has been developed keeping in mind the internationally active banks, supervisory authorities worldwide are being encouraged to consider adopting this revised Framework at such time as consistent with their broader supervisory priorities. Each national supervisor should consider carefully the benefits of the revised Framework in the context of its domestic banking system when developing a timetable and approach for implementation. Given the resource and other constraints, these plans may extend beyond the Committee's implementation dates, and also implementation of Basel II in the near future may not be the first priority for supervisors in several non-G10 countries. The IMF and World Bank are of the view that future financial sector assessments would not be conducted on the basis of adoption of or compliance with the revised Framework, but would be based on the country's performance relative to the chosen standards. Supervisors are being encouraged to consider implementing key elements of the supervisory review and market discipline components of the new Framework even if the Basel II minimum capital requirements are not fully implemented by the implementation date. The Accord Implementation Group (AIG) of the Basel Committee on Banking Supervision (BCBS) is entrusted to promote consistency in the Framework's application by encouraging supervisors to exchange information on implementation approaches.

The revised Framework continued to be based on three pillar (minimum capital requirements, supervisory review, and market discipline) approach. In the revised framework, some of the key elements of the 1988 capital adequacy framework have been retained, including the general requirement for banks to hold total capital equivalent to at least 8 per cent of their risk-weighted assets; the basic structure of the 1996 Market Risk Amendment regarding the treatment of market risk; and the definition of eligible capital. An attempt has, however, been made to arrive at significantly more risk-sensitive capital requirements – to institute internal ratings-based (IRB) approach in place of the broad brush standardised approach of 1988 Accord, that are conceptually sound and at the same time pay due regard to particular features of the present supervisory and accounting systems in individual member countries. A range of options for determining the capital requirements for credit risk and operational risk have been provided.

The need for banks and supervisors to give appropriate attention to the second (supervisory review) and third (market discipline) pillars of the revised Framework has also been highlighted. The interactions between regulatory and accounting approaches at both the national and international level can have significant consequences for the measures of capital adequacy and for the costs associated with the implementation of these approaches. In the most recent consultations, issues such as changes in the approach to the treatment of expected losses and unexpected losses and to the treatment of securitisation exposures, changes in the treatments of credit risk mitigation and revolving retail exposures, have been incorporated. The need for banks using the advanced IRB approach to incorporate the effects arising from economic downturns into their loss-given-default (LGD) parameters has also been highlighted. It is, however, necessary to ensure that the Framework keeps pace with market developments and advances in risk management practices.

The new capital adequacy framework (Basel II) also raises a variety of implementation challenges for both supervisors and banks. Taking this into account, the Financial Stability Institute (FSI), in coordination with BCBS, developed a Basel II Implementation Assistance Questionnaire to identify Basel II implementation plans and to determine corresponding capacity building needs in the non-BCBS supervisory community. Out of the 107 jurisdictions in Africa, Asia, the Caribbean, Latin America, the Middle East and non-BCBS Europe, 88 non-BCBS jurisdictions intend to adopt Basel II. Therefore, taking into account the 13 BCBS member countries, more than 100 countries worldwide will be implementing Basel II. With regard to the timeframe for adopting the new capital adequacy framework, Basel II would be implemented widely across regions during 2007-09. One of the major drivers for moving to Basel II in non-BCBS jurisdictions seems to be the intended implementation of this framework locally by foreign controlled banks or local branches of foreign banks. For Pillar 1 - minimum capital requirements - the foundation internal ratings-based (IRB) approach is envisaged to be the most used methodology for calculating capital requirements for credit risk (in terms of banking assets moving to Basel II) closely followed by the (simplified) standardised approach. As regards allocating capital for operational risk, the basic indicator approach is anticipated to be widely employed across regions. The challenge regarding Pillar 2 implementation relates to acquiring and upgrading the human and technical resources necessary for the review of banks' responsibilities under Pillar 1. An additional area of concern is the coordination of home and host supervisors in the cross-border implementation of Basel II. With regard to Pillar 3, the primary challenge seems to be that of aligning supervisory disclosures with international and domestic accounting standards.

Reference:

BIS (2004), 'Basel II: International Convergence of Capital Measurement and Capital Standards: a Revised Framework', *Basel Committee Publications* No. 107, June.

BIS (2004), 'Implementation of Basel II: Practical Considerations', *Basel Committee Publications* No. 107, July.

BIS (2004), 'Implementation of the New Capital Adequacy Framework in Non-Basel Committee Member Countries', Financial Stability Institute *Occasional Paper* No. 4, July.

Box II.13: Capital Charge for Market Risk

As per the capital adequacy requirements laid out by the Basel Committee on Banking Supervision (BCBS), banks are required to build capital for market risks in addition to their credit risk. The market risk is defined as the risk of losses in on-balance sheet and off-balance sheet positions arising from movements in market prices. The market risk positions subject to capital charge requirement include: (i) risks pertaining to interest rate related instruments and equities in the trading book; and (ii) foreign exchange risk (including open position in precious metals) throughout the bank (both banking and trading books). The BCBS had issued the 'Amendment to the Capital Accord to incorporate market risks' in January 1997 which provided a detailed account of the methodology to set capital requirements for market risks.

In India, as an initial step towards prescribing capital charge for market risks, banks have been advised to: (i) assign an additional risk weight of 2.5 per cent on the entire investment portfolio; (ii) assign a risk weight of 100 per cent on the open position limits on foreign exchange and gold; and (iii) build up Investment Fluctuation Reserve up to a minimum of five per cent of the investments held in Held for Trading and Available for Sale categories in the investment portfolio. In May 2003, the Reserve Bank issued draft guidelines on computing capital charge for market risks, on the lines of the Basel Committee framework, and based on the feedback received from select banks, it was decided in June 2004 that banks should maintain capital charge for market risks in a phased manner over a two-year period: (a) Capital for market risks on securities included in the trading book by March 31, 2005, and (b) capital for market risks on securities included in the Available for Sale category by March 31, 2006. Trading book for the purpose of these guidelines would include: (i) securities included under the Held for Trading category, (ii) securities included under the Available for Sale category, (iii) open gold position limits, (iv) open foreign exchange position limits, (v) trading positions in derivatives; and (vi) derivatives entered into for hedging trading book exposures.

The Basel Committee has suggested two broad methodologies for computation of capital charge for market risks, *viz.*, the standardised method and the banks' internal risk management models method. As banks in India are still in a nascent stage of developing internal risk management models, it has been decided that, to start with, banks may adopt the standardised method. Under the standardised method there are two principal methods of measuring market risk, a 'maturity' method and a 'duration' method. As 'duration' method is a more accurate method of measuring interest rate risk, it has been decided to adopt standardised duration method to arrive at the capital charge. Accordingly, banks are required to measure the general market risk charge by calculating the price sensitivity (modified duration) of each position separately.

Apart from managing the market risks in their books on an ongoing basis, *i.e.*, at the close of each business day, banks would also be required to maintain strict risk management systems to monitor and control intra-day exposures to market risks. To begin with, capital charge for market risks is applicable to banks on a global basis. At a later stage, this would be extended to all groups where the controlling entity is a bank.

measure, banks could shift SLR securities to the HTM category any time, once more, during the current accounting year. Such shifting should be done at the acquisition cost/book value/market value on the date of transfer, whichever is the least, and the depreciation, if any, on such transfer should be fully provided for. The non-SLR securities held as part of HTM may remain in that category. No fresh non-SLR securities would be permitted to be included in the HTM category. All other prudential norms applicable to securities included under the HTM category would continue to apply. Consistent with international standards that do not place any cap on HTM category, such a move was considered advisable taking into account the statutory nature of the 25 per cent SLR while ensuring prudence and transparency in valuation on transfer to HTM. While the earlier prescription was relatively more conservative, the recent changes recognised the dynamic interface with the interest rate cycles. Whereas the Reserve Bank recognises the need for continuing to build up IFR, banks have been advised to prepare themselves to implement the capital charge for market risk as envisaged under Basel II norms in a phased manner by end-March 2006.

Risk Weight for Retail Finance

2.69 In the recent past, the growth of housing and consumer credit has been very strong. The fast growing housing and consumer credit sectors also represent some degree of higher penetration, but the quality of lending needs to be ensured. As a temporary counter cyclical measure, the mid-term Review of annual policy for 2004-05 increased the risk weight from 50 per cent to 75 per cent in the case of housing loans and from 100 per cent to 125 per cent in the case of consumer credit including personal loans and credit cards.

Risk Weight for Exposure to PFIs

2.70 Guidelines issued in October 1998 prescribed risk weights on investment in bonds/ debentures of select Public Financial Institutions (PFIs) at 20 per cent. Banks were also advised that exposures to corporates, which are guaranteed by select PFIs, would tantamount to exposure on those PFIs for capital adequacy purposes and would consequently attract a risk weight of 20 per cent. Since the financial positions of PFIs are divergent, preferential treatment to PFIs for capital adequacy purposes on a privileged basis is not justified. Accordingly, banks have been advised on June 15, 2004 that with effect from April 1, 2005, exposures to all PFIs would attract a uniform risk weight of 100 per cent towards credit risk.

Income Recognition, Asset Classification and Provisioning

2.71 In line with the international practices and as per the recommendations made by the Committee on the Financial System (Chairman Shri M. Narasimham), the Reserve Bank introduced, in a phased manner, prudential norms for income recognition, asset classification and provisioning for the advances portfolio of the banks so as to move towards greater consistency and transparency in the published accounts. The endeavour of the Reserve Bank is to move to a policy of income recognition that is more objective and based on record of recovery rather than on any subjective considerations. Likewise, the classification of assets of banks has to be done on the basis of an objective criteria which would ensure a uniform and consistent application of the norms. Also, the provisioning should be made on the basis of the classification of assets based on the period for which the asset has remained non-performing and the availability of security and the realisable value thereof. Banks have been urged to ensure that while granting loans and advances, realistic repayment schedules may be fixed on the basis of cash flows/fluidity with borrowers so as to facilitate prompt repayment by the borrowers and improvement in the record of recovery in advances.

Buyback of Illiquid Securities by Government

2.72 The Union Budget, 2003-04 announced that if banks declare the premium received under the Government of India Debt Buyback Scheme for illiquid securities as business income, for income tax purposes they would be allowed additional deduction to the extent such income is used for provisioning of their NPAs. In order to enable banks to take benefits of the structure of tax incentives for the premium received, banks were exempted from the requirement of appropriating the profit on sale of securities from the HTM category to the capital reserve account, as a one-time measure, in respect of identified securities which are sold to the Government of India under the above scheme of Government of India's Debt Buyback Programme.

Revised NPA Norm for Agricultural Advances

2.73 In terms of earlier guidelines, all specified direct agricultural advances were treated as NPA when interest and/or instalment of principal remain unpaid after it has become due for two harvest seasons but for a period not exceeding two half years. However, in the case of longer duration crops, the prescription of not exceeding two-half years was considered to be inadequate. In order to align the repayment dates with harvesting of crops, it has been decided on June 2004 effective September 30, 2004, *viz.*, loans granted for short duration and long duration crops would be treated as NPA if the instalment of principal or interest thereon remains overdue for two crop seasons and one crop season, respectively. In respect of agricultural loans other than those specified and term loans given to non-agriculturists, identification of NPAs would be done on the same basis as non-agricultural advances, which at present, is the 90 days delinquency norm.

Provisioning Norms

2.74 As per the earlier guidelines, banks were advised to make a provision of 50 per cent in respect of the secured portion of NPAs included in 'doubtful for more than three years' category irrespective of its age, till it is identified as a loss asset. On a review, it has been decided in June 2004 to introduce a graded higher provisioning on the secured portion of NPAs under this category as on March 31, 2004, ranging from 60 per cent to 100 per cent over a period of three years in a phased manner, with effect from March 31, 2005. However, in respect of all advances classified as 'doubtful for more than three years' on or after April 1, 2004, the provisioning requirement would be 100 per cent. The provisioning requirement for unsecured portion of NPAs under the above category will continue to be 100 per cent.

Accounting Standards

2.75 Based on the recommendations made by the Working Group to recommend steps to eliminate/reduce gaps in compliance by banks with the Accounting Standards (Chairman: Shri N.D. Gupta), detailed guidelines were issued on March 29, 2003 relating to certain accounting standards[7]. The Working Group had also made recommendations in respect of Accounting Standards 24 (discontinuing operations), 26 (intangible assets) and 28 (impairment of assets). In April 2004, guidelines were issued to ensure banks' compliance with these accounting standards and banks have been advised to ensure that there are no qualifications by the auditors in their financial statements for non-compliance with any accounting standard.

Empanelment of Statutory Auditors

2.76 Keeping in view the vast changes that have taken place in the size and complexity of operations of public sector banks as also the fact that the eligibility norms for empanelment of audit firms for appointment as their statutory auditors had remained unchanged for almost two decades without any major changes, a Working Group was set up to examine the extant norms and practices followed for appointment of statutory auditors of public sector banks and suggest modifications, if necessary. These recommendations were accepted by the Reserve Bank and were to be made applicable from the year 2004-05. However, on receipt of request from the Institute of Chartered Accountants of India, the implementation thereof has been deferred by one year.

Risk Management

2.77 With a view to furthering compliance with the Core Principles for Effective Banking Supervision, the Reserve Bank had issued guidelines on country risk management and provisioning in February 2003. The guidelines on country risk management were applicable only in respect of countries, where a bank has net funded exposure of two per cent or more of its total assets. The guidelines were reviewed taking into account the experience of banks in implementing the guidelines and were extended to countries where a bank has net funded exposure of one per cent or more of its total assets, to be effective from year ending March 31, 2005.

Banks' Investment in Non-SLR Securities

2.78 It has been emphasised by the Reserve Bank that banks should observe prudence in order to contain the risk arising out of non-SLR investment portfolio, in particular through the private placement route. For this purpose, detailed prudential guidelines on the subject have been issued in November 2003, which *inter alia* address aspects of coverage, regulatory requirements, listing and rating requirements, fixing of prudential limits, internal assessments, role of Boards, disclosures and trading and settlement in debt securities.

2.79 The guidelines cover banks' investments in non-SLR securities issued by corporates, banks, FIs and State and Central Government sponsored institutions, SPVs, *etc.* The guidelines apply to investments both in the primary as well as secondary market. The guidelines are, however, not applicable to investments in securities issued directly by Central and State Governments, which are not reckoned for SLR purposes, and investment in equity shares. With a view to operationalising the guidelines and to ensure smooth transition, certain clarifications and modifications were issued in December 2003. However, a study of select banks revealed that banks continue to have significant share of unlisted and unrated investments in their non-SLR portfolio. Accordingly, banks have been urged to prepare themselves to comply with the prudential requirements within the prescribed timeframe.

[7] AS 5: Net Profit or Loss for the period, prior period items and changes in accounting policies; AS 9: Revenue recognition; AS 15: Accounting for retirement benefits in the financial statements of employers; AS 17: Segment reporting; AS 18: Related party disclosures; AS 22: Accounting for taxes on income; AS 23: Accounting for Investments in Associates in Consolidated Financial Statements; AS 25: Interim Financial Reporting; and AS 27: Financial Reporting of Interests in Joint Ventures.

4. NPA Management by Banks

One-Time Settlement/Compromise Scheme

2.80 In May 2003, the time limit for processing of applications received under the revised guidelines for compromise settlement of chronic NPAs of public sector banks, up to Rs.10 crore was extended to December 31, 2003. Based on the requests received for further extending the time limit for operation of the guidelines and in consultation with Government of India, the time limit for receiving applications was further extended up to July 31, 2004.

Lok Adalats

2.81 With the enactment of Legal Services Authority Act, 1987, *Lok Adalats* were conferred a judicial status and have since emerged as a convenient method for settlement of disputes between banks and small borrowers. The Reserve Bank has issued guidelines to commercial banks and FIs advising them to make increasing use of *Lok Adalats*. Government has recently revised the monetary ceiling of cases to be referred to *Lok Adalats* organised by Civil Courts from Rs.5 lakh to Rs.20 lakh.

2.82 The number of cases filed by commercial banks with *Lok Adalats* stood at 485,046 involving an amount of Rs.2,433 crore. The number of cases decided was 205,032 involving an amount of Rs.974 crore, and the recoveries effected in 159,316 cases stood at Rs.328 crore as on March 31, 2004.

Debt Recovery Tribunals

2.83 The Recovery of Debts Due to Banks and Financial Institutions Act was enacted in 1993 to provide for the establishment of tribunals for expeditious adjudication and recovery of debts due to banks and FIs and for matters connected therewith and incidental thereto. The amendments made in 2000 to the above Act and the Rules framed thereunder have strengthened the functioning of DRTs. On the recommendations of the Reserve Bank, Government has since set up a working group headed by Additional Secretary (FS), Government of India to improve the functioning of DRTs.

2.84 As on June 30, 2004, out of 63,600 cases (involving Rs.91,926 crore) filed with DRTs by the banks, 27,956 cases (involving Rs.25,358 crore) have been adjudicated by them. The amount recovered so far through the adjudicated cases is placed at Rs.7,845 crore.

Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002

2.85 The Act provides, *inter alia* for enforcement of security interest for realisation of dues without the intervention of courts or tribunals. The Security Interest (Enforcement) Rules, 2002 has also been notified by Government to enable Secured Creditors to authorise their officials to enforce the securities and recover the dues from the borrowers. The Supreme Court in its judgement dated April 8, 2004 in M/s. Mardia Chemicals has upheld the constitutional validity of the Act and its provisions except that a subsection 2 of Section 17 by the secured creditor, in case the borrower wants to appeal against the secured creditor's notice under Section 13 (4) of the Act. It has declared Section 17 (2) as unconstitutional and violative of Article 14 of the Constitution of India. In the wake of this judgement, many banks have pointed out practical difficulties likely to arise in speeding up the recovery of NPAs. The suggestion of banks, IBA and other organisations in this regard are being examined to carry out necessary amendments in the Act. In the Union Budget 2004-05, the Government has proposed to amend the relevant provisions of the Act to appropriately address the Supreme Court's concerns regarding a fair deal to borrowers while, at the same time, ensuring that the recovery process is not delayed or hampered.

2.86 As on June 30, 2004, 27 public sector banks had issued 61,263 notices involving outstanding amount of Rs.19,744 crore, and had recovered an amount of Rs.1,748 crore from 24,092 cases.

Corporate Debt Restructuring

2.87 The Scheme of Corporate Debt Restructuring (CDR) started in 2001 with a view to put in place a mechanism for timely and transparent restructuring of corporate debts of viable entities facing problems, outside the purview of BIFR, DRT and other legal proceedings, was further fine-tuned in February 2003 based on the recommendations made by a

Working Group under Shri Vepa Kamesam. A recent review of the operation of the Scheme revealed that nearly one-third of the units assisted under the Scheme improved their financial position. However, issues relating to proper identification and successful implementation of packages along with other operational aspects need to be addressed from a systemic point of view. Accordingly, a Special Group has been constituted to review the performance of the CDR mechanism and suggest measures to make it more effective. The Group is expected to submit its Report by December 2004.

2.88 The number of cases and value of assets restructured under the CDR mechanism stood at 94 and Rs.64,017 crore, respectively, as on June 30, 2004. The major beneficiaries were iron & steel, refinery, fertilisers and telecommunication industries, accounting for more than two-third share of value of assets restructured.

Asset Reconstruction Companies (ARCs)

2.89 To solve the problem of bad loans, several institutions have initiated steps towards establishment of ARCs, which takeover non-performing loans of banks and FIs at a discounted rate, and manage and dispose such assets. The Reserve Bank has granted certificate of registration (CoR) to three ARCs so far out of which ARCIL has already started its operations. So far ARCIL has acquired NPAs worth Rs.9,631 crore from banks and FIs at a price of Rs.2,089 crore. In order that ARCs have a sound capital base and a stake in the management of the NPAs acquired, the requirement of owned funds for commencement of business has been stipulated as not less than 15 per cent of the assets acquired or Rs.100 crore, whichever is less.

Credit Information on Defaulters and Role of Credit Information Bureau

2.90 The development of an efficient credit information system is considered critical for the development of a sound financial system. Dissemination of credit information covering data supplied on suit-filed defaulters in the financial system is being undertaken by CIBIL with effect from March 2003, and the data can be accessed on CIBIL's website. The Reserve Bank had issued instructions to banks and FIs on October 1, 2002, and February 10, 2003, respectively, to obtain the consent of all their borrowers for pooling of data for development of a comprehensive credit information system. In order to give further thrust in the matter of operationalisation of CIBIL, the Reserve Bank advised banks/FIs to review the measures taken at their Board level and report compliance to the Reserve Bank about the same. It was reported by a major nationalised bank that they have submitted credit information relating to 80 per cent of their eligible borrowers after obtaining necessary consents. Banks have been urged to make persistent efforts in obtaining consent from all their borrowers, in order to establish an efficient credit information system, which would help in enhancing the quality of credit decisions and improving the asset quality of banks, apart from facilitating faster credit delivery. Further, with a view to strengthening the legal mechanism and facilitating credit information bureaus to collect, process and share credit information on borrowers of bank/FIs, a draft Credit Information Companies Regulation Bill, 2004 covering registration, responsibilities of the bureaus, rights and obligations of the credit institutions and safeguarding of privacy rights is under active consideration of the Government.

2.91 Following the recommendations of Working Group on Wilful Defaulters (Chairman: Shri S.S. Kohli), with a view to making the scheme of wilful defaulters effective, the banks/FIs were issued a revised definition of 'wilful defaulters' on May 30, 2002. Reserve Bank issued further guidelines on July 29, 2003 to banks/FIs who are required to form a Committee of higher functionaries headed by the Executive Director for classification of borrowal accounts as wilful defaulters, and create a redressal mechanism in the form of Committee headed by Chairman and Managing Director for giving a hearing to borrowers who represent that they have been wrongly classified as wilful defaulters. On representation by the borrowers who were classified as 'wilful defaulters' that the redressal mechanism should precede the classification as 'wilful defaulter', it has been further clarified vide circular dated June 17, 2004, that the classification of the defaulter as wilful and the mechanism for redressal of the grievance of the borrower concerned is to be carried out thoroughly through two distinct processes, *viz*., (i) identification of default as 'wilful' based on the prescribed norms through a Committee approach; and (ii) suitably advising the borrower about the proposal to classify him as wilful defaulter along with the reasons therefor. The concerned borrower would be provided reasonable time (say, 15 days) for making representation against such decision, if he so desires, to the Committee headed by the Chairman and Managing Director. A final declaration as 'wilful defaulter' would be made only after a view is taken by the Committee on specific representation.

5. Supervision and Supervisory Policy[8]

Board for Financial Supervision

2.92 A number of supervisory initiatives were taken by the Board for Financial Supervision (BFS) to strengthen its oversight over the financial system in the light of the fast changing economic and financial landscape. The BFS held 12 meetings during 2003-04.

2.93 Several important issues were discussed in the meetings of BFS during 2003-04 including investments and advances, internal controls, NPAs, provisioning, disclosure and ratings. As regards advances/investments of banks, the major areas of concern included: (i) the need for obtaining proper security and transparency in application of interest rates for housing loans; (ii) fixing the limit on exposure of banks with respect to gross advances rather than capital funds as is being done presently; (iii) the case for exclusion of new economy businesses, like information technology, services sector, retail trade, while applying the 15 per cent ceiling on unsecured advances; (iv) the systemic impact of cross-holdings of subordinated debt and equities across banks and financial institutions; and (v) impact on financial position of banks of marking to market cent-per-cent of investments.

2.94 For placing better internal controls in the banks, it was considered that the time allowed for reconciliation of outstanding entries for making provisions be reduced from one year to six months. With a view to reducing the burden on the banks, it was also contemplated to categorise the multiple guidelines issued to the banks into three groups, *viz.*, structure required in the banks, internal reporting system in the banks and reporting to the regulator. The need to revise the zero-risk weight for exposure to the State Government undertakings and State Government guarantees in case of defaults and the need to separate out defaulters with outstanding above Rs.10 crore from the list of defaulters with outstanding amounts of Rs.1 crore and above, were also highlighted. The need to examine the adequacy of provisions for pension, gratuity and other terminal benefits for bank employees in the light of a recent revision by LIC in the premium rates was also brought out. It has also been decided to allow banks to disclose their provision for NPAs not reported in the previous year separately, if these did not reflect the performance of the present management, after due assessment by an independent auditor appointed by the Reserve Bank.

2.95 Apart from these, detailed instructions were issued to ensure safety, integrity and confidentiality of inspection findings/scrutiny reports used by the Inspecting Officers, and to draft the inspection reports in a manner that would lend itself to a better and timely compliance. Principal Inspecting Officers were advised to submit a separate note on the quality of compliance with the guidelines on 'Know Your Customer' (KYC), and to examine circular trading in securities, if any, carried out by banks. The coverage of items reported under the OSMOS returns have been fine tuned in line with the changes in regulatory and supervisory guidelines by introducing additional returns related to the consolidated prudential norms, risk based supervision and returns for capturing supervisory data daily from off-shore banking units (OBUs).

2.96 A Risk Based Supervision (RBS) Manual had been drafted and finalised keeping in view international best practices and customised to suit the Indian conditions, the institutional mechanism to monitor the progress of the banks in preparedness for RBS was being monitored continuously, and risk based supervision is

[8] While the policy measures are discussed in this Chapter with respect to fiscal 2003-04 (April-March) and 2004-05 (so far), the supervisory details are discussed over the period covering July 2003-June 2004, since the Reserve Bank accounting year spans over July-June.

being taken up on a pilot basis from the year 2004. The recommendations of the report of 'Consultative Group on the role of Directors of Bank and Financial Institutions' regarding corporate governance were conveyed to banks for implementation. Initially, consolidated financial statements and consolidated prudential reporting has been mandated for all groups where the controlling entity is a bank. In due course, the banks in mixed conglomerates would be brought under consolidated supervision. Certain changes were made in the method of awarding ratings under CAMELS and CALCS model for Indian and foreign banks, respectively, such as, increase the marks for fraud monitoring and prevention.

2.97 The Sub-Committee (Audit) set up by the BFS (with two non-official Members of BFS headed by the Vice-Chairman of BFS) in January 1995 to lay down and review the policies governing audit of banks, *etc.* continued to function during the year. The Sub-Committee (Audit) of the BFS held four meetings during the year. The recommendations of a Working Group set up to review the eligibility norms for empanelment of audit firms as statutory auditors and other audit related issues were firmed up for implementation from 2004-05. The format of the report of half-yearly review of accounts of public sector banks has been revised and, in June 2003, listed banks have been advised to adopt the revised format for quarterly financial results with 'limited review', as required by the SEBI. In pursuance of the recommendations of the Committee on Legal Aspects of Bank Frauds (Chairman: Dr. N.L. Mitra), banks have been also advised to include specific reporting of suspected frauds or fraudulent activity to the Chief Executive Officer of the bank and the Reserve Bank in the terms of appointment of external auditors. A structured questionnaire calling for information from the public sector banks on the performance of their Statutory Central Auditors (SCAs) containing *inter alia*, detailed observations/recommendations on continuance or otherwise of their statutory auditors has been introduced during the year 2003-04 with a view to assessing the performance of the statutory central auditors more objectively.

2.98 The Board reviewed the monitoring done with regard to bank frauds and housekeeping in public sector banks including reconciliation of entries in inter-branch accounts, inter-bank accounts (including nostro accounts) and balancing of the books of accounts. The banks have been advised to ensure that each and every desk in the branches certifies that there was no laxity in implementing the laid down systems and procedures. Similarly, in the area of reconciliation of entries in inter-branch and inter-bank as well as balancing of books of account, considerable improvement has been ensured through continuous monitoring by the BFS. With a view to strengthen the consultative process in financial regulation, a Standing Technical Advisory Committee on Financial Regulation was constituted in November 2003 (Box II.14).

Corporate Governance

2.99 The matter regarding the application submitted by a bank for granting acknowledgement for effecting transfer of 33.55 per cent of share capital of the bank in favour of four companies belonging to a Group was discussed by the BFS in detail. Based on the information available and having taken into account all relevant factors, the Board felt that it was not possible to be satisfied about 'fit and proper' status of the applicants; and the Reserve Bank advised the bank that it was unable to grant acknowledgement for transfer of shares that was applied for. Subsequently, the Group entered into an agreement for sale of shares to seven individuals. The matter is being examined by the Reserve Bank in consultation with the Independent Advisory Committee set up as per the guidelines of February 3, 2004.

Disclosure of Penalties, etc. Imposed by the Reserve Bank

2.100 In view of the added emphasis on the role of market discipline under Basel II and with a view to enhancing further transparency, banks have been advised on October 19, 2004 that all cases of penalty imposed by the Reserve Bank as also strictures/directions on specific matters including those arising out of inspection should be placed in the public domain. The issue of disclosure of imposition of penalties on banks and findings of the Reserve Bank inspections were reviewed by the BFS and it was decided that monetary penalty imposed by the Reserve Bank should be disclosed in the balance sheets.

Box II.14: Standing Technical Advisory Committee on Financial Regulation

The Standing Technical Advisory Committee on Financial Regulation was constituted on November 20, 2003 in order to strengthen the consultative process among banks, market participants and regulators of financial markets, more particularly, in the context of carrying forward India's prudential regulatory system in line with the best international practices. The Committee has a broad based representation of chief executives of select banks in public, private and foreign sector as also from the financial institutions, NBFCs, apart from academics in the field of banking. The Committee would initially function for two years from the date of its first meeting, and would meet as often as may be necessary, but ordinarily once in two months.

The terms of reference of the Committee include the following: (a) to review current regulatory regime with a view to help the Reserve Bank in simplifying and rationalising it, in particular to move towards clearer as well as unambiguous regulatory prescriptions and enhance internal control systems; (b) to consider the existing regulatory practices on prudential norms and disclosure standards for banks and non banks regulated by the Reserve Bank and recommend measures for progressive alignment with international best practices consistent with India's needs; (c) to advise on the changes needed from time to time, in the regulatory framework in the light of the emerging diversification of business mix of the financial services industry; (d) to help analyse, as appropriate, harmonisation of regulatory and prudential norms for the various entities in the financial services sector in alignment with prescriptions of other regulators; (e) to explore appropriate regulatory responses to developments in the banking and financial markets; (f) to outline the steps to be taken by the Reserve Bank and banking entities in the context of Basel II norms; (g) to suggest measures for strengthening corporate governance in institutions regulated by the Reserve Bank; and (h) to tender advice on any other specific issue relevant to the regulation of financial sector either referred to it by the Reserve Bank or considered appropriate by the Committee.

Since its constitution, the Committee's assistance and views have been sought on a wide range of topical regulatory issues. The benefits of the members' views are also being sought on further measures to deregulate some of the existing prescriptions.

On the basis of the advice of the Committee, a User Committee comprising of nominees of SBI, Bank of Baroda, Union Bank of India, ICICI Bank Ltd., HSBC, IBA, Fixed Money Market and Derivatives Association (FIMMDA), Primary Dealers Association of India (PDAI) and Foreign Exchange Dealers Association of India (FEDAI) has been set up. All regulatory departments would refer circulars to the User Committee for their views. The nominees are required to promptly respond to the draft circular with their suggestions so as to ensure clarity of the circulars to its users.

As regards disclosure of serious findings of the Reserve Bank during the inspection, each case would be examined by BFS to decide whether any finding was required to be publicised in depositors' interest and public interest. If so, the bank will be given an opportunity for a hearing before decision is taken to place the finding in public domain after taking into account the response and corrective action taken. Both monetary penalties and adverse findings which have been decided to be placed in public domain will be disclosed through the websites of the Reserve Bank and concerned bank. These will also have to be disclosed in the annual reports. In the case of foreign banks, disclosure may be made in the balance sheet of Indian operations.

Prompt Corrective Action

2.101 The Prompt Corrective Action (PCA) scheme was reviewed by the BFS, and it was decided to continue the scheme in the present form. A few banks which have come under the trigger zones were advised to take necessary preventive action. There has been improvement in the working of some of these banks.

Supervisory Rating of Banks

2.102 Certain changes were made in the method of awarding ratings under CAMELS and CALCS model for Indian and foreign banks, respectively. Weights given for fraud monitoring by banks has been increased by reallocation of marks under the paragraph 'systems and control' and 'systems' for Indian and foreign banks, respectively with a view to ensuring better compliance. For awarding marks for the component 'earnings' under CAMELS model, it had been decided to consider profit before tax (PBT) instead of profit after tax (PAT) to avoid the impact of a large amount of tax or refund of tax in a particular year and the banks have been advised accordingly.

Monitoring of Frauds

2.103 Occurrence and delay in disposal of large value frauds continued to receive the attention of the BFS. To ensure concerted action by banks and FIs, progress in respect of large value frauds of Rs.10 crore and above relating to the period prior to 2000 were followed up since 2001. Due to continuous follow up there has been considerable improvement in completion of staff side action. It has now been decided to follow up all such cases relating to the period after 2000 also. Further, age-wise quarterly data on pending staff side cases of all frauds in public sector banks was being collected since June 30, 2003 for better monitoring. A review of the data reported by public sector banks showed that there had been considerable improvement over the period.

2.104 Based on a suggestion by the Central Bureau of Investigation (CBI) and Central Vigilance Commission (CVC) all the Indian commercial banks have been advised in January 2004, to appoint a Special Committee of the Board to monitor large value frauds involving amounts of Rs.1 crore and above. Frauds involving amounts of less than Rs.1 crore will continue to be monitored by the Audit Committee of the Board (ACB) in banks, as per the earlier practice. All the banks have reported constitution of Special Committees.

2.105 In view of the large number of vigilance cases handled and keeping in view the changing scenario in the banking industry, CVC has accepted the representation made by the IBA and has decided that only such vigilance cases in which an officer of the level of Scale V and above is involved need to be referred to the Commission for advice. Vigilance cases involving an officer in Scale IV and below are allowed to be handled by the banks themselves. The modified arrangement is expected to enable expeditious disposal of the references made to CVC, as also to provide a conducive environment for the staff in public sector banks to perform their duties consistent with normal commercial judgements.

2.106 A 'Technical Paper on Bank Frauds' which brought out various issues like legal definition of frauds, international legal framework, delay in closure of cases, recent measures taken based on the recommendations of Dr. N L Mitra Committee Report, *etc.* was reviewed by the BFS. With a view to have an integrated approach and give focused attention to monitoring of frauds not only in commercial banks, but entire financial system, Frauds Wing of the Department of Banking Supervision has been hived off and a separate Fraud Monitoring Cell has been constituted headed by a Chief General Manager with effect from June 1, 2004. The Cell will monitor and follow up frauds perpetrated in commercial banks, financial institutions, local area banks, urban co-operative banks, non-banking financial companies, *etc.*

2.107 A change in the policies and procedures of the Reserve Bank was mooted with a view to empowering the common person and safeguarding his rights in undertaking legitimate transactions. Accordingly, a Standing Committee was constituted on Procedures and Performance Audit on Public Services (Chairman: Shri S.S. Tarapore) to undertake procedures and performance audit on public services and regulatory clearances in the Reserve Bank and to co-ordinate with the *Ad-hoc* Committees on Customer Services set up by banks. The Committee has since submitted four reports relating to individuals covering: (i) foreign exchange transactions; (ii) Government transactions; (iii) banking operations relating to deposit accounts and other facilities; and (iv) currency management (non-business), which have been placed on the Reserve Bank website alongwith the action taken reports of the Reserve Bank (Box II.15).

6. Consultative Process in Policy Formulation

2.108 In order to ensure timely and effective implementation of the measures, the Reserve Bank has been adopting a consultative approach before introducing policy measures. A consultative approach not only enables benchmarking the financial services against international best standards in a transparent manner, but also provides useful lead time to market players for smooth adjustment with regulatory changes.

Resource Management Discussions

2.109 The Resource Management Discussion meetings are held every year prior to the Monetary and Credit Policy announcements with select banks. These meetings mainly focus on perception and outlook of the bankers on economy, liquidity condition, credit outflow, development of different markets and direction of interest rates along with their expectations from the policy and suggestions in this respect. During 2003-04 these meetings were conducted with 10 banks (including two foreign banks and two private sector banks) during March 11-17, 2004. The feedback received from these meetings was taken into consideration while formulating the annual policy for 2004-05.

Box II.15: Standing Committee on Procedures and Performance Audit on Public Services

The recommendations of the Committee which have already been implemented by the Reserve Bank are detailed below:

Report on Exchange Control Relating to Individuals

- The name of Exchange Control Department changed to Foreign Exchange Department effective January 31, 2004.
- Simplified application cum declaration form introduced for drawal of foreign exchange.
- FAQs and printed pamphlets on important facilities issued.

Report on Government Transactions Relating to Individuals

- Citizens' charter revamped and displayed in the Reserve Bank's public departments with brochures, available with all offices.
- Applications standardised for savings bonds containing features and subscribers' rights with regard to services thereunder introduced in all offices/agencies.
- Regional Offices to organise customer meets and customer service orientation training for staff and conduct on the spot verification of arrangements provided by agency banks.
- New Delhi and Chennai offices to implement, on pilot basis, issue of post-dated interest warrants in the case of senior citizens.

Report on Banking Operations

- *Ad hoc* Committees/CEOs of banks advised to take necessary action for adoption of IBA's model deposit policy by all banks.
- Banks to constitute a Customer Service Committee of the Board at the Apex level, to address issues such as formulation of deposit policy for the bank, establishment of product approval process, operation of deceased depositor's accounts, survey of depositor satisfaction and the triennial audit of customer services.
- Banks advised to include in their deposit policy that changes in any instruction on the operation of the senior citizens' deposit accounts should be confirmed to the depositor within a month.
- Banks to remove unfair practices in respect of despatch of cheque books through courier, to avoid inscrutable entries in pass books/statement of accounts, not to include in the account opening form information collected for purposes other than KYC.
- *Ad hoc* committees to examine the working of enquiry counters in the banks.
- Banks to examine the recommendation for appointment of Quality Assurance Officers in their banks. *Ad hoc* Committees of banks are to take necessary action in this regard.
- Regional offices to constitute a Group on Customer Service for ongoing monitoring of the quality of the customer service provided by the banks in their region.
- Incognito visits by the Reserve Bank officers to bank branches to assess the level of customer services. The Reserve Bank to consider giving weightage to depositors' complaints while evaluating a bank's performance.
- Banks to develop a comprehensive and transparent policy on collection of cheques and interest compensation for delayed collection in line with the instructions issued by the Reserve Bank from time to time. Changes, if any, in the policy to be intimated to the customers promptly.

Report on Currency Management

- Banks and Regional Offices to ensure compliance regarding recommendations of the Report on services to common persons.
- Revised draft citizen's charter put on the Reserve Bank website and circulated among Reserve Bank offices/banks.
- Note refund rules with simplified explanations put on the Reserve Bank website.
- Currency chest agreement is being revised.
- The bank branches maintaining small coin depot advised to freely accept uncurrent coins.

Technical Advisory Committee on Money, Foreign Exchange and Government Securities Markets (TAC)

2.110 The Technical Advisory Committee under the Chairmanship of Deputy Governor of the Reserve Bank has emerged as a key consultative mechanism among the regulators and various market players. The Committee has been crystallising the synergies of experts across various fields of the financial market and thereby acting as a facilitator for the Reserve Bank in steering reforms in money and Government securities markets. As a matter of convention, the members of this Committee are nominated in their individual capacity representing different segments of the economy *viz.*, Government, academicians, practising economists, banks, financial institutions, credit rating agencies, stock exchanges, trade bodies such as FIMMDA, PDAI, *etc.*

2.111 Keeping in view the inter-linkages among money, Government securities and foreign exchange markets with implications for monetary policy operations, the Committee has been reconstituted recently by widening its scope to include the foreign exchange market. The Committee advises the Reserve Bank on an ongoing basis, regarding the development of healthy and vibrant money, foreign exchange and Government securities markets. The Committee meets at least once every quarter.

National Payments Council

2.112 Reforms in the payment and settlement system are being overseen by the National Payments Council (NPC), which is the apex policy-making body in the arena. The NPC is chaired by a Deputy Governor, and consists of representatives from banks, the National Stock Exchange (NSE), the Securities and Exchange Board of India (SEBI), and a non-banking finance company. The NPC took several policy initiatives during 2003-04 including extension of Structured Financial Messaging Solution (SFMS) facilities over the Internet, removal of the limit on electronic modes of funds transfers, and extension of RTGS facilities to primary dealers.

7. Money, Government Securities and Foreign Exchange Markets

Money Market

2.113 Development of an efficient and vibrant money market constitutes an integral part of financial liberalisation and is considered a pre-requisite for efficient transmission of monetary policy. With a view to developing money market instruments, institutions and operating procedures and preserving the integrity of money market, the Reserve Bank has taken a number of measures in recent years.

a) Call/Notice Money Market

Progress towards Pure Inter-Bank Call Money Market

2.114 To accelerate the process of moving towards a pure inter-bank call/notice money market, the limit on lendings by non-bank participants was reduced successively from 75 per cent (June 14, 2003) to 60 per cent (December 7, 2003), to 45 per cent (June 26, 2004), and further to 30 per cent to be effective January 8, 2005 of their average daily lending in call/notice money market in 2000-01. In case a particular non-bank institution face genuine difficulties in deploying its excess liquidity, the Reserve Bank could consider providing temporary permission to lend a higher amount in call/notice money market for a specific period, on a case by case basis.

Participation of Primary Dealers

2.115 With a view to developing the repo market as also to ensure balanced development of various segments of money market, primary dealers (PDs) have been allowed to borrow with effect from February 7, 2004, on average in a reporting fortnight, up to 200 per cent of their net owned funds (NOF) as at end-March of the preceding financial year. However, any PD having a genuine difficulty in adhering to the limit may approach the Reserve Bank for appropriate reasonable dispensation with full justification for extension of period of compliance sought.

2.116 As stipulated in the Fiscal Responsibility and Budget Management Act 2003, the participation of the Reserve Bank in the primary issues of Government securities will stand withdrawn from April 1, 2006, warranting a review of processes and technological infrastructure consistent with market advancements. The Reserve Bank's intervention directly in the market or through PDs on a real time basis may become necessary in due course. Keeping the above in view, it has been proposed in the mid-term Review of annual policy for 2004-05 to constitute a Study Group for strengthening OMO framework. In addition to this, a sub-group (Chairman: Dr. R.H. Patil) of the Technical Advisory Committee on money, foreign exchange and Government securities markets (TAC) has been constituted with a view to evaluate the role of PDs in the Government securities market with particular emphasis on their obligation and ability to cope with emerging risk and possible diversification of their balance sheets.

Reciprocal Line Facility

2.117 Lending/borrowing in call/notice money market now include transactions under Reciprocal Line Facility from the fortnight beginning February 7, 2004 and this should not exceed the prudential limits specified for this purpose.

b) Term Money Market

2.118 One of the main reasons for non-development of a deep and liquid term money market in India is the absence of a vibrant repo market. Inability of participants to clearly formulate interest rate expectations over a medium-term horizon also affects the volumes in the term money segment. This has resulted in market participants locking their funds short. Skewness in liquidity among participants has also been observed. Besides, corporates' preference for 'cash' credit rather than for 'loan' credit generally forces banks to deploy a large amount in call/notice money market rather than in term money market to meet sudden demand from corporates.

c) Certificates of Deposit (CDs)

2.119 This segment of the financial market witnessed increasing activity following the issuance of guidelines on investments by banks in non-SLR debt securities, reduction in stamp duty on CDs, a ban on premature closure of CDs and greater opportunity for secondary market trading. These developments have led to greater demand for investment in CD by mutual funds particularly in the wake of their improved funds position. In order to improve their access to the market, some of the top rated banks have begun to get their CDs rated.

d) Commercial Paper (CP)

2.120 With a view to developing the CP market, a status paper was placed on the Reserve Bank website to be discussed with market participants as well as in the TAC. Taking into account the suggestions and market response, the following measures were announced in the mid-term Review of anuual policy for 2004-05: (i) the minimum maturity period of CP is reduced from 15 days to 7 days with immediate effect; (ii) issuing and paying agents (IPAs) would report issuance of CP on the negotiated dealing system (NDS) platform by the end of the day (The date of commencement of reporting to be finalised in consultation with market participants); and (iii) with a view to moving towards the settlement on a T+1 basis, a Group comprising market participants would be constituted to suggest rationalisation and standardisation in respect of processing, settlement and documentation of CP issuance.

e) Collateralised Borrowing and Lending Obligation (CBLO)

2.121 CBLO has been operationalised as a money market instrument by CCIL on January 20, 2003. The maturity of CBLO varies from one day to one year. The regulatory provisions and accounting treatment of CBLO are the same as those applicable to other money market instruments. CBLO has been exempted from CRR subject to banks maintaining minimum CRR of 3 per cent. The daily average turnover in CBLO segment increased from Rs.47 crore in April 2003 to about Rs.2,500 crore in April 2004 and further to Rs.8,466 crore in October 2004. The total membership of the CBLO segment stood at 79 in October 2004. With a view to encouraging further development of this segment, the Reserve Bank has effected automated value-free transfer of securities between market participants and the CCIL.

f) Interest Rate Futures (IRFs)

2.122 In order to enable banks to hedge their interest rate risk, the Reserve Bank allowed banks and primary dealers to transact in exchange traded interest rate futures in June 2003. While PDs were allowed to hold trading as well as hedging positions in Interest Rate Futures (IRFs), banks were allowed only to hedge their underlying Government securities in AFS and HFT categories. Accordingly, the National Stock Exchange (NSE) introduced futures on notional 10-year Government security, 3-month Treasury Bill and 10-year Government zero coupon in June 2003. Activity in the IRF market, however, has not picked up mostly because of valuation problems and subdued activity of banks in the IRF market.

2.123 The SEBI revisited issues pertaining to introduction of new futures contracts in consultation with the Fixed Income Money Market and Derivatives Association of India (FIMMDA). On January 5, 2004, the SEBI permitted trading of IRFs contract on an underlying 10-year coupon-bearing notional bond which would be priced on the basis of the yield-to-maturity (YTM) of a basket comprising bonds with maturity ranging from 9 to 11 years. The product is awaiting launch by the exchanges.

Committee on Rupee Interest Rate Derivatives

2.124 The Reserve Bank set up an Internal Working Group on Derivatives in September 2003 which recommended, *inter alia*, (i) harmonisation of regulations between OTC interest rate derivatives and exchange traded interest rate derivatives; and (ii) permission to those banks to hold trading positions in IRF market which have adequate internal risk management and control systems and robust operational framework subject to certain conditions. The recommendations of the Working Group are under examination after further discussion in TAC.

Government Securities Market

2.125 The Reserve Bank, in consultation with market participants, has taken significant steps to broaden and deepen the Government securities market. Such measures include *inter alia* the issuance of uniform accounting norms for repo and reverse repo transactions, extension of repo facility to gilt account holders, facility for anonymous screen-based order-driven trading system for Government securities on stock exchanges, introduction of exchange-traded interest rate derivatives on the National Stock Exchange (NSE), relaxation in regulation relating to sale of securities by permitting sale against an existing purchase contract, facilitating the roll over of repos and switch over to the Delivery versus Payments (D*v*P) III mode of settlement.

Reporting on NDS Platform

2.126 The Reserve Bank has extended the facility of settlement in Government securities transactions over NDS-CCIL System besides the settlement under Delivery verses Payment (D*v*P) system to all market participants. All Government securities transactions (both outright and repo) are being settled compulsorily through CCIL only, and any transaction in Government securities settled by the banks outside the NDS-CCIL system are not being accepted by the Reserve Bank since April 1, 2003.

2.127 With a view to improving transparency and strengthening efficiency in the market, the Reserve Bank has been making continuous improvement in its software such that NDS members could report all their call/notice/term money trades over NDS including such trades with non-NDS members. It was made mandatory for all NDS members to report all their call/notice money market deals on NDS with effect from the fortnight beginning May 3, 2003. Deals done outside NDS should be reported within 15 minutes on NDS, irrespective of the size of the deal or whether the counterparty is a member of the NDS or not. As indicated in the annual policy Statement of 2004-05, a Working Group (Chairman: Dr.R.H. Patil) has reviewed the performance of NDS in the context of its operational efficiency and recommended an anonymous electronic screen based order matching trading system on the NDS. The Report of the Group has been placed in the public domain for wider dissemination.

Capital Indexed Bonds

2.128 Capital Indexed Bonds (CIBs) as a type of inflation indexed bonds were initially introduced in December 1997. In addition to inflation risk hedging capabilities, the CIBs provide risk diversification benefits to the investors and the issuers alike. In view of the lukewarm response from the market, there were no further issuances of CIB. A discussion paper on CIB was placed on the website of the Reserve Bank as well as Government of India on May 24, 2004 for comments so as to reintroduce a modified CIB. In this regard, market conventions for secondary market trading and settlement of the bonds are being finalised in consultation with Fixed Income Money Market and Derivatives Association of India (FIMMDA) and Primary Dealers Association of India (PDAI). Suitable modifications in the PDO-NDS trading, clearing and settlement system are being undertaken. The CIBs are expected to be introduced during 2005-06 in consultation with the Government.

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

2.129 Operational and prudential guidelines on STRIPS are being formulated. Dates for consolidation of coupon strips (March 25/ September 25 and May 30/November 30) would be aligned with coupon payment dates in future issuances. Towards this, the coupon payment dates of 6.01 per cent Government Stock 2028, issued on August 7, 2003, were aligned to March 25/September 25. Primary Dealers who meet certain financial criteria would be authorised to undertake stripping and reconstitution of securities. The Public Debt Office of the Reserve Bank would act as a registry of stripped bonds. The necessary enabling legal provisions will come into effect with the passage of the Government Securities Bill to be introduced in the Parliament soon. The system requirements specifications for launch of the STRIPS have been finalised and the requisite software modules are being developed to accommodate STRIPS in the PDO-NDS.

Transactions in Government Securities-Relaxation of Guidelines

2.130 In view of frequent representations to review the extant stipulations which did not permit any sale transaction in a Government security without the seller actually holding the security in its portfolio, and in view of institutional arrangements such as settlement of Government security transactions through the CCIL, which has reduced the settlement risk, revised guidelines on transactions in Government securities were announced. These have come into effect from April 2, 2004. These relaxations facilitate further deepening of the Government securities market through improved liquidity. Further, repo rollover would facilitate non-banks to move away from the call/notice money market and also enable banks to reduce their dependence on the call money market.

2.131 In accordance with the above announcement, it has now been decided to permit sale of a Government security already contracted for purchase, provided: (i) the purchase contract is confirmed prior to the sale, (ii) the purchase contract is guaranteed by CCIL or the security is contracted for purchase from the Reserve Bank, and (iii) the sale transaction would settle either in the same settlement cycle as the preceding purchase contract, or in a subsequent settlement cycle so that the delivery obligation under the sale contract would be met by the securities acquired under the purchase contract. To facilitate operationalisation of the proposal, it has also been decided to shift the settlement of Government securities transactions carried through CCIL to the DvP-III mode so that each security is deliverable/receivable on a net basis for a particular settlement cycle as against the earlier system of gross settlement of securities under the DvP-II mode. So far as purchase of securities from the Reserve Bank through OMO is concerned, no sale transactions should be contracted prior to receiving the confirmation of the deal/advice of allotment from the Reserve Bank. As a corollary to the above changes, it has been advised that ready forward (repo) transactions in Government securities, which are settled under the guaranteed settlement mechanism of CCIL, may be rolled over, provided the security prices and repo interest rate are renegotiated on roll over. It was further clarified that the purchase contract referred to above would include the second (repurchase) leg of a repo transaction. A monthly review of the working of the above arrangements has been proposed.

Settlement of Over the Counter (OTC) Derivatives through CCIL

2.132 A central counterparty based clearing arrangement for OTC derivatives apart from extending the benefits of netting, reduces counterparty risk. As indicated in the annual policy Statement of 2004-05, in order to strengthen the OTC derivatives market and to mitigate the risks involved, it was agreed 'in principle' to allow a clearing arrangement for OTC derivatives through CCIL. CCIL has since developed the pricing and risk models for this process, which are being fine-tuned on the basis of market feedback. The clearing arrangement is expected to be operationalised by March 2005.

Turnover Tax

2.133 A small tax at the rate of 0.15 per cent of the value of security was proposed on transactions in securities on stock exchanges in the Union Budget for 2004-05. Later, it has been clarified that the proposed transaction tax on securities purchases would apply only to trades where securities are delivered.

Market Stabilisation Scheme

2.134 Following the recommendations of the Report of the *Working Group on Instruments of Sterilisation* (December 2003), and with a view to strengthen the Reserve Bank in its ability to conduct exchange rate and monetary management operations in a manner that would maintain stability in the foreign exchange market and enable it to conduct monetary policy in accordance with its stated objectives, the Government of India signed a Memorandum of Understanding (MoU) with the Reserve Bank on March 25, 2004 detailing the rationale and operational modalities of the Market Stabilisation Scheme (MSS) exclusively for sterilisation operations. The scheme has come into effect from April 1, 2004. The ceiling on the outstanding amount under MSS was fixed initially at Rs.60,000 crore which, however, was subject to an upward revision based on the liquidity assessment. The ceiling was enhanced to Rs.80,000 crore on August 26, 2004 on account of the emerging liquidity situation. The threshold level of the ceiling for further review is placed at Rs.70,000 crore. An indicative schedule for the issuance of Treasury Bills/dated securities under the MSS for the first quarter of the 2004-05 (April 1, 2004-June 30, 2004) was announced to provide transparency and stability in the financial markets. It was proposed to sterilise an aggregate of Rs.35,500 crore (face value) through issuances of Treasury Bills/dated securities under the MSS during the first quarter of 2004-05. A schedule for the second quarter (July 1, 2004 - September 30, 2004) was issued on June 29, 2004 which indicated issuances of Rs.36,500 crore (inclusive of rolling over of Rs.19,500 crore under 91-day Treasury Bills maturing during the quarter. The indicative calendar for the third quarter (October 1, 2004 – December 31, 2004) was announced on September 29, 2004 for MSS issuances of Rs.25,500 crore (including of rollover of Rs.16,955 crore under 91-day Treasury Bills maturing during the quarter). Taking into account all the relevant factors indicating changes in the emerging liquidity situation, it was decided not to conduct the auctions of both 91-day and 364-day Treasury Bills under the MSS on November 10, 2004. The outstanding amount of securities issued under the MSS amounted to Rs.55,686 crore (face value) as on November 13, 2004 comprising Rs.16,705 crore of 91-day Treasury Bills, Rs.13,981 crore of 364-day Treasury Bills and dated securities amounting to Rs.25,000 crore.

Foreign Exchange Market

Issue of Guarantee for Trade Credits: Liberalisation

2.135 In order to promote investment activity and to further liberalise the procedures relating to trade credits on imports, the mid-term Review of annual policy for 2004-05 proposed to accord general permission 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.

Export Oriented Units: Relaxation of Time Limit for Export Realisation

2.136 In line with the announcement made in Government's Foreign Trade Policy in September 2004, the mid-term Review of anuual policy for 2004-05 also announced that 100 per cent EOUs and units set up under EHTPs, STPs and BTPs schemes would be permitted to repatriate the full value of export proceeds within a period of twelve months.

Booking of Forward Contracts: Relaxation

2.137 In order to further liberalise the process of booking forward contracts, the limit for outstanding forward contracts booked by importers/exporters was 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.

Forex Market Group

2.138 In order to review comprehensively the initiatives taken by the Reserve Bank so far in the foreign exchange market and identify areas for further improvements, an internal Group would be constituted to consult with market participants and the TAC and submit its Report within three months.

Survey on Impact of Trade Related Measures

2.139 In view of the substantial relaxation and simplification of procedures in the recent period, a fresh survey for evaluation of the impact of the measures taken by the Reserve Bank to reduce the transaction cost for exports, is being undertaken.

8. Legal Reforms in the Banking Sector

2.140 Development of suitable legal framework is a prerequisite for strengthening the banking sector by way of removing the operational constraints during the process of financial sector reforms. The Reserve Bank has suggested various legislative amendments which are under consideration of the Government of India.

2.141 The Industrial Development Bank (Transfer of Undertaking and Repeal) Bill, 2003 was passed on December 8, 2003. It provides for the transfer and vesting of the undertaking of the Industrial Development Bank of India in a company to be formed and registered under the Companies Act, 1956 to carry on banking business and for matters connected therewith or incidental thereto and also for the repeal of the Industrial Development Bank of India Act, 1964. Industrial Development Bank has started functioning as a banking company with effect from October 1, 2004.

2.142 The Sick Industrial Companies (Special Provisions) Repeal Bill, 2001 was passed on December 11, 2003 and has become an Act of Parliament (Act No.1 of 2004). The Sick Industrial Companies (Special Provisions) Act, 1985 (SICA) has been repealed and it envisages dissolution of the Board for Industrial and Financial Reconstruction (BIFR) and Appellate Authority for Industrial and Financial Reconstruction (AAIFR) and all proceedings pending before BIFR and AAIFR prior to their dissolution shall stand abated.

Bills transmitted to the Government

2.143 The need to provide greater operational flexibility to the Reserve Bank has been under the consideration of Government of India for some time. In this regard, the Government of India has called for the Reserve Bank's comments on the draft of the Reserve Bank of India (Amendment) Bill, which is in the process of being finalised.

2.144 A Draft Bill to provide for the regulation and supervision of payment systems in India by the Reserve Bank has been forwarded to the Government of India for their consideration. The important aspects of the Payment & Settlement Systems Bill, 2002 include, according power to the Reserve Bank to regulate and supervise the payment systems by determining standards, calling for information, returns and documents.

2.145 As indicated in the annual policy Statement of 2004-05, the Reserve Bank would set up a Board for Payment and Settlement Systems (BPSS) that would lay down the policies for the regulation and supervision of the payment and settlement systems encompassing the domestic and cross-border systems. The constitution of the Board would help ensure a more effective regulation and supervision of the various payment and settlement systems in the country. The draft regulation to set up the BPSS has been transmitted to the Government for notification in the Gazette.

2.146 The Government Securities Bill 2003 proposes to replace the Public Debt Act, 1944 (PD Act) and aims to meet market requirements such as pledged hypothecation of Government securities, enhancing limit for summary disposal and facilitating the use of technology in the Government securities market.

2.147 Based on the recommendations of the Siddiqui Committee and Iyer Committee, a draft Bill on Credit Information Bureau was transmitted to the Government. The proposed draft Bill, which is now titled as 'Credit Information Companies Regulation Bill', 2004 is to provide for establishment of credit information companies and to facilitate efficient distribution of credit and other related matters. The Bill envisages that all banks, FIs and other institutions as specified by the Reserve Bank, which are termed, as 'credit institutions' in the Bill should compulsorily become a member of at least one Credit Information Company. The functions of such Credit Information Companies would be to collect from banks, FIs and other specified institutions data pertaining to credit information of their constituents and process and preserve such data and share the same with specified users for specified purposes on payment of prescribed fees and subject to other conditions as stipulated in the Bill. One of such credit information company known as Credit Information Bureau (India) Ltd. (CIBIL) has already come into existence and has commenced functions of collecting, processing preserving and disseminating such data to its member credit institutions. However, in absence of specific legislation, functions of the CIBIL at present is limited only to such data where disclosure is permissible under the existing legal framework — these data pertain to suit filed accounts and such accounts wherein the constituents of the credit institution have already given their requisite consent for disclosure of such information.

2.148 Based on the decision taken by the Reserve Bank in the light of recommendations of the joint team consisting of the representatives of the Ministry of Finance, the Reserve Bank and the DICGC, an outline of the proposed Bill '*Bank Deposit Insurance Corporation*' has already been transmitted to the Government of India. The outline amongst others provides for registration of banks as insured banks, insurance of deposits of such insured banks, charging of risk based premium for such insurance, winding up and liquidating of insured banks on application by the Reserve Bank, dropping the existing credit guarantee functions of the Corporation, enabling the new Corporation to complete the residuary functions of the old Corporation in relation to its obligations already assumed towards the credit institutions pursuant to credit guarantees issued by the old Corporation under Credit Guarantee Schemes, and to empower the new Corporation to make suitable recommendations to the Reserve Bank for restoring the health of insured banks or for their resolution, *i.e.*, liquidating/merger, if the Corporation considers it necessary to do so.

2.149 As desired by the Government, the draft legislation on 'The Factoring of Debts due to Industrial and Commercial Undertakings Bill, 2002' has been revised and transmitted to the Government. Besides defining certain expressions like factored debt, assignment, *etc*., the proposed legislation, in brief, provides for (i) the rights and liabilities of the parties involved in a factoring transaction (ii) notice, mode of assignment of factored debts, *etc*., with a view to overcoming the present legal impediments in the growth of factoring business and help in the promotion of an efficient and viable factoring operation which in turn will help to mitigate the problem of delayed payments to industrial and commercial undertakings, especially SSI units.

9. Technological Developments

2.150 Computerisation of banking has received high importance in recent years. While the new private sector banks, the foreign banks and a few old private sector banks have already put in place 'Core Banking solutions', the public sector banks are adopting similar systems. Although all the public sector banks have already crossed the 70 per cent level of computerisation of their business, the direction from the Central Vigilance Commission (CVC), to achieve 100 per cent computerisation, has resulted in renewed vigour in these banks towards fulfilment of this requirement which could go a long way to better customer service. Networking in banks has also been receiving focussed attention during recent times. As part of the INdian FInancial NETwork - INFINET, the terrestrial lines are being augmented, with increased data transfer capabilities.

Payment and Settlement Systems

2.151 Payment and settlement systems serve an important role in the economy as the main arteries of the financial sector. It has been the endeavour of the Reserve Bank to improve the efficiency of the financial system by ensuring safe, secure and effective payment and settlement systems for the country. India has a myriad of payment systems, while settlement systems in the country have generally tended to fall in the category of deferred net settlement (DNS) systems which entail some element of risk. With a view to providing a less riskier system which would also comply with the requirements of the Core Principles for Systemically Important Payment Systems (SIPS) of the Bank for International Settlements (BIS), the Reserve Bank implemented the Real Time Gross Settlement System (RTGS) during the year 2003-04 (Box II.16). The impetus given towards retail payment systems also continued, with a new facility being made available – the Special Electronic Funds Transfer (SEFT) System, covering about 127 centres of the country.

2.152 In view of the substantial progress made in the payment and settlement system as envisioned in the 'Payment System Vision Document 2001-04', the Reserve Bank has taken steps to draft a document on 'Payment and Settlement Systems Vision for 2005-08' under the guidance of the National Payment Council. The draft document would be placed in the

Box II.16: RTGS in India

The Real Time Gross Settlement (RTGS) System was implemented by the Reserve Bank on March 26, 2004, after a comprehensive audit and review of the software, also by conducting extensive training of users at commercial banks. The RTGS provides for an electronic based settlement of inter-bank and customer based transactions, with intra-day collateralised liquidity support from the Reserve Bank to the participants of the system. The RTGS system has also been enabled for straight through processing (STP) of customer transactions without manual intervention. The system which was initially started with four banks, besides the Reserve Bank, as participants, now has about 94 participants, comprising of scheduled commercial banks and primary dealers, with average daily turnover of about Rs.24,000 crore. As on November 19, 2004, 51 banks offer RTGS payment services through 1,451 branches located in 152 cities and towns. This coverage is expected to increase to 3,000 branches in 275 centres by the year-end. The coverage will be extended to about 500 centres comprising commercially important centres, capital market intensive centres and e-commerce centres.

The RTGS System will be fully integrated with the Accounting System of the Reserve Bank and other settlement services such as Deferred Net Settlement (DNS) Systems, the settlement of which would be performed as RTGS transactions through a facility for Multi Lateral Net Settlement batch processing.

The RTGS System has several unique features. It is a single, all-India system, with the settlement being effected in Mumbai. The payments are settled transaction by transaction. The settlement of funds is final and irrevocable. The settlement is done in real time; the funds settled can be further used immediately. It is a fully secure system, which uses digital signatures and PKI based encryption, for safe and secure message transmission. It provides for intra-day collateralised liquidity support for the member-banks to smoothen the temporary mismatches of fund flows and thereby ensuring smooth settlements. Under the RTGS System, inter-bank transactions; customer based inter-bank transactions and net clearing transactions can be settled. Both high value and retail payments can be effected through the RTGS system. Thus it provides less risk-based funds transfers for both banks and for their customers, apart from providing for more efficient funds management at the treasuries of banks.

public domain for feedback and discussions, and would be implemented from April 2005.

2.153 With a view to helping banks efficiently manage their funds as also to eliminate avoidable movement of funds around various centres for settlement purposes, a national settlement system (NSS) would be introduced in a phased manner by linking up different clearing houses managed by the Reserve Bank and other banks for centralised settlement at one place. It would also help the Reserve Bank closely monitor the liquidity position of banks. In the first phase, the settlement for various clearings in the four metro cities would be accounted for under the NSS. The NSS is expected to be operationalised in early 2005.

2.154 The Indian retail payment system is characterised by a substantial number of funds transfers being effected through the cheque clearing system (constituting the MICR and Non-MICR Clearings). In addition, other technologically advanced and secure systems such as the Electronic Clearing Service (ECS-Debit and Credit Clearing), Electronic Funds Transfer (EFT), the Special EFT and card based systems (credit, debit, ATM and smart cards) are also gaining increased usage by customers of banks (Table II.1). While ECS-Credit and ECS-Debit systems are for bulk payments and are akin to the automated clearing houses (ACH) elsewhere, the EFT and SEFT systems are for individual one-to-one credit transfer based transactions. To provide for transfer of funds electronically across a large number of bank branches in the country as a forerunner to the nation-wide funds transfer system (NEFT), the SEFT System was introduced from April 1, 2003. SEFT is a system with the settlement being centralised at Mumbai and providing for same day funds settlement with multiple settlements during the day. SEFT covers 2,312 branches of 29 banks situated in 127 cities across the country. This scheme facilitated the introduction of the T+2 settlement system by the capital markets. Growth in these modes of payment services has been significant during the current year too. While ECS (credit) tranfers recorded a transactions volume of 198.64 lakh during the period April 2004-October 2004, ECS (debit) recorded a volume of 75.95 lakh transactions and SEFT volume rose to 1.71 lakh- all of which indicate increasing customer acceptance for electronic modes of funds movement.

2.155 It has been decided to remove the existing limit per transaction for ECS and EFT with effect from November 1, 2004 so as to facilitate the usage of these facilities on a larger scale and to take care of the various segments of the financial sector, including the securities markets.

Table II.1: Transactions through Electronic Payment Methods (2003-04)

Type	Volume of transactions (000's)	Growth in volume over previous year (per cent)	Value of transactions (Rs. crore)	Growth in value over previous year (per cent)
1	2	3	4	5
ECS-Credit	20,315	8.3	9,676	41.0
ECS-Debit	7,874	73.5	2,241	116.9
EFT	775	109.5	15,711	575.2
SEFT	82	n.a.@	2,305	n.a.@
Credit Cards	97,405	118.6	17,268	128.6
Debit Cards	86,379	138.6	18,513	132.2
Smart Cards	1,717	101.0	89	(-56)

@ SEFT was introduced with effect from April 1, 2003.

2.156 In recent years, plastic cards (credit, debit and smart cards) have gained greater acceptance and momentum as a medium of financial transactions. The volume and value of transactions undertaken using these cards have increased significantly (Box II.17). A significant feature is the proliferation and increasing usage of debit cards as compared to the growth of credit cards. Automated Teller Machine (ATM) cards are also slowly but steadily on the rise highlighting the need for optimising investments made by banks. Banks were therefore advised to share their ATMs and during the year under review, many banks have joined together in small clusters to share their ATM networks. In order to facilitate inter-operability among these clusters at national level, the Institute for Development and Research in Banking Technology (IDRBT), Hyderabad, has set up a National Financial Switch (NFS) to facilitate apex level connectivity of other switches established by banks. The number of ATMs by the public sector banks nearly doubled from 3,473 as at the end of March 2003 to 6,748 as at the end of March 2004.

2.157 Rapid developments in technology and financial markets have led to innovations in retail payments modalities. The share of e-payments in both domestic and cross-border retail payments is increasing both in terms of number and value. It is, hence, important to ensure financial integrity of the electronic money issuers as also the security of their operations (Box II.18). Reserve Bank's concerns also include conduct of monetary policy and oversight of payment system. A Working Group on Risk Mitigation Mechanism for the Indian Retail Payment Systems has been constituted by the Reserve Bank with members from various banks and the Indian Banks' Association. The Group is in the process of formulating strategies required for achieving the objectives, and is expected to submit its Report by November 2004.

Box II.17: Credit Cards in India

The usage of cards by customers of banks in India has been in vogue since the mid-eighties although large-scale usage has been witnessed only during the last decade. The first entrant in the card sector was the credit card, which has witnessed large-scale acceptance as a medium of usage at many Points of Sale (PoS), across different merchant establishments.

As at the end of October 2004, 112.02 lakh credit cards have been issued by banks to their customers. Almost all the categories of banks issue credit cards, with the largest shares being accounted for by three large banks in the country - ICICI Bank, Citibank and State Bank of India. Most of the card based payment authorisations take place in an online mode, with the reach covering about 10 lakh merchant establishments across the country. Credit cards have found greater acceptance in terms of usage in the major cities of the country, with the four major metropolitan cities accounting for the bulk of the transactions.

Issue of credit cards by banks are subject to their own internal prudential norms such as income recognition and asset classification. The Reserve Bank has introduced various liberalisation measures such as the permission for banks to issue international credit cards to resident Indians. While impressing upon banks to take appropriate remedial measures to guard against accumulation of non-performing loans, the Reserve Bank has suggested that banks should observe the code of ethics formulated by the Indian Banks' Association for engaging recovery agents to collect credit card overdues. Recently, it has been decided to constitute a Working Group to look into the regulatory and customer protection aspects and suggest measures for card usage in a safe, secure and customer friendly manner.

Apart from being a source of revenue for banks, credit cards play an important role in the country in reducing the cost of currency management, increasing the safety of transactions, providing for traceability of transactions, *etc.*

Banks have been issuing other types of cards also like Debit cards, ATM cards and smart cards. In recent years, the growth of debit cards issuance and usage have gained greater momentum. As at the end of October 2004, banks in India had issued 378.52 lakh cards.

Box II.18: e-Banking: Regulation and Supervision

Areas of concern for the Reserve Bank are regulation of: (i) Issuance of e-money, (ii) Status of issuers of e-money – which financial market participants could be allowed to issue e-money and (iii) the prudential norm to be followed for preserving effectiveness of monetary policy and integrity of the e-money. Several working groups have been constituted by the Reserve Bank with a view to address the regulatory issues relating to electronic money from time to time. Report of the Working Group on Electronic Money (Chairman: Shri Zarir J. Cama) submitted in July 2002 identified areas of concern from the point of view of the central bank in the context of more widespread use of e-money so that the conduct of monetary policy is not impaired and at the same time, the integrity of the instrument (*i.e.*, e-money) is also preserved. Some of the suggestions made by the Group include multipurpose e-money to be issued only by authorised banks on a credit basis and should be strictly regulated and closely monitored; ensure redeemability in order to preserve the unit of account function of money as well as to control money supply in the economy; reporting of monetary statistics for the purposes of monetary policy and protection against criminal abuse, such as money laundering.

The Working Group on Internet Banking set up by the Reserve Bank focussed on technology and security issues, legal issues as well as regulatory and supervisory issues. Recommendations of the Group are to be implemented in a phased manner. The Reserve Bank guidelines on 'Risks and Controls in Computers and Telecommunications' will also be applicable to internet banking.

The policy response of the Reserve Bank relating to technical security includes: designating a network and database administrator; a security policy; Information Systems Auditing; use of logical access control techniques; use of proxy server type of firewall and PKI (Public Key Infrastructure) as the most favoured technology.

In regard to the legal framework the rights and obligations on the part of the respective participants (customers, merchants, issuers and operators) in an e-money scheme must be clearly defined and disclosed, and be enforceable under all relevant jurisdictions. Moreover, Information Technology Act (2000) and subsequent amendments have granted explicit recognition to electronic modes of payment.

Issues of policy concerns for the future include risk of a run on the e-money system dependent on ability of the system to detect fraud and operational problems; difficulties of judging and foreseeing the weak spots in cryptography based security system; problems in backup facilities in networked payment products; safeguards against anti-competitive practices and antitrust concerns which endanger payment system stability; outsourcing, disclosures and customer education, contingency planning, *etc.* Apart from these, several cross border issues and law-enforcement issues are also important for the effective regulation of the system.

Facilities for Paper based Clearing

2.158 Cheque clearing continued to be the largest mode of settlement in terms of volumes of processing. During the year under review, 12 more centres (Rajkot, Allahabad, Gwalior, Jodhpur, Varanasi, Kozhikode, Thrissur, Bhubaneshwar, Nashik, Raipur, Jabalpur and Vishakapatnam) commenced MICR based clearing using state-of-the-art reader sorter based processing capabilities, taking the total number of MICR centres to 39. The Working Group on Cheque Truncation and e-cheques (Chairman: Dr. R. B. Barman) recommended an image based cheque truncation at the presenting bank. A pilot cheque truncation project is being planned to be implemented covering the National Capital Territory of Delhi and its nearby areas. The system would entail the physical cheques being truncated within the presenting bank to derive maximum efficiency. Settlement would be generated on the basis of the current structure of the MICR fields. Electronic images would be used for payment processing. Grey Scale technology for image capture would be used for imaging. The preservation period of paper instruments would be one year and that of the electronic images would be eight years. A Centralised Agency per clearing location would act as an image warehouse for the banks. Minimum entry norms for Warehouse Agency recommended are technical competency, efficiency orientation and size of resources.

Online Tax Accounting System (OLTAS)

2.159 A measure aimed at providing better facilities for the Government tax collection and for tax payers was the introduction of the On Line Tax Accounting System (OLTAS) with a network of various banks authorised for collection of tax receipts. The Reserve Bank and the Tax Information Repository at the National Securities Depository Ltd. (NSDL) are also part of the OLTAS. Data is captured from the challans submitted by tax payers tendered at the designated bank branches and transmitted electronically to the repository. The collection and transmission of data on tax collections have thus been made efficient on a T+1 cycle basis. The OLTAS works in a fully secured environment, with data being transmitted using encryption facilities and digital signatures for enhanced security. The system, in live operations from July 1, 2004 is performing well. Under the OLTAS, 15 offices of the Reserve Bank, and 11,699 authorised branches of 31 agency banks transmit daily data on income/corporate tax collected by them to the tax information network (TIN) hosted by NSDL. The income tax challan form has also been simplified and made into a single copy challan. In order to simplify the refund procedures and ensure better customer service, the Reserve Bank has suggested to the Central Board of Direct Taxes (CBDT) to do away with advice based refunds. CBDT has accepted the suggestion for grant of refunds up to Rs.25,000 through Electronic Clearing System (ECS) facility at select centres in respect of individual tax payers. With the proposal for ECS based Income Tax Refunds, the entire processing for income tax payers would get a fillip.

Online Indirect Taxes Accounting System: Status

2.160 At the request of the Central Board of Excise and Customs (CBEC), a system similar to OLTAS has been envisaged for streamlining the present systems and procedures in regard to transmission of data pertaining to excise duty and service tax. The Reserve Bank has constituted a High Powered Committee on Online Indirect Taxes Accounting System (OLITAS) (Chairman: Shri J.N. Nigam) with members drawn from the Government, IBA, State Bank of India, reputed information technology companies, and NSDL.