

MONETARY AND CREDIT INFORMATION REVIEW

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POLICY

Guidelines on Merger/Amalgamation for UCBs

To encourage and facilitate consolidation and emergence of strong entities and providing an avenue for non-disruptive exit of weak/unviable entities in the co-operative banking sector, the Reserve Bank of India issued guidelines for merger/amalgamation in the sector. The Reserve Bank of India has forwarded the guidelines to the chief executives of the urban cooperative banks with a request to place them before their board of directors. The guidelines were also forwarded to the registrars of cooperative societies.

According to the guidelines, the Reserve Bank of India will consider proposals for merger and amalgamation in the urban banks sector in the following circumstances:

(i) When the networth of the acquired bank is positive and the acquirer bank assures to protect entire deposits of all the depositors of the acquired bank;

(ii) When the networth of acquired bank is negative but the acquirer bank on its own assures to protect deposits of all the depositors of the acquired bank; and

(iii) When the networth of the acquired bank is negative and the acquirer bank assures to protect the deposits of all the depositors with financial support from the state government extended upfront as part of the process of merger.

In all cases of merger/amalgamation, the financial parameters of the acquirer bank post merger will have to conform to the prescribed minimum prudential and regulatory requirement for urban co-operative banks. The realisable value of assets will have to be assessed through a process of due diligence.

While considering such proposals, the Reserve Bank will confine itself to the financial aspects of the merger and to the interests of depositors as well as the stability of the financial system.

Who can merge?

A cooperative bank can merge only with another cooperative bank situated in the same state or with a cooperative bank registered under Multi State Cooperative Societies Act.

Procedure for Merger

An application for merger giving the proposed scheme will have to be submitted by the banks concerned to the Registrar of Cooperative Societies/Central Registrar of Cooperative Societies (RCS/CRCS). The acquirer bank will also forward a copy of the scheme to the Reserve Bank along with the draft scheme, valuation report and other information relevant for consideration of the scheme of merger. The Reserve Bank will examine the scheme with reference to the financial aspects and the interests of depositors based on the criteria/factors and convey its decision to the concerned state RCS and, in case the acquirer is a multi-state cooperative bank, to the CRCS and the RCS of the state in which the acquired bank is situated.

The Reserve Bank has asked the registrars to comply with due process prescribed in the Statutes before they seek it's approval, as they are the authorities vested with the responsibility of administering the Acts. They would also ensure compliance with the statutory procedures for notifying the amalgamation after obtaining the sanction of the Reserve Bank.

UCBs

Entry of UCBs into Insurance Business

On a review, it has been decided to allow Scheduled Primary (Urban) Co-operative Banks having a minimum net worth of Rs.50 crore instead of Rs.100 crore, as at present, to undertake insurance agency business without risk participation. Other terms and conditions would remain unchanged. The Reserve Bank of India has reiterated that no UCBs should undertake insurance agency business without obtaining its prior permission. The Reserve Bank has also decided to allow all Primary (Urban) Cooperative Banks to undertake insurance business on a referral basis, without any risk participation through their network of branches. Under the referral arrangement, banks provide physical infrastructure within their select branch premises to insurance companies for selling their products to the bank's customers with adequate disclosure and transparency, and in turn earn referral fees on the basis of premia collected. The permission to undertake insurance business on referral basis is subject to the following conditions:

(i) The banks should comply with the Insurance Regulatory and Development Authority (IRDA) regulations for undertaking referral business with insurance companies.

(ii) The banks should not adopt any restrictive practice of forcing their customers to go in only for a particular insurance company in respect of assets financed by them. The customers should be allowed to exercise their own choice.

(iii) The banks desirous of entering into referral arrangement, besides complying with IRDA regulations, should also enter into an agreement with the insurance company concerned for allowing use of their premises and making use of the existing infrastructure. The agreement should be for a period not exceeding three years at the first instance and the banks should have

the discretion to renegotiate the terms depending on their satisfaction with the service or replace it by another agreement after the initial period. Thereafter, the banks will be free to sign a longer term contract with the approval of their Board.

(iv) As the participation by a bank's customer in insurance products is purely on a voluntary basis, it should be stated in all publicity material distributed by the bank in a prominent way. There should be no 'linkage' either direct or indirect between the provision of banking services offered by the bank to its customers and use of the insurance products.

(v) The risk, if any, involved in referral arrangement should not get transferred to the business of the bank.

The banks need not obtain prior approval of the Reserve Bank to undertake referral business.

UCBs to correctly display Their Names

The Reserve Bank of India has reiterated that the urban cooperative banks (UCBs) must ensure that they correctly display their full names in any stationery item, publicity material, name board, etc., even while using it in a logo, if the name was sought to be displayed, only the full name of the bank should be displayed and the banks should not use abridged version of the name. Primary (urban) co-operative banks were advised to ensure that all advertisement/s, stationery items, boards, etc., not correctly depicting their names in accordance with the Certificate of

Registration and the licence issued to them, were withdrawn forthwith. Primary (urban) co-operative banks were also asked to submit a compliance report in this regard to the concerned regional office of the Reserve Bank of India on or before March 31, 2005. As per the existing instructions, UCBs have to display only their full name in the form in which it appears in the Certificate of Registration issued by the Registrar of Co-operative Societies (RCS) and the licence granted by the Reserve Bank of India. It was, however, observed that some banks did not adhere to these instructions in totality. The Reserve Bank of India, therefore, advised that it was mandatory for every Primary (urban) Cooperative Bank (UCB) to display its full name in any stationery item, publicity material, name board, etc., and must conform to the name as it is appeared in the Certificate of Registration issued by the Registrar of Co-operative Societies (RCS) of the respective state and the licence granted to the bank by the Reserve Bank of India. Further, the Reserve Bank stated that banks were prohibited from using any abridged form of their name. The usage of name in its abridged form did not depict the correct status of the urban co-operative banks and created confusion in the minds of general public regarding their status.

BRANCH BANKING

Advances against Units of Debt-oriented Mutual Funds

On review, the Reserve Bank of India has decided that individual banks may themselves decide in accordance with their loan policy on the quantum and margin requirement for loans/advances to individuals against units of exclusively debt-oriented mutual funds. At the time of extending credit facility, however, the banks should satisfy themselves about the acceptability of credit needs of the borrower and the end use of funds. The existing guidelines for loans and advances against units of other mutual funds (other than exclusively debt-oriented mutual funds), remain unchanged.

The change has been effected in view of the representations received from banks stating that banks' lending to individuals against units of exclusively debt-oriented mutual funds may be exempted from Rs.10 lakh/Rs.20 lakh ceiling as such advances are not reckoned as part of the banks' exposure to capital market. The earlier guidelines did not distinguish between debt-oriented and equity-oriented mutual funds. Therefore, the banks' lending to individuals was limited to Rs.10 lakh and Rs.20 lakh even against units of debt-oriented mutual funds held in physical and dematerialised form, respectively.

Non-acceptance of Coins by Bank Branches

The Reserve Bank of India has again advised the banks to ensure that their branches accept coins of all denominations without any restriction from the members of public. The Reserve Bank has cautioned the banks that the government and the Reserve Bank continue to receive complaints regarding non-acceptance of coins by bank branches in various parts of the country. The banks were requested to periodically sensitise the staff so that there was no cause for complaint from the customers. The Reserve Bank has advised the banks to continue the surprise visits by Regional Managers/Zonal Managers to verify compliance by the branches with the instructions relating to acceptance of coins.

Later, the Reserve Bank of India stated that there was no dearth of coins of any denomination and the members of public should assert their right to get the appropriate change and should

not accept other goods in return for the balance amount due to them. It also reiterated that coins of all denominations are legal tender. The Reserve Bank had come across reports and had also received complaints that traders and shopkeepers were reluctant to return the small change on grounds of non-availability of coins, particularly, 25 and 50 paise denominations. The Reserve Bank of India informed that there was absolutely no shortage of coins of any denomination with all the offices of the Reserve Bank of India and also banks. In fact, the Reserve Bank in many of its offices was facing the problem of reverse flow of coins, i.e., members of public were returning the coins.

Detection of Forged Notes in Chest Remittances

The Reserve Bank of India has decided to stipulate a time-bound plan to arrest the increasing trend in the circulation of forged notes through the banking channel and advised the banks to provide table top note sorting machines of appropriate capacity at all the chest branches as per the time frame below:

- (i) Banks that have up to 100 currency chests should install note sorting machines of appropriate capacity at all their currency chests by the end of May 2005 and submit Action Taken Report (ATR) to the Reserve Bank on May 31, 2005.
- (ii) Banks having more than 100 currency chests should provide such machines in a phased manner by the end of November 2005 and submit Action Taken Report on November 30, 2005.
- (iii) The programme for installation of the machines should be reported by zonal/circle/regional offices to the concerned issue offices of the Reserve Bank within one month.

Earlier the Reserve Bank had stressed the need for careful examination of notes by the branches/chest branches of banks at the time of receipt of remittances so as to prevent the re-entry of forged notes into circulation and the inclusion of forged notes in the remittances sent to the Reserve Bank's offices. It was also indicated that necessary infrastructural facilities like sorting machines for proper sorting/identification of suspect notes should be provided at branches, particularly chest branches. However, on a recent review of the position, it was observed that large number of forged notes continue to be detected in the remittances sent by currency chests.

Pay Orders for Matured Relief/Savings Bonds

The Reserve Bank of India received suggestions from the joint holders of Relief/Savings Bonds that the payment orders representing the maturity proceeds of the bonds be issued in the name of any one of the investors instead of all the holders as is being done at present. The matter was examined in the Reserve Bank and it has been decided to allow release of maturity proceeds in favour of one of the joint holders in whose favour all other remaining holders have executed a Power of Attorney as per the Joint Holders Power of Attorney. Interest warrants are

already allowed to be issued in the name of first holder subject to obtention of Joint Holders Power of Attorney.

BANKING

Draft Prudential Guidelines on Capital Adequacy

The Reserve Bank of India released draft guidelines for implementation of Basel II in India and has sought feedback from the banks for finalisation. The draft guidelines are placed on the Reserve Bank's website (www.rbi.org.in) for wider access.

The draft guidelines are intended to ensure migration to Basel II in a non-disruptive manner and have been drawn by the Reserve Bank through consultation with a representative sample of total 14 banks representing Indian public and private banks as well as foreign banks. Keeping in view the goal to have consistency and harmony with international standards, the Reserve Bank has decided that at a minimum, all banks in India will adopt Standardised Approach for credit risk and Basic Indicator Approach for operational risk with effect from March 31, 2007. Further, to guide the banks towards a smooth transition to the revised framework, the guidelines propose that banks in India could adopt a parallel run of the revised framework with effect from April 1, 2006.

After adequate skills are developed, both in banks and at supervisory levels, some banks may be allowed to migrate to IRB Approach after obtaining the specific approval of Reserve Bank.

The Reserve Bank recalled that the Basel Committee on Banking Supervision (BCBS) released the document, "International Convergence of Capital Measurement and Capital Standards: A Revised Framework", popularly known as Basel II, on June 26, 2004. The Revised Framework builds on the current framework to align regulatory capital requirements more closely with underlying risks and its implementation is expected to promote adoption of stronger risk management practices in banks.

The Revised Framework consists of three-mutually reinforcing Pillars, namely, minimum capital requirements, supervisory review of capital adequacy and market discipline. Under Pillar 1, the Framework offers three distinct options for computing capital requirement for credit risk and three other options for computing capital requirement for operational risk. These approaches for credit and operational risks are based on increasing risk sensitivity and allow banks to select an approach that is the most appropriate to the stage of development of bank's operations. The approaches available for computing capital for credit risk are Standardised Approach, Foundation Internal Rating Based Approach and Advanced Internal Rating Based Approach. The approaches available for computing capital for operational risk are Basic Indicator Approach, Standardised Approach and Advanced Measurement Approach.

Implementation of Risk-based Internal Audit in Banks

The Reserve Bank of India has reviewed the implementation of the risk-based internal audit (RBIA) in various banks and observed that there are certain gaps/deficiencies which need to be addressed in order to ensure that the RBIA framework is effective. Some of the gaps/deficiencies from the original guidance note on risk based internal audit are:

- (a) The risk assessment of branches should be carried out on the basis of the "inherent business risks" and "control risks".
- (b) The risk assessment should not only indicate the level of risk as High, Medium and Low but also the trend of risk in terms of increasing, decreasing or stable.
- (c) The risk assessment should invariably be undertaken on a yearly basis.
- (d) The bank should undertake 100 per cent transaction testing if an area falls in cell "C-Extremely High Risk" of the risk matrix.

The bank may also consider 100 per cent transaction testing if an area falls in cell “B- Very High Risk” or “F- Very High Risk”, and the risks are showing an increasing trend. The banks may also consider transaction testing with an element of surprise in respect of low risk areas which would be audited at relatively longer intervals. As regards the areas falling in other cells (viz., ‘A- High Risk’, ‘D-Medium Risk’, ‘E-High Risk’, ‘G- Low Risk’, ‘H-Medium Risk’, ‘I-High Risk’) of the risk matrix, the bank has to decide on the level of transaction testing based on its risk based internal audit policy duly approved by the Board.

(e) The bank has to prepare a Risk Audit Matrix which would be based on the magnitude and frequency of risk. Preparation of the Risk Audit Matrix can also enable the bank to move towards the Advanced Measurement Approach for Operational Risk under Basel II.

The Reserve Bank has advised the banks to review the methodology of conducting the risk-based internal audit and the policy in this regard so as to align the same with the guidelines. Banks should form a Task Force comprising senior executives and entrust them with the responsibility of chalking out an action plan for switching over to risk-based internal audit.

SSI Investment Limit in respect of Sports Goods

The Reserve Bank of India has advised all banks that the Government of India had since enhanced the ceiling limit on investment in plant and machinery from rupees one crore to rupees five crore in respect of certain items of stationery, drugs and pharmaceuticals. The government of India had in a gazette notification dated October 13, 2004, listed seven items belonging to sports goods which were so far reserved for manufacture in the Small Scale Industries (SSI) Sector. These items were in addition to the 13 stationery and 10 drugs and pharmaceutical items listed in the reserved items for manufacture in the SSI sector investment limit for which had already been enhanced.

FOREX

Compounding of Contravention under FEMA

The Government has, in consultation with the Reserve Bank of India, reviewed the procedures for compounding of contravention under Foreign Exchange Management Act (FEMA). The procedures have been reviewed to provide comfort to the citizens and corporate community by minimising transaction costs, while taking severe view of wilful, *malafide* and fraudulent transactions. Accordingly, the responsibilities of administering compounding of contravention cases under FEMA have been vested with the Reserve Bank with exception of clause (a) of Section 3 of FEMA 1999 which deals essentially with *hawala* transactions. The Directorate of Enforcement would continue to deal with these cases.

Under FEMA, compounding of contravention allows the contravener to settle an offence through imposition of a monetary penalty without going in for litigation after the contravener acknowledges having committed the contravention.

The Reserve Bank has since issued directions to the Authorised Dealers operationalising the revised procedures for compounding of contravention under FEMA. These procedures have been put on the RBI website (www.rbi.org.in). It may be

noted that once a contravention has been compounded by the Compounding Authority, no proceeding or further proceeding will be initiated or continued, against the contravener.

Process for Compounding

(a) An Application for compounding of a contravention under FEMA may be submitted to the Compounding Authority (CA) either on being advised of a contravention under FEMA either through a memorandum or *suo moto* on being made or becoming aware of the contravention.

(b) Application for compounding any contravention in prescribed form together with a copy of the memorandum, wherever applicable, with the prescribed fee [(as given in the Foreign Exchange (Compounding Proceedings) Rules, 2000)] has to be submitted with relevant facts and supporting documents to : The Compounding Authority, [Cell for Effective implementation of FEMA (CEFA)], Foreign Exchange Department, 11th Floor, Central Office Building, S. B. Singh Road, Fort, Mumbai- 400001.

(c) On receipt of the application for compounding, the proceedings would be concluded and order issued by the Compounding Authority within 180 days from the date of the receipt of the application for compounding.

(d) The sum for which the contravention has been compounded shall be paid within fifteen days from the date of the order of compounding.

(e) The payment towards application fee and the sum for which contravention has been compounded shall be paid by demand draft in favour of the Compounding Authority, i.e., " Reserve Bank of India" and payable at Mumbai.

(f) The process and procedures for compounding under the revised Compounding Rules may be reviewed after six months.

The Reserve Bank has advised the authorised dealers to bring these instructions to the notice of their constituents and customers concerned.

No Prior RBI Permission for ESOP

With a view to further liberalising overseas investment, it has now been decided that even in cases where the foreign company offering its shares under Employees Stock Option Scheme (ESOP) and has an indirect shareholding in the Indian company, i.e., through a Special Purpose Vehicle (SPV) or a step down subsidiary, no prior permission of the Reserve Bank is required, as long as such holding is not less than 51 per cent. As such, a person resident in India, being an individual, who is an employee or a director of an Indian office; or branch or a subsidiary of a foreign company in India; or of an Indian company in which foreign equity holding is not less than 51 per cent, may purchase the equity shares offered by the foreign company. The Reserve Bank at present on a case to case basis grants permission for holding the shares of the ultimate parent company, or subsidiary, or group-company as the case may be in cases where investment in India has been made through a holding company/SPV.

Edited and published by **Alpana Killawala** for the **Reserve Bank of India**, Press Relations Division, Central Office, Shahid Bhagat Singh Marg, Mumbai-400 001 and printed by her at **Alco Corporation**, A-2, 72, Shah & Nahar Ind. Estate, Lower Parel (West), Mumbai - 400 013. **Readers may write to the Director DRRP (Sales Section), DEAP, Reserve Bank of India, Amar Building, Sir P. M. Road, P. B. No. 1036, Mumbai - 400 001 for renewal and change of address. MCIR is also available on Internet at www.cir.rbi.org.in**