Chapter II

Policy Developments in Commercial Banking

2.1 A safe and sound financial sector is a prerequisite for sustained growth of any economy. Globalisation, deregulation and advances in information technology in recent years have brought about significant changes in the operating environment for banks and other financial institutions. These institutions are faced with increased competitive pressures and changing customer demands. These, in turn, have engendered a rapid increase in product innovations and changes in business strategies. While these developments have enabled improvement in the efficiency of financial institutions, they have also posed some serious risks. The regulatory and supervisory policies are, accordingly, being reshaped and reoriented to meet the challenge of containing systemic risks. In this changing milieu, the main challenge for the supervisors has been to maintain the stability of the financial system and, at the same time, provide sufficient flexibility to financial institutions so that they can respond effectively to the growing competition while taking advantage of business opportunities and technological developments.

2.2 The Reserve Bank has also been suitably reorienting the regulatory and supervisory framework so as to meet the challenges of a new environment. It has been the endeavour of the Reserve Bank to develop a competitive, strong and dynamic banking system so that it plays an effective role in supporting the growth process of the economy. The emphasis has been on safeguarding the financial stability of the overall system through increased emphasis on prudential guidelines and effective monitoring, improving institutional soundness, strengthening the regulatory and supervisory processes by aligning with international best practices and by developing the necessary technological and legal infrastructure. While the approach towards the reforms has essentially been gradual and relevant to the context, consultative processes and appropriate timing and sequencing of measures have succeeded in aiding growth, enhancing efficiency, avoiding crises and imparting resilience to the financial system.

2.3 During 2004-05, the Reserve Bank further strengthened the regulatory and supervisory framework to align it with international best practices with suitable adaptations. The conduct of financial regulation and supervision in 2004-05 continued to be guided by the objective of maintaining confidence in the financial system by enhancing its soundness and efficiency. In order to enhance transparency and to strengthen corporate governance practices, a detailed framework was laid down for diversified ownership. The Reserve Bank also continued to monitor the progress of the banking sector for implementing the Basel II framework. The gradual opening up of the banking sector consistent with the WTO commitments was articulated in the 'roadmap for foreign banks' released in March 2005. Finally, the Reserve Bank stressed financial inclusion by emphasising the facilitation of transactions by the common person and strengthening of the credit delivery systems as a response to the pressing societal needs of the economy.

2.4 Against this backdrop, this Chapter provides an overview of various policy measures undertaken by the Reserve Bank in the Indian commercial banking sector during 2004-05 (July-June) and major policy developments during 2005-06 so far. The measures relating to the monetary and credit policy are presented in Section 2, followed by a review of the measures initiated in the area of credit delivery in Section 3. Prudential regulatory and supervisory measures initiated during this period are set out in Section 4 and Section 5, respectively. Section 6 delineates the evolving consultative approach to policy formulation. This is followed by policy developments relating to the financial markets, *i.e.*, the money market, the Government securities market and the foreign exchange market in Section 7. Initiatives relating to payment and settlement systems and technological developments are outlined in Section 8 and Section 9, respectively, while Section 10 details the measures undertaken to strengthen the legal infrastructure.

2. Monetary and Credit Policy

2.5 The policy Statements of the Reserve Bank provide a framework for the monetary, structural and prudential measures that are initiated from time to time consistent with the overall objectives of growth, price stability and financial stability. In recent years, monetary management had to be constantly fine-tuned to keep pace with the fast evolving changes, accentuated by the growing sophistication of financial markets and integration of domestic economy with the international economy. Against the backdrop of liquidity abundance and occasional spikes in inflation rate during 2003-04, it was indicated in the Annual Policy Statement for 2004-05 that "... barring the emergence of any adverse and unexpected developments in the various sectors of the economy and assuming that the underlying inflationary situation does not turn adverse, the overall stance of monetary policy for 2004-05 will be: (i) provision of adequate liquidity to meet credit growth and support investment and export demand in the economy while keeping a very close watch on the movements in the price level; and (ii) consistent with the *status quo*, while continuing with the above, to pursue an interest rate environment that is conducive to maintaining the momentum of growth and macroeconomic and price stability".

2.6 While monetary management in the first half of 2004-05 was conducted broadly in conformity with the monetary policy stance announced in the Annual Policy Statement for 2004-05, there was a change in the stance in the Mid-term Review in October 2004. Several factors contributed to this change. First, there was a carry forward of excess liquidity of over Rs.81,000 crore. Second, the headline WPI inflation accelerated beyond the anticipated level during the first half of the year. Third, the seasonal decline in food prices did not materialise fully. Fourth, international commodity prices remained high and volatile. Fifth, internationally, monetary policy stance in a number of countries was shifting from highly accommodative to a neutral one. Sixth, the pass-through of international commodity price pressures to domestic inflation had implications for inflationary expectations. Seventh, given the uncertainties, the reaction of financial markets was turning increasingly adverse. Since interest rates were at historically low levels, the upside risk was high. Indeed, a sharp upward movement in interest rates towards the middle of the year ensued a selling pressure in the Government securities market. Eighth, the equity markets touched a low on May 17, 2004 which had an adverse impact on sentiments temporarily. Moreover, these developments occurred at a time when industrial growth was looking up after a prolonged period of sluggishness and non-food credit was picking up. In the event, the Reserve Bank had to balance the considerations of growth while containing inflationary expectations.

2.7 Given the role of supply factors in the inflation process, the policy response was in concert with the Government. In signalling its commitment to price stability, the Reserve Bank switched its stance from a 'very close watch on the movements in the price level' in the Annual Policy Statement to 'equal emphasis on price stability' in the Mid-term Review. Importantly, liquidity management for the purpose was emphasised with a switch from a provision of 'adequate liquidity' to 'appropriate liquidity'. The policy measures were calibrated to evolving circumstances, especially with a view to stabilising inflationary expectations.

2.8 Monetary management during the second half of 2004-05 was conducted broadly in conformity with the stance of the policy set out in the Mid-term Review of the year. During this period, the Reserve Bank had to contend with two dominant alternate views on the conduct of monetary policy. Since inflation at that time was deemed to be supply induced, it was argued that direct monetary policy action may be premature, especially as the industry was coming out of a sluggish phase. On the other hand, the deterioration in inflationery expectations, given the observed acceleration in headline inflation, accompanied by sharp movements in market interest rates, were testing the resolve of the central bank on price stability. Since the deterioration of inflationary expectations occurred under conditions of overhang of excess liquidity, strong credit growth, incomplete pass-through of oil price shock and uncertainties about its second round effects, the other argument was in favour of monetary policy response to contain inflationary expectations.

2.9 Recognising these viewpoints, during 2004-05, a series of initiatives were undertaken in a measured and calibrated manner. First, the Reserve Bank communicated its assessment of the supply-induced nature of inflation to the market on several occasions. Second, the market was sensitised to the differential behaviour of inflation at the producer's and the consumer's level, the former being higher

as observed in a number of other oil-importing countries. Third, the Government responded with fiscal measures, particularly by reducing customs and excise duties on oil. Fourth, corporates also responded positively by moderating the exercise of their pricing power. Fifth, for a more flexible management of liquidity, overnight fixed rate reverse repo under the Liquidity Adjustment Facility (LAF) was introduced. Sixth, the cash reserve ratio (CRR) was raised by one-half of one percentage point to 5.0 per cent. Seventh, the remuneration of CRR was delinked from the Bank Rate and was reduced to 3.5 per cent to enhance its effectiveness as a monetary instrument. Eighth, banks were allowed to transfer their investments into 'held to maturity' (HTM) category up to their statutory minimum statutory liquidity ratio (SLR) requirement after providing for depreciation. While this measure provided an opportunity to banks to interface with interest rate cycles, at a macro level, it also helped in maintaining financial stability. Ninth, the fixed reverse repo rate under the LAF was raised by 25 basis points to 4.75 per cent[1]. However, the repo rate and the Bank Rate were left unchanged at 6.0 per cent each, signalling the short-term nature of upward inflationary pressures. Finally, in order to enable the Reserve Bank to address the overhang of liquidity, the Government raised the ceiling of the Market Stabilisation Scheme (MSS) from Rs.60,000 crore to Rs.80,000 crore.

2.10 The overall stance of monetary policy for the year 2005-06 as announced in Annual Policy Statement in April 2005 followed the same line as set out in Mid-term Review of October 2004, *viz*., (i) provision of appropriate liquidity to meet credit growth and support investment and export demand in the economy while placing equal emphasis on price stability; (ii) consistent with the above, to pursue an interest rate environment conducive to macroeconomic and price stability, and maintaining the momentum of growth; and (iii) to consider measures in a calibrated manner, in response to evolving circumstances with a view to stabilising inflationary expectations. In order to ensure that appropriate liquidity is maintained in the system to meet all legitimate requirements of credit, it was indicated that the Reserve Bank would continue with its policy of active demand management of liquidity through open market operations (OMO), including the MSS, the LAF and the CRR and using the policy instruments at its disposal flexibly, as and when the situation warranted. Furthermore, to enable structured communication with markets on a more frequent basis while retaining the flexibility to take specific measures necessitated by the evolving circumstances, it was decided that, in addition to the Mid-term Review of the Annual Policy Statement, the Reserve Bank would release two more quarterly reviews of monetary policy: a First Quarter Review of Part I of the Statement in July and a Third Quarter Review in January.

2.11 The conduct of monetary policy during the first quarter of 2005-06 was in accordance with the stance announced in the Annual Policy Statement. The macroeconomic developments and conditions in financial markets were broadly in line with anticipations in the Statement. To be sure, there were factors both in favour and against continuation of the stance. Factors such as increased global uncertainties, high and volatile international prices of oil, incomplete pass-through of oil prices domestically, upward trajectory of policy rate in the US, overhang of liquidity, high credit growth, sustained industrial growth and possible capacity pressures, enlargement of trade deficit, infrastructural constraints and delayed monsoon were prompting a change in the stance of policy. However, there were several other factors which favoured the *status quo*. The oil price hike was managed well with a combination of monetary and fiscal measures. Overhang of liquidity declined with the increase in the absorptive capacity of the economy and excess liquidity remained sterilised. Visible liquidity under the LAF also declined, while money supply growth was within the projected trajectory. Other factors that favoured the continuation of the stance included broad-basing of credit flows, revival of industrial growth after a long period of sluggishness, pick-up in investment demand, favourable investment climate, sustained corporate earnings and profits, moderate levels of inflation both at the wholesale and retail levels, continuation of somewhat accommodative monetary policy globally and projection of a moderate inflation during 2005 despite high oil prices. The First Quarter Review released on July 26, 2005 indicated that "the considerations in favour of *status quo* are evenly matched by those for change in stance, but

[1] With effect from October 29, 2004, the international usage for the terms 'repo' and 'reverse repo' under LAF operations has been adopted by the Reserve Bank. Accordingly, absorption of liquidity by the Reserve Bank in the LAF window is termed as 'reverse repo' and injection of liquidity as ' repo'.

the balance of convenience at this juncture, lies in continuing with *status quo* while monitoring the unfolding constellation of uncertainties, especially in the global arena". On the basis of assessment of macroeconomic outlook, the overall stance in the First Quarter Review of the Annual Policy Statement remained broadly unchanged.

2.12 In the Mid-term Review of Annual Policy Statement released on October 25, 2005, it was indicated that barring the emergence of any adverse and unexpected developments in various sectors of the economy, including the outlook for inflation, the overall stance of monetary policy for the remaining part of the year would be: "(i) consistent with emphasis on price stability, provision of appropriate liquidity to meet genuine credit needs and support export and investment demand in the economy; (ii) ensuring an interest rate environment that is conducive to macroeconomic and price stability, and maintaining the growth momentum; and (iii) to consider measures in a calibrated and prompt manner, in response to evolving circumstances with a view to stabilising inflationary expectations." In view of the prevailing macroeconomic and overall monetary conditions, reverse repo rate and repo rate were raised. Several measures were also initiated to improve credit delivery mechanism, strengthen the prudential norms and improve the payment and settlement systems (Box II.1)

2.13 The Annual Policy Statements of the Reserve Bank as well as its Mid-term Reviews have also laid emphasis on structural and regulatory measures for strengthening the financial system. Policy measures have been taken from time to time with a view to increasing operational efficacy of monetary policy, redefining the regulatory role of the Reserve Bank, strengthening prudential norms and development of technological and institutional infrastructure. The Annual Policy Statement for 2005-06 aimed at continuation of the Reserve Bank's resolve to pursue integration of the various segments of the financial system, nurture conducive credit culture and enhance the quality of financial services. The Statement also set out a medium-term framework for: (i) development of the money market, the foreign exchange market and the Government securities market; (ii) enhancing credit flow to agriculture and small industry; (iii) institutional reform in co-operative banking, non-banking financial companies and regional rural banks; (iv) ensuring availability of quality services to all sections of the population with emphasis on availability of banking services to the common person, especially depositors; and (v) action points in technology and payment systems.

Statutory Pre-emptions

2.14 There has been a distinct move away from the use of direct instruments of monetary control to market-based instruments from 1991-92. As a result, the statutory pre-emptions in the form of CRR and SLR have been significantly reduced in phases. The SLR was progressively brought down from the peak rate of 38.5 per cent in February 1992 to the statutory minimum of 25 per cent by October 1997. Commercial banks, however, held Government and other approved securities at a much higher level of 38.5 per cent of net demand and time liabilities (NDTL) at end-March 2005. In terms of volume, such holdings above the SLR amounted to Rs.2,60,582 crore.

2.15 While the Reserve Bank continues to pursue its medium-term objective of reducing the CRR to the statutory minimum level of 3.0 per cent, the CRR of scheduled commercial banks (SCBs) was increased by one-half of one percentage point of NDTL in two stages of 25 basis points each to 4.75 per cent effective September 18, 2004 and further to 5.0 per cent effective October 2, 2004. Furthermore, the remuneration of the eligible cash balances under CRR was de-linked from the Bank Rate and reduced to 3.5 per cent effective September 18, 2004. The increase in CRR was necessitated partly for absorbing liquidity from the system, but more importantly, for signalling the Reserve Bank's concern regarding inflationary expectations.

Interest Rate Structure

2.16 Deregulation of interest rates has been one of the key features of financial sector reforms. The deregulation of interest rates in recent years has improved the competitiveness of financial environment and strengthened the transmission mechanism of monetary policy. Sequencing of interest rate deregulation has also enabled a better price discovery and has imparted greater efficiency in the resource allocation process. The process has been gradual and predicated upon institution of prudential regulation of the banking system, market behaviour, financial opening and, above all, the underlying macroeconomic conditions. Interest rates have been largely

Box II.1: Major Policy Announcements in the Mid-Term Review of Annual Policy for the Year 2005-06

1. Monetary Measures

- Bank Rate left unchanged at 6.0 per cent.
- Reverse repo rate and the fixed repo rate under the Liquidity Adjustment Facility (LAF) increased by 25 basis points each to 5.25 per cent and 6.25 per cent, respectively effective October 26, 2005. Accordingly, the spread between reverse repo rate and the repo rate under the LAF maintained at 100 basis points.
- The cash reserve ratio (CRR) kept unchanged at 5.0 per cent.

2. Interest Rate Policy

- Indian Banks' Association to review the benchmark prime lending rate (BPLR) system and issue transparent guidelines for appropriate pricing of credit.

3. Government Securities Market

- Intra-day short selling in Government securities proposed to be introduced.
- NDS-OM module to be extended to all insurance entities which are mandated to invest in Government securities.

4. Foreign Exchange Market

- Special purpose vehicles (SPVs) or any other entity, notified by the Reserve Bank, which are set up to finance infrastructure companies/projects would be treated as financial institutions and ECBs raised by such entities would be considered under the approval route.
- Banks allowed to issue guarantees or standby letters of credit in respect of ECBs raised by textile companies for modernisation or expansion of textile units.

5. Credit Delivery Mechanisms

- As announced by the Finance Minister, banks were advised to take necessary action with regard to a policy package for stepping up credit to small and medium enterprises.
- The Micro Finance Development Fund (MFDF) set up in the NABARD re-designated as the Microfinance Development and Equity Fund (MFDEF) and its corpus increased from Rs.100 crore to Rs.200 crore. The modalities with regard to the functioning of the MFDEF are being worked out.
- The report of the Internal Working Group set up to examine issues relating to rural credit and micro-finance is under examination.
- An Internal Working Group proposed to be set up in regard to relief measures to be provided in areas affected by natural calamities.

6. Prudential Measures

- Bank's aggregate capital market exposure restricted to 40 per cent of its net worth on a solo and consolidated basis; consolidated direct capital market exposure modified to 20 per cent of the bank's consolidated net worth. Banks having sound internal controls and robust risk management systems can approach the Reserve Bank for higher limits.
- General provisioning requirement for 'standard advances' increased from the present level of 0.25 per cent to 0.40 per cent; banks' direct advances to agricultural and SME sectors exempted from the additional provisioning requirement.
- The Reserve Bank is examining various types of capital instruments that can be permitted under the New Capital Adequacy Framework for the banks.
- Supervisory review process to be initiated with select banks having significant exposure to some sectors such as real estate, highly leveraged NBFCs, venture capital funds and capital markets, in order to ensure that effective risk mitigants and sound internal controls are in place.
- With a view to achieving greater financial inclusion, all banks advised to make available a basic banking 'no frills' account either with 'nil' or very low minimum balances as well as charges that would make such accounts accessible to vast sections of population. All banks urged to give wide publicity to the facility of such a 'no-frills' account so as to ensure greater financial inclusion.
- General permission to banks to issue debit cards in tie-up with non-bank entities.

7. Payment and Settlement Systems

- By end-March 2006, 15,000 branches are proposed to be covered by Real Time Gross Settlement (RTGS) connectivity, and the number of monthly transactions of the system is expected to expand from one lakh to two lakh.
- The National Electronic Funds Transfer (NEFT) system would be implemented in phases for all networked branches of banks all over the country.
- The pilot project for Cheque Truncation System is expected to be implemented in New Delhi by end-March 2006.
- National Settlement System (NSS) to enable banks to manage liquidity in an efficient and cost effective manner to be introduced in the four metropolitan centres by end-December 2005.
- A new company for retail payment systems proposed to be set up under Section 25 of the Companies Act, 1956 to be owned and operated by banks. The proposed company is likely to get operational from April 1, 2006.
- Banks urged to test their business continuity plans periodically and ensure continuous service.

8. Urban Co-operative Banks

- Currency chest facility and licence to conduct foreign exchange business (authorised person licence) extended to scheduled UCBs registered under the Multi-State Co-operative Societies Act and under the State Acts where the State Governments concerned have assured regulatory coordination by entering into MoU with the Reserve Bank.
- Acquirer UCB permitted to amortise the losses taken over from the acquired UCB over a period of not more than five years, including the year of merger.

9. Computation of Exchange Rate Indices – New Series

- The Reserve Bank has recently updated its nominal effective exchange rates (NEER) and real effective exchange rates (REER) indices. The new 6-currency indices and the revised 36-country indices of NEER and REER would be published in the Reserve Bank of India Bulletin of December 2005.

deregulated except for: (i) savings deposit accounts; (ii) non-resident Indian (NRI) deposits; (iii) small loans up to Rs.2 lakh; and (iv) export credit.

Bank Rate and Repo/Reverse Repo Rate

2.17 With a view to devising an instrument that would signal the stance of monetary policy, the Bank Rate was reactivated in April 1997 and linked to the rates of various standing facilities. In the recent period, however, most of the liquidity injection at the short end of the market is conducted through the repo rate under the LAF. As such, the importance of the Bank Rate as a signalling rate has declined. The Reserve Bank, accordingly, announces the Bank Rate in tune with the prevailing macroeconomic environment. On a review of the macroeconomic developments, the Bank Rate was kept unchanged at 6.0 per cent in the Annual Policy Statement for 2005-06 and its Mid-term Review in October 2005. The Bank Rate was last revised on April 29, 2003, when it was reduced by 25 basis points to the present level of 6.0 per cent.

2.18 Consequent upon the announcement made in the Mid-term Review of Annual Policy of 2004-05, auctions of 7-day and 14-day reverse repo were discontinued with effect from November 1, 2004 and the LAF scheme is now being operated through overnight fixed rate repo and reverse repo. In view of the prevailing macroeconomic and overall monetary conditions, it was announced in the Annual Policy Statement of 2005-06 that the fixed reverse repo rate would be raised by 25 basis points under the LAF to 5.00 per cent effective April 29, 2005. The spread between the reverse repo rate and the repo rate was also reduced by 25 basis points to 100 basis points. The fixed repo rate under the LAF was left unchanged at 6.0 per cent.

Deposit Rates

2.19 At present, on the deposits side, interest rates only on savings deposits and NRI deposits only are being prescribed by the Reserve Bank. The Monetary and Credit Policy Statement of 2002[2] had weighed the option of deregulation of interest rate on savings accounts but it was observed that the time was not opportune considering that bulk of such deposits was held by households in semi-urban and rural areas. It was, however, felt that deregulation would facilitate better asset-liability management for banks and competitive pricing to benefit the holders of savings accounts. In the Mid-term Review of Annual Policy for 2004-05, banks were allowed the discretion to reduce the minimum tenor of retail domestic term deposits (under Rs.15 lakh) from 15 days to 7 days.

2.20 Interest rate ceilings on FCNR(B) deposits are linked to LIBOR rates of corresponding foreign currencies (at present LIBOR minus 25 basis points except in the case of Japanese Yen where the cap is based on the prevailing LIBOR rate), while NRE deposit rates are linked to the US dollar LIBOR/SWAP rates. The ceiling for NRE deposit rates was raised to LIBOR/SWAP rate of corresponding maturity plus 50 basis points in the Mid-term Review of Annual Policy for 2004-05. Banks are allowed to fix the rates on both the FCNR(B) deposits and NRE deposits on a monthly basis.

Lending Rates

2.21 The lending rates presently regulated by the Reserve Bank are the concessional rates (below BPLR of the respective banks) for certain sectors such as exports and small loans up to Rs.2 lakh, and under the differential rate of interest (DRI) scheme. The Annual Policy Statement for 2005-06 flagged the need for continuance of remaining interest rate prescriptions for wider public debate.

2.22 Lending rates were deregulated in October 1994 and banks were required to announce a prime lending rate (PLR), taking into account the cost of funds and transaction cost, among others, with the approval of their Boards. The PLR was made the floor rate for credit limits over Rs.2 lakh. Subsequently, banks were permitted to operate two PLRs – one for short term and the other for long-term loans. The concept of tenor linked PLR, *i.e.*, PLR for different maturities was introduced in April 1999 to give banks more operational flexibility. Lending rates across banks, however, tended to vary widely with banks charging higher spreads over the PLRs for non-prime borrowers. Despite a fall in deposit rates and lowering of cost of funds over the period, the range of PLRs of public sector banks remained sticky downwards. As downward rigidity of PLR emerged as a vital policy issue for the Reserve

[2] Annual Policy Statement prior to 2004-05 was known as Statement on Monetary and Credit Policy.

Bank, particularly in respect of credit delivery to small and medium sized borrowers at a reasonable cost, it was decided in the Monetary and Credit Policy for 2002-03 to place the information on PLRs and maximum and minimum interest rates on bank advances in the public domain for customers' protection and meaningful competition. Furthermore, with continued downward stickiness of PLRs, the Reserve Bank mooted the concept of benchmark prime lending rate (BPLR) on April 29, 2003 to address the need for transparency in banks' lending rates as also to reduce the complexity involved in pricing of loans. Since all other lending rates can be determined with reference to the BPLR arrived at by taking into account term premia and/or risk premia, the system of tenor-linked PLR was discontinued. Following the announcement made in the Mid-term Review in November 2003, the Indian Banks' Association (IBA) advised banks to take into account the following broad parameters while arriving at the BPLR: (i) actual cost of funds; (ii) operating expenses; and (iii) a minimum margin to cover regulatory requirement of provisioning/capital charge and profit margin.

2.23 As regards interest rates on export credit, in the Monetary and Credit Policy Statement of April 2002, it was indicated that "linking domestic interest rates on export credit to PLR has become redundant in the circumstances as effective interest rates on export credit in rupee terms were substantially lower than the PLR". The Mid-term Review of October 2002 had mooted deregulation of interest rate on rupee export credit in phases to encourage greater competition in the interest of exports. Accordingly, ceiling rate of PLR plus 0.5 percentage points on pre-shipment credit beyond 180 days and up to 270 days and post-shipment credit beyond 90 days and up to 180 days was deregulated with effect from May 1, 2003. Further, it was indicated that liberalisation would be considered at a later date and it would be examined whether the ceiling rates on pre-shipment credit up to 180 days and post-shipment credit up to 90 days should also be discontinued to encourage greater competition among banks for export credit. The present ceiling for interest rate on pre-shipment (up to 180 days) and post-shipment (up to 90 days) rupee export credit is valid up to April 30, 2006.

2.24 Interest rate ceiling on small loans up to Rs.2 lakh is linked to BPLR for ensuring availability of credit at reasonable rates as also for the reason that small borrowers have limited ability to manage interest rate risk. There is a contrary view that: (a) given the competitiveness in the credit market, high share of sub-BPLR lending and increasingly broad-based credit structure, availability of credit to all segments of the economy at a price consistent with their risk profiles becomes important; and (b) lending rate regulation has dampened large flow of credit to small borrowers and imparted an element of downward rigidity to BPLR. Interest rate regulation on export credit has been favoured for making available credit to exporters at internationally competitive rate. There is, however, a view that in the light of competitive lending rates in the economy, it is important to ensure that regulated interest rates do not restrict credit flow to all segments of exporters with different risk profiles.

2.25 The Annual Policy Statement for 2005-06 indicated that "while there is merit in moving forward to impart greater competitiveness and depth to the activities of the financial system by further deregulating interest rates in some segments which have hitherto remained regulated for various reasons found relevant at different stages, it is proposed to continue with *status quo* as various issues pertaining to above regulations on interest rates are being debated".

3. Credit Delivery

2.26 The Reserve Bank has taken several measures to create a conducive environment for banks to provide adequate and timely finance to different sectors of the economy at reasonable rates without procedural hassles. It has been the endeavour of the Reserve Bank to ensure adequate credit growth for productive sectors in tandem with the accommodation of borrowing programme of the Central and the State Governments, while closely assessing its implications for demand-management to maintain macro and price stability. Besides imparting constant vigil on the quantum and cost of credit, the quality and other attributes associated with credit deployment have been equally emphasised. Keeping in view the imperative need for removal of bottlenecks to credit delivery, the Reserve Bank undertook a series of measures in 2004-05, particularly relating to the priority sector, agriculture, micro-finance and small scale industries.

Priority Sector Lending[3]

2.27 Domestic scheduled commercial banks and foreign banks are required to extend a minimum of 40 per cent and 32 per cent, respectively, of their net bank credit to the priority sector with sub-targets set for lending to various sub-sectors. Domestic scheduled commercial banks having a shortfall in lending to the priority sector/agriculture are required to make contribution to the Rural Infrastructure Development Fund (RIDF) established in National Bank for Agriculture and Rural Development (NABARD). In the case of foreign banks operating in India, those who fail to achieve the priority sector lending target or sub-targets, an amount equivalent to the shortfall is required to be deposited with Small Industries Development Bank of India (SIDBI). Even though such arrangements regarding the priority sector shortfall are in place, banks are urged to take appropriate steps to increase the flow of credit to the priority sector, agriculture and weaker sections so as to achieve the stipulated targets.

2.28 In order to align bank credit to the changing needs of the society, the scope and definition of priority sector have been fine-tuned over time by including new items as also by enhancing credit limit of the constituent sub-sectors. As part of this process, some more measures were initiated in 2004-05. First, the ceiling on credit limit to farmers against pledge/hypothecation of agricultural produce (including warehouse receipts) was increased from Rs.5 lakh to Rs.10 lakh under the priority sector. Second, the limit on advances under the priority sector for dealers in agricultural machinery, including drip/sprinkler irrigation systems was increased from Rs.20 lakh to Rs.30 lakh and for distribution of inputs for allied activities from Rs.25 lakh to Rs.40 lakh. Third, banks were permitted to extend direct finance to the housing sector up to Rs.15 lakh, irrespective of location, as part of their priority sector lending. Fourth, investments by banks in the mortgage backed securities (MBS) have been classified as direct lending to housing within the priority sector lending subject to certain conditions. Fifth, loans advanced to distressed urban poor to prepay their debt to non-institutional lenders, against appropriate collateral or group security, have been classified as advances to weaker sections within the priority sector. Sixth, investment limit in plant and machinery for seven items belonging to sports goods, which figure in the list of items reserved for manufacture in the small scale industries (SSI) sector, was enhanced from Rs.1 crore to Rs.5 crore for the purpose of classification under priority sector advances. Seventh, banks were urged to make efforts to increase their disbursements to small and marginal farmers to 40 per cent of their direct advances under Special Agricultural Credit Plans (SACP) by March 2007. All private sector banks were also asked to formulate SACP targets from 2005-06 with an annual growth rate of at least 20-25 per cent of credit disbursements to agriculture. Eight, investment by banks in securitised assets representing direct lending to the SSI sector have been classified as their direct lending to the SSI sector under priority sector lending, subject to certain conditions. Ninth, it was decided that investments made by banks on or after April 1, 2005 in the special bonds issued by certain specified institutions would not be eligible for classification under priority sector lending and such investments which have already been made by banks up to March 31, 2005 would cease to be eligible for classification under priority sector lending in a phased manner. Further, it was decided that investments made by banks on or after July 1, 2005 in venture capital would not be eligible for classification under priority sector lending, while such investments already made up to June 30, 2005 would not be eligible for classification under priority sector lending with effect from April 1, 2006. Finally, the recommendations of the Working Group on Flow of Credit to the SSI Sector (Chairman: Dr. A.S. Ganguly) in regard to evaluation of methods of utilisation of deposits made by foreign banks with SIDBI for shortfall in their priority sector obligations have been accepted by the Reserve Bank and, accordingly, the structure of the extant scheme has been revised.

Lending and Deposits Rates under RIDF

2.29 On the basis of representations made by various State Governments and NABARD, it was decided, with the approval of the Central Government, to restructure the lending and deposit rates in respect of the amounts disbursed on or before October 31, 2003 out of RIDF IV to VII with effect from April 16, 2005 (Table II.1).

[3] Priority sector comprises agriculture (both direct and indirect), small scale industries, small roads and water transport operators, small business, retail trade, professional and self-employed persons, State sponsored organisations for Scheduled Castes/Scheduled Tribes, education, housing (both direct and indirect), consumption loans, micro-credit, small loans to the software, and food and agro-processing sector.

Table II.1: Lending and Deposits Rates under RIDF

RIDF	Deposit rates payable to banks (per cent per annum)		Lending rates payable by State Governments (per cent per annum)	
	Existing	Revised	Existing	Revised
1	2	3	4	5
IV	11.5	8.0	12.0	8.5
V	11.5	8.0	12.0	8.5
VI	11.0	8.0	11.5	8.5
VII	Interest rate linked to shortfall in agricultural lending (varying between 10 and 7 per cent)	7.5	10.5	8.0

Interest Rates on Deposits with SIDBI in lieu of Shortfall in Priority Sector Obligations

2.30 Based on the recommendations of the Working Group on Flow of Credit to the SSI Sector, interest rates on deposits placed by foreign banks with SIDBI, in *lieu* of shortfall in priority sector lending targets, were inversely linked to the extent of shortfall in the overall target (32 per cent of net bank credit) or aggregate shortfall in sub-targets SSI (10 per cent) and export credit (12 per cent), whichever is higher (Table II.2). The term of the deposits placed with SIDBI by foreign banks would be for a period of three years.

Credit to Agriculture and Allied Activities

2.31 In line with the announcement made by the Central Government in June 2004 to double the flow of credit to agriculture in three years, the Union Budget, 2005-06 proposed to increase the flow of credit to agriculture by 30 per cent during the year. It has been the endeavour of the Reserve Bank to enhance the credit flow to agriculture by removing bottlenecks in credit delivery. Most of the recommendations of the Advisory Committee on Flow of Credit to Agriculture and Related Activities from the Banking System (Chairman: Prof. V.S. Vyas) have been implemented by the Reserve Bank and NABARD. Out of 99 recommendations made by the Committee, 33 recommendations were accepted and implemented by October 2005. These related to : (i) procedural modifications and rationalisation of systems and procedures; (ii) tie-ups with related farm machinery manufacturers by banks; (iii) use of a flexible revolving credit limit to small borrowers of production or investment loans for meeting temporary shortfalls in family cash flows; (iv) co-opting joint liability group (JLG) and self-help group (SHG) approaches in addressing issues relating to financing oral lessees; (v) addressing delays/ refusal in opening savings bank accounts of SHGs; (vi) improving staffing in the rural areas to promote retail lending to agriculture, use of individual volunteers, farmers' clubs or NGOs/SHGs as direct selling agents; (vii) building synergy between good working primary agricultural credit societies and commercial banks; (viii) use of IT in rural branches; (ix) working out appropriate incentive structure for prompt repayment; (x) making the rates of interest on small loans reasonable; and (xi) improving the efficiency of credit delivery to small borrowers and association with contract farming. Furthermore, some of the recommendations *viz.*, stepping up credit for marketing and introduction of negotiable warehousing receipt system, support of State Governments for collecting dues reduction of stamp duty on agricultural loans, legal amendments to Agricultural Produce Marketing Committee (APMC) Act by the State Governments, amendment to NABARD Act for operational autonomy, which were referred to the Government of India for examination, have been accepted.

2.32 With a view to further increasing the flow of credit to agriculture, the following measures were proposed in the Annual Policy Statement for 2005-06. First, in order to make an assessment

Table II.2: Interest Rates on Deposits with SIDBI

Sr. No.	Shortfall in overall target (32 per cent of net bank credit) or aggregate shortfall in sub-targets SSI (10 per cent) and export credit (12 per cent), whichever is higher	Rate of interest on the entire deposit to be made with SIDBI (per cent per annum)
1	2	3
1.	Less than 2 percentage points	Bank Rate (6 per cent at present)
2.	2 and above, but less than 5 percentage points	Bank Rate *minus* 1 percentage point
3.	5 and above, but less than 9 percentage points	Bank Rate *minus* 2 percentage points
4.	9 percentage points and above	Bank Rate *minus* 3 percentage points

of customer satisfaction on credit delivery in rural areas by banks, it was proposed to conduct a survey with the help of an outside agency. Second, keeping in view the importance of post-harvest operations, the limit on loans to farmers through the produce marketing scheme was proposed to be increased from Rs.5 lakh to Rs.10 lakh under priority sector lending. There is a growing realisation amongst bankers that there are increasing business opportunities in financing agriculture. Banks were, therefore, urged to continue their efforts to step up credit to agriculture.

2.33 With a view to increasing the flow of credit to agriculture, the Reserve Bank set up an Expert Group on Investment Credit (Chairman: Shri Y.S.P. Thorat) to formulate a strategy for increasing investment credit in agriculture. The Group in its Report submitted in June 2005 identified several factors which constrain growth in investment in agriculture. These include meagre growth in minor irrigation and farm mechanisation; declining public sector investment; limited credit absorptive capacity; lack of effective mechanism for technology transfer and poor extension services; inadequate extension services; limited infrastructure for agro processing, storage, warehousing, value addition and marketing; restrictions on purchases outside the *mandis;* weather aberrations and output price fluctuations; inadequate risk mitigation mechanism; and non-availability of land records. The Group emphasised the need to accelerate investment in agriculture in order to achieve the desired level of growth. It also highlighted the need for investments to be appropriately structured, timed and well implemented in order to attain maximum effectiveness (Box II.2).

Micro-finance

2.34 The programme of linking self-help groups (SHGs) with the banking system has emerged as a major micro-finance programme in the country. Accordingly, the Union Budget for 2005-06 proposed to enhance the annual target of credit linkage to 2.5 lakh SHGs during 2005-06 from 2 lakh SHGs during 2004-05.

2.35 As a follow-up to the announcement in the Union Budget, 2005-06, the Reserve Bank constituted an Internal Group to Examine Issues

Box II.2: Expert Group on Investment Credit

Major Recommendations of the Group are set out below:

- In view of various changes in the Indian rural canvas over the past few years, there is need for a shift in the thrust areas for investment credit to agriculture. Apart from the traditional investments such as land development and irrigation, increased focus needs to be accorded to the entire supply chain management of agriculture products, reform of agriculture markets and public management in agricultural infrastructure.
- State Governments need to lay emphasis on legal provisions/computerisation of land records, legal support for recovery, reforms in agricultural marketing, improving credit absorptive capacity through supporting infrastructure, strengthening infrastructure, improving extension network and developing marketing links.
- NABARD should take special steps to facilitate capacity building of credit institutions in appraisal skill, particularly in North Eastern States, and design appropriate products for financing rural infrastructure projects outside the RIDF by mobilising resources from the market or banks at competitive rates of interest.
- Water management policies and investment in water conservation be designed jointly by the State Governments and banks for improving productivity in agriculture.
- The State Governments and NABARD should make investments in participatory community projects and in soil treatment to make wasteland and fallow land cultivable.
- With a view to strengthening the institutional credit mechanism, short-term credit be integrated with term credit and efforts be made to reach the 'unreached' areas, promote supplementary credit delivery channels, outsource monitoring services, provide loan support for diversified agriculture, review HR policies, share the pool of technical expertise and make use of the model bankable projects prepared by NABARD.
- The Reserve Bank along with banks could adopt agency models for credit delivery,
- Government of India/State Governments and organisations engaged in agricultural research and development (R&D) to reorient R&D activities.
- To mitigate the risk in financing of agriculture, the Group suggested several measures. These included: (i) developing suitable financial products and commodity exchanges; (ii) allowing banks to operate on behalf of farmers and participate in commodity futures; (iii) establishing a risk fund for fragile agriculture; (iv) designing special risk mitigation packages for low asset-based borrowers; (v) using warehousing receipts with price hedging instruments; (vi) adopting technology for dissemination of market intelligence; (vii) sharing borrower information; and (viii) financing value chain by banks/through RIDF.

Relating to Rural Credit and Micro-finance (Chairman: Shri H.R. Khan). The Group in its Report submitted in July 2005 observed that there is an imperative need to work out efficient mechanisms involving external entities to cater to the under-serviced areas and the rural poor (Box II.3). The recommendations of the Group are being examined by the Reserve Bank.

2.36 In the Annual Policy Statement for 2005-06, the Reserve Bank voiced its concern on the exclusion of vast sections of the population from the formal financial system and announced to implement policies to encourage banks which provide extensive services while disincentivising those which are not responsive to the banking needs of the community, including the underprivileged. It was also decided to monitor the nature, scope and cost of services of banks to assess whether there is any denial, implicit or explicit, of basic banking services to the common person. Banks were also urged to review their existing practices to align them with the objective

Box II.3: Recommendations of the Internal Group to Examine Issues Relating to Rural Credit and Micro-finance

The Group felt that extended outreach to the under-serviced areas and the rural poor would facilitate acquisition of a large number of customers, *albeit* small ones with substantial potential for large increase in business volumes and profit as banking with the poor is rather profitable banking. The major recommendations of the Group are set out below:

- For providing comprehensive financial services encompassing savings, credit and remittance, insurance and pension products in rural areas, the Group recommended two models, *viz*., the Business Facilitator Model and the Business Correspondent Model as proactive response.
- Under the Business Facilitator Model, it was envisaged that banks could use a wide array of civil society organisations (CSOs) and others for supporting them by undertaking non-financial services. The Facilitators would provide support services for effective delivery of financial services such as: (i) borrower identification; (ii) collection, processing and submission of applications; (iii) preliminary appraisal; (iv) marketing of the financial products including savings; (v) post-sanction monitoring; (vi) promotion and nurturing SHGs/Joint Liability Groups (JLGs); and (vii) follow-up for recovery.
- NGOs, farmers clubs, functional co-operatives, IT enabled rural outlets of corporates, postal agents, insurance agents, well-functioning panchayats, rural multi-purpose kiosks/village knowledge centres, agri-clinics/business centers financed by banks, Krishi Vigyan Kendras, Khadi and Village Industry Commission (KVIC)/ Khadi and Village Industries Commission Board (KVIB) units may function as the Business Facilitators.
- Under the Business Correspondent Model, institutional agents/other external entities may support the banks for extending financial services. The Business Correspondents would function as "pass through" agencies to provide credit related services such as disbursal of small value credit, recovery of principal/ collection of interest and sale of micro insurance/mutual fund products/pension products besides the other functions of Business Facilitator Model.
- Registered NBFCs with significant rural presence, NGO-micro-finance institutions (MFIs) set up under the Societies/ Trust Act, Mutually Aided Co-operative Societies (MACS) with a charter to undertake financial functions, IT enabled rural outlets of corporates with appropriate contractual agreements with the principal, well running primary agricultural credit societies (PACSs) and post offices may function as the Business Correspondents.
- The micro credit portfolio of the regulated MFIs may be made eligible for direct finance from NABARD; a line of credit may be extended by NABARD to provide liquidity assistance in view of the co-variant nature of credit risk of the MFIs.
- Institutions such as NABARD and SIDBI may provide bulk lending support to start-up MFIs and funds of State/ Central Development/Finance Corporations, if feasible, may be channelised through NABARD to identified MFIs.
- Accounting standards for SHGs and NGOs may be developed, codified, and standardised by NABARD as a promotional initiative in consultation with the Institute of Chartered Accountant of India (ICAI).
- NABARD, in consultation with Ministry of Information and Technology, may draw up a time bound action plan to set up Rural Kiosks/ Village Knowledge Centers, partly funded from RIDF. The remaining cost may be borne by the Central/State Governments on a shared basis.
- The MFIs may be rated to help banks/financial institutions to decide about engaging them as their agents and funding them. The rating agencies need to be accredited with an appropriate authority.
- NABARD, SIDBI and major banks may consider promoting independent rating agencies by way of equity contributions. Financial support may be provided to the accredited rating agencies to cover their operational deficits for a period of three to five years and the expenses in this regard may be met from the Micro Finance Development and Equity Fund (MFDEF).
- Non-deposit taking MFIs may attempt self-regulation by forming State level associations.
- A separate and exclusive regulatory and supervisory framework for MFIs may not be required for the present.
- Considering the high transaction costs and the emphasis on timely availability of credit, it may not be appropriate to fix any ceiling on interest rates and service fees charged by MFIs.

of financial inclusion. In order to give a further fillip to micro-finance movement, the Reserve Bank allowed non-Government organisations (NGOs) engaged in micro-finance activities as an additional channel of resource mobilisation, to access external commercial borrowings (ECBs) up to US $ 5 million during a financial year for permitted end-use under the automatic route.

Service Area Approach

2.37 Consequent upon the announcement made in the Mid-term Review of Annual Policy Statement for the year 2004-05 and on the basis of recommendations made by the Advisory Committee on Flow of the Credit to Agriculture and Related Activities from the Banking System, the Service Area Approach (SAA) scheme was reviewed on December 8, 2004 and it was decided to dispense with the restrictive provisions of the scheme, while retaining the positive features of the SAA such as credit planning and monitoring of the credit purveyance. These relaxations have been introduced with a view to enabling rural borrowers to have easy access to institutional credit from any bank of their choice at a competitive price and to provide banks, public and private, with a level playing field. The SAA was introduced in April 1989 with a view to bringing about an orderly and planned development of rural and semi-urban areas of the country. Under the SAA, all rural and semi-urban branches of banks were allocated specific villages, generally in geographically contiguous areas, the overall development and the credit needs of which were to be taken care of by the respective branches.

Relief Measures for Persons Affected by Natural Calamities

2.38 In view of loss of life and property caused by *Tsunami* in December 2004 in the States of Andhra Pradesh, Tamil Nadu and Kerala and the Union Territories (UTs) of Pondicherry and Andaman and Nicobar Islands, the convenor banks of the State Level Bankers' Committees (SLBCs) in these States/Union Territories were advised to assess the situation and take immediate measures to provide appropriate relief to the affected people in terms of standing guidelines issued by the Reserve Bank. A Task Force (Chairman: Shri V. Leeladhar) was also constituted on December 27, 2004 to monitor the progress of relief and rehabilitation measures through banks and to constantly review the situation to see whether any further measures were required. Special meetings of the SLBCs were convened in the above-referred three States and two UTs. Special measures were initiated by banks to provide financial assistance to persons, particularly those engaged in fisheries in the affected areas. Based on the suggestions received from a few SLBCs, the consumption loan limit was enhanced from the existing Rs.1,000 to Rs.3,000 in the case of persons affected by *Tsunami*. The Regional Directors of the Reserve Bank in the concerned States/UTs were advised to send a small team of officials to take stock of the situation.

2.39 Furthermore, instructions were issued to all scheduled commercial banks to receive donations to the Prime Minister's Relief Fund at all branches and nominate a nodal branch at New Delhi for the purpose of collection. The Central Government exempted, subject to certain conditions, up to March 31, 2005, all associations (other than political parties), having a definite cultural, economic, educational, religious or social programme from the provisions of the Foreign Contributions (Regulation) Act, 1976, enabling them to accept foreign contributions in cash and kind for providing relief to *Tsunami* victims, without obtaining formal approval from the Central Government. All scheduled commercial banks were advised to issue necessary instructions to their branches in this regard.

2.40 The Reserve Bank permitted its staff in the States concerned to undertake relief work in the affected areas. In addition, banks were urged to take the help of good NGOs working in the areas to identify borrowers and sanction consumption loan of Rs.5,000, extendable up to Rs.10,000 at the discretion of the bank managers without any collateral to the affected persons. Banks were also directed to allow opening of savings bank accounts with nominal balance, provide education loans to the affected persons, formulate a scheme for financing of defaulting fishermen and other types of borrowers and identify the victims who are in need of assistance and provide them necessary relief without waiting for any list of victims to be formally made available by the Government. The Union Government also announced the Rajiv Gandhi Rehabilitation Package for *Tsunami* affected areas under which subsidy is provided

by the Government for loans provided to the victims of *Tsunami* for purchase/repair of boats. At the same time, the Indian Banks' Association advised its member banks that while the ceilings on loans indicated under the package were for the limited purpose of extending subsidy, banks should provide loans to the extent of full unit costs after taking into account the eligible subsidy.

Relief Measures in Areas Affected by Unprecedented Rains and Floods in Maharashtra

2.41 Consequent to the unprecedented rains and floods resulting in heavy damage to life and property in the State of Maharashtra, the convenor bank of the State Level Bankers' Committee (SLBC) was advised to assess the situation and take immediate measures to provide appropriate relief to the affected people in terms of Reserve Bank's standing guidelines on relief measures by banks in areas affected by natural calamities. In particular, attention of banks was drawn regarding financial assistance to artisans, self-employed, traders, tiny and small-scale industrial units affected by the unprecedented calamity. As per the existing instructions, banks were advised to extend general consumption loans up to Rs.1000 to eligible persons in the areas affected by natural calamity in the States where the State Governments have constituted risk funds for such lendings by commercial banks. In view of the situation prevailing in the State, banks were also advised to consider increasing the limit of consumption loan to be provided to the affected persons in the State up to Rs.5,000 without any collateral. This limit may be enhanced to Rs.10,000 at the discretion of the branch manager, depending on the repaying capacity of the borrower. Banks were also advised to consider provision of financial assistance for the purpose of repairs/reconstruction of dwelling units and also to small road transport operators, including taxi and auto rickshaw operators affected by the calamity, keeping in view the viability of the proposals. Banks were requested to take necessary action to expeditiously restore banking services in the affected areas.

Relief Measures in the State of Jammu and Kashmir and Other Parts of North India Hit by Severe Earthquake

2.42 Consequent to the earthquake in the State of Jammu and Kashmir and other parts of North India resulting in heavy damage to life and property, the convenor bank of the State Level Bankers' Committee (SLBC) of the State of Jammu and Kashmir was advised to convene a special State Level Bankers' Committee meeting, to which National Housing Bank (NHB) and Small Industries Development Bank of India (SIDBI) were also invited, to assess the situation and take immediate measures to provide appropriate relief to the affected people in terms of Reserve Bank's standing guidelines and also to consider and recommend any special measures that might be required in the affected areas. Banks were advised to extend general consumption loans, as per the existing instructions, up to Rs.1,000 to eligible persons in the areas affected by natural calamity in the States where the State Governments have constituted risk funds for such lending by commercial banks. In view of the situation prevailing in the State of Jammu and Kashmir, banks were also advised to consider increasing the limit of consumption loan to be provided to the affected persons in the State up to Rs.5,000 without any collateral. This limit may be enhanced to Rs.10,000 at the discretion of the branch manager, depending on the repaying capacity of the borrower. Banks were further advised to consider provision of financial assistance for the purpose of repairs/reconstruction of dwelling units *etc*. damaged on account of the earthquake. Banks were also advised to take necessary action expeditiously to restore banking services in the affected areas. The Reserve Bank also advised National Housing Bank to consider provision of financial assistance for the purpose of construction/repairs of dwelling units damaged by the earthquake.

Role of Banks in providing Loans against Warehouse Receipts and Commodity Futures

2.43 In pursuance of the announcement made in the Mid-term Review of Annual Policy Statement for the year 2004-05, the Reserve Bank constituted a Working Group on Warehouse Receipts and Commodity Futures (Chairman: Shri Prashant Saran) with a view to examining the role of banks in providing loans against warehouse receipts and evolving a framework for participation of banks in the commodity futures market. The Working Group in its Report submitted in April 2005 recommended that banks may be permitted to offer futures-based products to farmers in order to enable them to hedge against price risk (Box II.4).

Box II.4: Report of the Working Group on Warehouse Receipts and Commodity Futures

The Working Group was entrusted with the task of evolving broad guidelines, criteria, limits, risk management system as also a legal framework for facilitating participation of banks in commodity (derivative) market and use of warehouse receipts in financing of agriculture. The major recommendations of the Group are set out below:

- As banks at present are not allowed to deal in goods, the Central Government may issue a Notification under clause (o) of sub-section (1) of Section 6 of the Banking Regulation Act, 1949 permitting banks to deal in the business of agricultural commodities, including derivatives.
- Considering the experience that banks already have in dealing with agricultural commodities, it would be prudent at the current stage to permit banks to deal with derivatives in agricultural commodities only.
- A system needs to be evolved by which warehouse receipts become freely transferable between holders as it would reduce transaction costs and increase usage.
- An umbrella structure, which may act as a Closed User Group (CUG) for everyone engaged in the agricultural commodities business, be created. The umbrella structure is envisaged as an electronic platform that would offer straight through processing for everyone connected with commodities. There can be more than one CUG which would be subject to regulation and supervision by a regulatory authority such as Forward Markets Commission (FMC).
- Proprietary positions in agricultural commodity derivatives could be used by banks to mitigate their risk in lending to farmers. To achieve this, they will have to buy options on futures.
- The Forward Contracts (Regulation) Act, 1952 be amended and the FMC should evolve a framework for introducing "options" trading in agricultural commodities in India.
- Banks may be permitted to have independent proprietary position in commodity futures linked in a macro way to their credit portfolio. However, suitable risk control measures may have to be adopted by banks.
- At present, purely cash-settled contracts are not available in India. The banks trading or dealing in commodity contracts should, therefore, be prepared to make or accept delivery of physical goods. While no restriction may be placed in this regard, banks may be persuaded to preferably close their positions and cash settle the contracts.
- Banks may be granted general permission to become professional clearing members of commodity exchanges subject to the condition that they do not assume any exposure risk on account of offering clearing services to their trading clients. At least for the present, banks may not be permitted to act as trading members in the commodity exchanges.
- While banks may continue to hold their equity stake in the commodity exchanges in order to provide them financial strength and stability, they may reduce/divest their equity holding to a maximum permitted level of 5 per cent over a period of time so as to avoid any conflict of interest.

Credit Flow to Small Scale and Medium Industries

2.44 Given the importance of small scale industries to the overall economy, especially their employment generating potential, flow of credit to this sector has been given high priority. While large industries have access to various sources of finance, the small scale industries (SSI) sector depends primarily on finance from banks and other financial institutions. Several measures have been initiated with a view to increasing the flow of credit to SSI units. These included refining of definition of small scale and tiny enterprises; broadening the scope for indirect finance to these industries; making investments in several avenues such as securitised assets, lines of credit, bills-discounting, leasing and hire purchase eligible for priority sector advances; and modification of targets for priority sector lending to SSIs. Besides, in pursuance of the recommendations made by several working groups and high powered committees appointed by the Central Government and the Reserve Bank, a set of comprehensive guidelines to be followed for advances to all categories of borrowers in the SSI sector has been evolved.

2.45 The Reserve Bank had set up a Working Group on Flow of Credit to the SSI Sector (Chairman: Dr. A.S. Ganguly) to look into various aspects of credit flow to the SSI sector. The Group submitted its Report on April 30, 2004. The Reserve Bank has so far accepted eight recommendations. These include identification of new clusters and adopting cluster-based approach for financing the small and medium enterprises (SME) sector; sponsoring specific projects as well as widely publicising the successful working models of NGOs; sanctioning higher working capital limits to SSIs in the North Eastern region for maintaining higher levels of inventory; and exploring new instruments for promoting rural industry. As recommended by the Working Group, interest rates on the deposits placed by foreign banks with SIDBI in *lieu* of shortfall in their priority sector lending obligations were restructured and the tenor of deposits was

increased from one year to three years with effect from financial year 2005-06 (see paragraph 2.30). Of the recommendations pertaining to other agencies, *viz.*, the Ministry of Small Scale Industries and the Ministry of Finance, Government of India, SIDBI, Credit Guarantee Fund Trust for Small Industries (CGTSI), Credit Information Bureau of India, Ltd. (CIBIL) and IBA, seven have been accepted fully, and three others partially.

2.46 An Internal Group was constituted (Chairman: Shri C. S. Murthy) to review all circulars and guidelines issued by the Reserve Bank in the past regarding financing of SSIs, suggest appropriate terms for restructuring of the borrowal accounts of SSIs/medium enterprises and also examine the guidelines issued by the Reserve Bank for nursing sick SSIs and suggest suitable relaxation and liberalisation of these norms. The Group in its final report submitted in June 2005 suggested several measures to streamline guidelines on credit flows to the SME sector (Box II.5).

2.47 The Reserve Bank initiated a number of measures during 2004-05 to enhance banks' lending to small scale industries. First, in order to facilitate smooth flow of credit to SSIs, the composite loan limit through a single window for SSI entrepreneurs was enhanced from Rs.50 lakh to Rs.1 crore. Second, in order to encourage securitisation of loans to the SSI sector, investments made by banks in securitised assets representing direct lending to the SSI sector were permitted to be treated as their direct lending to the SSI sector under the priority sector, provided the pooled assets represent loans to the SSI sector which are reckoned under the priority sector and the securitised loans are originated by banks/ financial institutions. Third, as recommended by the Ganguly Working Group, interest rates on the deposits placed by foreign banks with SIDBI in *lieu* of shortfall in their priority sector lending obligations were restructured and the tenor of deposits increased from one year to three years from financial year 2005-06. Fourth, investments in special bonds issued by specialised institutions that were to be accorded priority lending status were further rationalised. Fifth, investment limit in plant and machinery for seven items belonging to sports goods, which figure in the list of items reserved for manufacture in the SSI sector, was enhanced from Rs.1 crore to Rs.5 crore for the purpose of classification under priority sector advances. Moreover, as a follow-up to the announcement made in the Annual Policy Statement for 2005-06 regarding formulation of a scheme of strategic alliance between branches of banks and branches of SIDBI located in the clusters, a scheme for "Small Enterprises Financial Centres (SEFCs)" was worked out in consultation with the Ministry of Small Scale Industries and the Ministry of Finance, Government of India, SIDBI, IBA and select banks and circulated to all scheduled commercial banks for implementation. The CIBIL is working out a mechanism for development of a system of proper credit records to enable banks to determine appropriate pricing of loans to small and medium enterprises. A simplified debt restructuring mechanism for units in the SME sector has been formulated and advised to all commercial banks for implementation,

Box II.5: Major Recommendations of the Internal Group to Review Guidelines on Credit Flow to SME Sector

Major recommendations of the Group are set out below:

- Empowered committees be constituted at the Regional Offices of the Reserve Bank to: (a) periodically review the progress in SSI and medium enterprises (ME) financing; (b) to co-ordinate with other banks/financial institutions and the State Governments for removing bottlenecks, if any; and (c) and to ensure smooth flow of credit to the sector.
- Banks may open specialised SME branches in identified clusters/centres with preponderance of SSI and ME units to enable the entrepreneurs to have easy access to the bank credit and to equip bank personnel to develop the requisite expertise.
- The boards of banks be empowered to formulate policies relating to restructuring of accounts of SME units subject to certain guidelines. Restructuring of accounts of corporate SSI/ME borrowers having credit limits aggregating Rs.10 crore or more under multiple banking arrangements will be covered under the revised corporate debt restructuring (CDR) mechanism.
- The extant guidelines on definition of a sick SSI unit be continued.
- All instructions relating to viability and parameters for relief and concessions to be provided to sick SSI units, prescribed by the Reserve Bank, be withdrawn and banks be given the freedom to lay down their own guidelines with the approval of their Board of Directors.

2.48 On August 10, 2005, the Union Finance Minister announced certain measures in the Parliament for stepping up credit to SMEs which are required to be implemented by all public sector banks. Accordingly, the Reserve Bank advised all public sector banks on August 19, 2005 to align their flow of credit to small and medium enterprises in line with the package announced by the Finance Minister (Box II.6). These measures, except setting up of specialised SME branches in identified clusters/centres with preponderance of medium enterprises, and one time settlement scheme for SME accounts, have been communicated to all private sector banks, foreign banks, regional rural banks and local area banks.

Export Credit

2.49 In view of the importance of export credit in maintaining the pace of export growth, the Reserve Bank has, over the years, undertaken several measures to ensure timely and hassle free flow of credit to the export sector. Banks extend working capital loans to exporters at pre and post-shipment stages and the credit limits sanctioned to exporters are based upon the financing bank's perception of the creditworthiness and past performance of exporters. Export financing may be denominated either in Indian rupees or in foreign currency. For both types of pre-shipment (up to 180 days) and post-shipment (up to 90 days) financing, the Reserve Bank sets a ceiling on the interest rate that banks may charge to borrowers under the scheme. Since the Reserve Bank fixes only the ceiling rate of interest for export credit, banks are free to fix lower rates of interest for exporters on the basis of their actual cost of funds, operating expenses, the track record and the risk perception of the borrower/exporter.

Box II.6: Policy Package for Stepping up Credit to Small and Medium Enterprises

Major policy measures announced by the Reserve Bank of India are set out below:

- Units with investment in plant and machinery in excess of SSI limit and up to Rs.10 crore may be treated as medium enterprises (ME). Only SSI financing will be included in the priority sector.
- Banks may fix self-targets for financing the SME sector so as to reflect a higher disbursement over the immediately preceding year, while the sub-targets for financing tiny units and smaller units to the extent of 40 per cent and 20 per cent, respectively, may continue. Banks may arrange to compile data on outstanding credit to the SME sector as on March 31, 2005 as per new definition and also show the break-up separately for tiny, small and medium enterprises.
- Banks may initiate necessary steps to rationalise the cost of loans to the SME sector by adopting a transparent rating system with cost of credit being linked to the credit rating of an enterprise.
- Banks may consider taking advantage of the Credit Appraisal and Rating Tool (CART) as well as a Risk Assessment Model (RAM) developed by SIDBI for risk assessment of proposals for SMEs.
- Banks may consider the ratings developed by National Small Industries Corporation as per availability and wherever appropriate structure their rates of interest depending on the ratings assigned to the borrowing SME units.
- In order to increase the outreach of formal credit to the SME sector, all banks, including Regional Rural Banks may make concerted efforts to provide credit cover on an average to at least 5 new small/medium enterprises at each of their semi-urban/urban branches per year.
- Based on the guidelines earlier issued by the Reserve Bank in July 2005, the Boards of banks may formulate comprehensive and more liberal policies than the existing policies in respect of loans to the SME sector. Till such time the banks formulate such a policy, the current instructions of the Reserve Bank will be applicable to advances granted/to be granted by banks to SME units.
- In view of the benefits accruing on account of cluster-based approach for financing the SME sector, banks may treat it as a thrust area and increasingly adopt the same for SME financing.
- A debt restructuring mechanism for nursing of sick units in the SME sector and a One- Time Settlement (OTS) scheme for SME accounts in the books of the banks as on March 31, 2004 were formulated and advised to all commercial banks and public sector banks respectively, for implementation.
- The existing institutional arrangements for review of credit to the SSI sector such as the Standing Advisory Committee in the Reserve Bank and cells at the commercial bank's head office level as also at important regional centres to review periodically the flow of credit to the SME sector, including tiny sector as a whole.
- Banks may ensure specialised SME branches in identified clusters/centres with preponderance of medium enterprises to enable the SME entrepreneurs to have easy access to the bank credit and to equip bank personnel to develop requisite expertise. The existing specialised SSI branches may also be redesignated as SME branches.
- For wider dissemination and easy accessibility, the policy guidelines formulated by Boards of banks as well as instructions/guidelines issued by the Reserve Bank may be displayed on the respective websites of banks as well as website of SIDBI. The banks may also prominently display all the facilities/schemes offered by them to small entrepreneurs at each of their branches.

2.50 In recent years, a number of measures were undertaken by the Reserve Bank with a view to aligning the export credit schemes in tune with the changing environment. These measures, *inter alia*, included rationalisation and liberalisation of export credit interest rates; flexibility in repayment/prepayment of pre-shipment credit; special financial package for large value exporters; export finance for agricultural exports; and freedom to banks to source funds from abroad without any limit exclusively for the purpose of granting export credit in foreign currency.

2.51 Following the proposal of the Ministry of Commerce and Industry in the Exim Policy 2003-04 released in January 2004, a Gold Card Scheme was drawn up by the Reserve Bank in May 2004 in consultation with select banks and exporters with a view to further simplifying access to bank credit by exporters, especially small and medium exporters and making it borrower-friendly in terms of procedure and credit terms. With effect from March 4, 2005, it was decided that the Scheme would not be applicable to those exporters who are blacklisted by the Export Credit Guarantee Corporation (ECGC) or included in the Reserve Bank's defaulter's list/caution list or making losses for the past three years or having overdue export bills in excess of 10 per cent of the previous year's turnover.

2.52 A Working Group was constituted (Chairman: Shri Anand Sinha) with an overall objective to review: (a) the existing procedures for export credit; (b) action taken on exporters' satisfaction survey; (c) Gold Card Scheme; (d) export credit for non-star exporters; and (e) the current interest rate structure in export credit. The Working Group, on examination of the various aspects relating to its terms of reference, made a host of recommendations in its Report submitted in May 2005 to improve the existing export credit delivery mechanism (Box II.7).

Expert Group on Credit-Deposit Ratio

2.53 As a part of the Common Minimum Programme (CMP), the Union Government had appointed an Expert Group (Chairman: Shri Y.S.P. Thorat) to examine the nature and magnitude of the problem of low credit-deposit ratio across States/regions and to suggest steps to improve the ratio, particularly in States where it is lower than 60 per cent. The Committee in its final report submitted to the Government of India on February 24, 2005 has made several recommendations to improve the credit-deposit ratio (Box II.8). The report of the Group has been accepted by the Government with certain modifications.

Box II.7: Major Recommendations of the Report of the Working Group to Review Export Credit

The major recommendations of the Group are set out below:

- Although existing procedures for export credit in place were adequate to take care of the interest of the exporters, there is a need for attitudinal change in approach of banks' officials. While posting officials, banks may keep in view the attitude of officials to exporters' credit requirements, especially the small and medium exporters.
- Banks should post nodal officers at Regional/Zonal Offices and major branches having substantial export credit for attending to the credit related problems of SME exporters.
- Banks should put in place a control and reporting mechanism to ensure that the applications for export credit, especially from SMEs are disposed off within the prescribed timeframe.
- Banks should raise all queries in one shot and should avoid piecemeal queries in order to avoid delays in sanctioning credit.
- Allocation to collateral securities should be sound and fully made use of.
- There was a need to look into the grievances of the small and medium exporters and a fresh "satisfaction survey" may be undertaken by an external agency regarding the satisfaction of the exporters with the services rendered by banks.
- Since the number of Gold Cards issued by banks is small, banks may be advised to speed up the process and adopt a simplified procedure regarding issue of the Cards.
- The Cards should be extended to all the eligible exporters, especially the SME exporters and the process may be completed within three months.
- The present interest rate prescription by the Reserve Bank may continue for the time being in the interests of the small and medium exporters.
- Interest rates on export credit in foreign currency may be raised by 25 basis points (*i.e.*, LIBOR + 1.00 per cent for the first slab and additional 2 per cent for the second slab), subject to the express condition that the banks will not levy any other charges in any manner under any name *viz*., service charge, management charge, *etc*. except for recovery towards out of pocket expenses incurred.
- Banks should give priority for the foreign currency export credit requirements of exporters over foreign currency loans to non-exporter borrowers.
- In view of the substantial increase in export credit in foreign currency through borrowings from abroad, there is a need to look into whether a regulatory limit could be prescribed, up to which banks may be allowed to borrow from abroad for the purpose.

Box II.8: Expert Group on Credit-Deposit Ratio - Major Recommendations

Major recommendations of the Expert Group are as under:

- While the existing indicator of credit as per sanction should continue to be used to monitor the credit-deposit ratio of banks in a district, it should give way to credit as per utilisation for the purpose of monitoring at the State and the bank level.
- The credit-deposit ratio at the State and the bank levels should also factor in the contribution made by banks towards the RIDF.
- District to be the unit for implementation, overseeing and monitoring. The districts to be organised into groups having credit-deposit ratio below 20 per cent, between 20-40 per cent, 40-60 per cent and more than 60 per cent.
- Sub-Committees styled as Special Sub Committees (SSC) of the District Level Co-ordination Committee (DLCC) to be set up in districts where the credit deposit ratio is below 40 per cent. The recommended framework for implementation in districts with credit deposit ratio less than 20 per cent to be the same as that below 40 per cent, except that the district to be jointly 'adopted' by the district administration and the Lead Bank.
- The State Government may give an upfront commitment regarding its responsibilities for creation of identified rural infrastructure together with support towards creating an enabling environment for banks to lend and recover their dues.

4. Prudential Regulation

2.54 A key element of the ongoing financial sector reforms has been the strengthening of the prudential framework by developing sound risk management systems and encouraging transparency and accountability. With a paradigm shift from micro-regulation to macro-management, prudential norms have assumed an added significance. The focus of prudential regulation in recent years has been on ownership and governance of banks and Basel II.

Ownership and Governance of Banks

2.55 Banks are special for several reasons. They accept and deploy large amount of uncollateralised public funds and leverage such funds through credit creation. Banks also administer the payment mechanism. Accordingly, ownership and governance of banks assume special significance. Legal prescriptions relating to ownership and governance laid down in the Banking Regulation Act, 1949 have, therefore, been supplemented by regulatory prescriptions issued by the Reserve Bank from time to time. The existing legal framework and significant current practices cover the following aspects: (i) composition of Boards of Directors; (ii) guidelines on corporate governance; (iii) guidelines for acknowledgement of transfer/allotment of shares in private sector banks issued as on February 3, 2004; and (iv) foreign investment in the banking sector, which is governed by the Press Note of March 5, 2004 issued by the Ministry of Commerce and Industry, Government of India.

2.56 The Reserve Bank had put a draft comprehensive policy framework for ownership and governance in private sector banks in public domain on July 2, 2004. Based on the feedback received on the draft policy, the Reserve Bank, in consultation with the Government of India, laid down a comprehensive policy framework on February 28, 2005. The broad principles underlying the framework ensure that: (i) ultimate ownership and control is well diversified; (ii) important shareholders are 'fit and proper' (as per the guidelines of February 3, 2004 on acknowledgement for allotment and transfer of shares); (iii) directors and CEO are 'fit and proper' and observe sound corporate governance principles (as indicated in circular of June 25, 2004); (iv) private sector banks maintain minimum capital (initially Rs.200 crore, with a commitment to increase to Rs.300 crore within three years)/net worth (Rs.300 crore at all times) for optimal operations and for systemic stability; and (v) policy and processes are transparent and fair.

2.57 In order to attain a well-diversified ownership structure, it is to be ensured that no single entity or a group of related entities has shareholding or control, directly or indirectly, in excess of 10 per cent of the paid-up capital of a private sector bank. Where any existing shareholding by any individual entity/group of related entities is in excess of 10 per cent, the bank will be required to indicate a time table for reduction of holding to the permissible level. Any bank having shareholding in excess of 5 per cent in any other bank in India will be required to indicate a time bound plan for reduction of such holding to the permissible limit of 5 per cent. The parent of any foreign bank having presence in India having shareholding directly or indirectly through any other entity in the banking group in excess of 5 per cent in any other bank in India will be similarly required to indicate a time bound plan for reduction of such holding to 5 per cent. In the case of restructuring of problem/weak banks or in the interest of consolidation in the banking sector, the Reserve Bank could permit a higher level of shareholding, including by a bank.

Road Map for Presence of Foreign Banks in India

2.58 At present, foreign banks may operate in India through only one of the three channels, *viz*., (i) branches; (ii) a wholly owned subsidiary (WOS); or (iii) a subsidiary with an aggregate foreign investment up to a maximum of 74 per cent in a private bank. With a view to delineate the direction and pace of reform process in this area and to operationalise the extant guidelines of March 4, 2004 in a phased manner, the Reserve Bank, on February 28, 2005, released the road map for presence of foreign banks in India.

2.59 The roadmap is divided into two phases. During the first phase, between March 2005 and March 2009, foreign banks wishing to establish presence in India for the first time could either choose to operate through branches or set up a 100 per cent WOS, following the one-mode presence criterion. For new and existing foreign banks, it is proposed to go beyond the existing WTO commitment of 12 branches in a year. Foreign banks already operating in India would be permitted to establish presence by way of setting up a WOS or conversion of the existing branches into a WOS. For this purpose, criteria such as ownership pattern, financial soundness, supervisory rating and the international ranking would be considered. The WOS should have a minimum capital of Rs.300 crore and would need to ensure sound corporate governance. The WOS will be treated on par with the existing branches of foreign banks for branch expansion with flexibility to go beyond the existing WTO commitments and preference for branch expansion in under-banked areas. The Reserve Bank may also prescribe market access and national treatment limitation consistent with WTO as also other appropriate limitations to the operations of WOS, consistent with international practices and the country's requirements. During this phase, permission for acquisition of shareholding in Indian private sector banks by eligible foreign banks will be limited to banks identified by the Reserve Bank for restructuring. The Reserve Bank may, if it is satisfied that such investment by the foreign bank concerned will be in the long-term interest of all the stakeholders in the investee bank, permit such acquisition. Where such acquisition is by a foreign bank having presence in India, a maximum period of six months would be given for conforming to the 'one form of presence' concept.

2.60 The second phase will commence in April 2009 after a review of the experience gained and after due consultation with all the stakeholders in the banking sector. In this phase, three inter-connected issues would be taken up. First, the removal of limitations on the operations of the WOS and treating them on par with domestic banks to the extent appropriate would be designed and implemented. Second, the WOS of foreign banks, on completion of a minimum prescribed period of operation, may be allowed to list and dilute their stake so that, consistent with March 5, 2004 guidelines, at least 26 per cent of the paid-up capital of the subsidiary is held by resident Indians at all times. The dilution may be either by way of initial public offer or as an offer for sale. Third, during this phase, foreign banks may be permitted to enter into merger and acquisition transactions with any private sector bank in India subject to the overall investment limit of 74 per cent.

Payment of Dividends

2.61 Another important aspect of corporate governance and ownership of banks is the principles that govern dividend payments to the shareholders and promoters. In an endeavour to further liberalise the norms of such payments, the Reserve Bank granted general permission to banks to declare dividends for the accounting year ended March 31, 2005 onwards, which comply with: (i) CRAR of at least 9 per cent for preceding two completed years and the accounting year for which it proposes to declare dividend; and (ii) net NPA of less than 7 per cent. In case any bank does not meet the above CRAR norm, but has a CRAR of at least 9 per cent for the accounting year for which it proposes to declare dividend, it would be eligible to declare dividend, provided its net NPA ratio is less than 5 per cent. The bank should comply with the provisions of Sections 15 and 17 of the Banking Regulation Act, 1949 and the prevailing regulations/ guidelines issued by the Reserve Bank, including creating adequate provisions for impairment of assets and staff retirement benefits, transfer of profits to Statutory Reserves. The proposed dividend should be payable out of the current year's profit and the Reserve Bank should not have placed any explicit restrictions on the bank for declaration of dividends.

2.62 It has also been stipulated that the dividend payout ratio [percentage of 'dividend payable in a year' (excluding dividend tax) to 'net profit during the year'] shall not exceed 40 per cent. In case the profit for the relevant period includes any

extraordinary profits/income, the payout ratio shall be computed after excluding such extraordinary items for reckoning compliance with the prudential payout ratio. The financial statements pertaining to the financial year for which the bank is declaring a dividend should be free of any qualifications by the statutory auditors, which have an adverse bearing on the profit during that year. In case of any qualification to that effect, the net profit should be suitably adjusted while computing the dividend payout ratio. For 2004-05, if the 'investment fluctuation reserve' is less than 4 per cent of securities included in the 'held for trading' (HFT) and 'available for sale' (AFS) categories, the dividend payout ratio shall be computed with respect to the adjusted net profit.

Managerial Autonomy for Public Sector Banks

2.63 The Government of India issued a managerial autonomy package for the public sector banks on February 22, 2005 with a view to providing them a level playing field with the private sector banks in India. Under the new framework, the Boards of public sector banks would enjoy more freedom to carry out their functions efficiently without any impediment. The functions, however, have to be in sync with the extant statutory requirements, government policy prescription and regulatory guidelines issued by the Reserve Bank from time to time. The revised guidelines allow public sector banks to pursue new lines of business, make suitable acquisitions of companies or businesses, close/merge unviable branches, open overseas offices, set up subsidiaries and exit a line of business. Similarly, these banks have been allowed to decide human resource issues, including staffing pattern, recruitment, placement, transfer, training, promotions and pensions as well as visits to foreign countries to interact with investors, depositors and other stakeholders. Besides, the Boards of Directors of stronger banks would have additional autonomy for framing their own human resource (HR) policies. Prescription of standards for categorisation of branches, based on volume of business and other relevant factors, have been left to the banks to decide. Public sector banks have been permitted to lay down policy of accountability and responsibility of bank officials.

Mergers and Amalgamation of Banks

2.64 In pursuance of the recommendations of the Joint Parliamentary Committee (2002), the Reserve Bank had constituted a Working Group to evolve guidelines for voluntary mergers involving banking companies. Subsequently, guidelines for merger/ amalgamation of private sector banks were issued on May 11, 2005 covering details of the process of merger proposal, determination of swap ratios, disclosures, and norms for buying/selling of shares by the promoters before and during the process of merger (Box II.9). While the guidelines deal with the merger proposals between two banking companies or between a banking company and a non-banking financial company, the principles underlying the guidelines would also be applicable as appropriate to public sector banks. Where an NBFC is proposed to be amalgamated with a banking company, the Board should also examine whether: (i) the NBFC has violated/is likely to violate any of the Reserve Bank/Securities and Exchange Board of India (SEBI) norms and if so, ensure that these norms are complied with before the scheme of amalgamation is approved; (ii) the NBFC has complied with the Know Your Customer (KYC) norms for all the

Box II.9: Guidelines on Merger and Amalgamation of Banks

The guidelines on merger and amalgamation, *inter alia*, stipulate the following:

- The draft scheme of amalgamation be approved individually by two-thirds of the total strength of the total members of Board of Directors of each of the two banking companies.
- The members of the Boards of Directors who approve the draft scheme of amalgamation are required to be signatories of the Deed of Covenants as recommended by the Ganguly Working Group on Corporate Governance.
- The draft scheme of amalgamation be approved by shareholders of each banking company by a resolution passed by a majority in number representing two-thirds in value of shareholders, present in person or by proxy at a meeting called for the purpose.
- The swap ratio be determined by independent valuers having required competence and experience; the Board should indicate whether such swap ratio is fair and proper.
- The value to be paid by the respective banking company to the dissenting shareholders in respect of the shares held by them is to be determined by the Reserve Bank.
- The shareholding pattern and composition of the Board of the amalgamating banking company after the amalgamation are to be in conformity with the Reserve Bank's guidelines.
- Where an NBFC is proposed to be amalgamated into a banking company in terms of Sections 391 to 394 of the Companies Act, 1956, the banking company is required to obtain the approval of the Reserve Bank before the scheme of amalgamation is submitted to the High Court for approval.

accounts, which will become accounts of the banking company after amalgamation; and (iii) the NBFC has availed of credit facilities from banks/FIs and if so, whether the loan agreements mandate the NBFC to seek consent of the bank/FI concerned for the proposed merger/amalgamation.

2.65 In the case of regional rural banks (RRBs), sponsor banks are being encouraged to amalgamate the RRBs sponsored by them at the State level. The Government of India (Ministry of Finance), after consultation with NABARD, the concerned State Governments and the Sponsor banks, issued nine notifications on September 12, 2005 under Section 23-A of the Regional Rural Banks Act, 1976 providing for amalgamation of 28 RRBs into nine new RRBs sponsored by nine banks in six States, *viz.*, Bihar, Gujarat, Karnataka, Maharashtra, Punjab and Uttar Pradesh. These amalgamations have become effective from September 12, 2005.

2.66 In order to reposition RRBs as an effective instrument of credit delivery in the Indian financial system, an Internal Working Group on RRBs was set up by the Reserve Bank in February 2005 (Chairman: Shri A.V. Sardesai) to examine various alternatives available within the existing legal framework for strengthening the RRBs and making them viable rural financial institutions. The Group, in its final report submitted in June 2005, made several recommendations for restructuring the RRBs (Box II.10). The main recommendations of the Working Group relating to restructuring options, change of sponsor banks, minimum capital requirements, governance and management, regulation and supervision have been sent to the Government of India for consideration.

Insurance Business

2.67 Entry in insurance business from 2004-05 has been made even more broad-based with the inclusion of other banking entities under its ambit. In October 2004, RRBs have been allowed to undertake, with prior permission of the Reserve Bank, insurance business as corporate agents without risk participation, subject to fulfilling certain terms and conditions such as positive net worth, compliance with prudential norms, NPAs not exceeding 10 per cent, continuous profits in the last 3 years and no accumulated losses. Besides, subject to certain conditions, they have also been allowed to undertake insurance business on a referral basis, without any risk participation, through their network of branches.

2.68 In line with the regulations on registration of Indian insurance companies as issued by the Insurance Regulatory and Development Authority (IRDA) and subsequent Government Notification specifying 'insurance' as a permissible form of business that could be undertaken by banks under Section 6(1)(o) of the Banking Regulation Act, 1949, commercial banks were permitted in August 2000 to set up insurance joint ventures on a risk participation basis and also to undertake insurance business as agents of insurance companies on a fee basis, without any risk participation by banks and

Box II.10: Internal Group on Regional Rural Banks (RRBs)

The major recommendations of the Group are set out below:

- To improve the operational viability of RRBs, the route of merger/amalgamation of RRBs may be considered along two lines: (i) merger between RRBs of the same sponsor bank in the same State; and (ii) merger of RRBs sponsored by different banks in the same State.
- A change in sponsor banks may, in some cases, help improve competitiveness, work culture and efficiency of concerned RRBs for which new banks, both public and private sector, could be considered.
- The merged entities and existing RRBs that have accumulated losses can be capitalised to wipe out the losses and satisfy minimum capital requirement. The CRAR may initially be kept at 5 per cent.
- For those RRBs which may not turn around within a specified time limit, say 3 to 5 years, an exit route may be considered subject to extant legal provisions.
- The process of appointment of Chairmen of RRBs may be re-examined to explore the possibility of appointing them from the open market through a transparent process.
- The Boards of RRBs may be strengthened by making them broad-based through inclusion of professionals such as agricultural experts, bankers, *etc.*
- An appropriate recruitment policy, providing for greater flexibility and freedom, may be required for RRBs.
- An appropriate incentive structure, career planning, relevant training, especially in skill upgradation and information technology, be evolved for employees of RRBs.
- It would be appropriate if both the regulatory and supervisory functions relating to RRBs are exercised by the Reserve Bank.
- RRBs may be encouraged to actively consider distribution of products of mutual fund/insurance companies, rationalisation of branch network, participate in consortium lending within their areas of operations.
- RRBs may be considered for currency chest facility and empowered to collect taxes by the State Governments.

their subsidiaries. Similarly, in June 2000, NBFCs registered with the Reserve Bank were permitted, with prior approval of the Reserve Bank, to set up insurance joint ventures for undertaking insurance business with risk participation and also to undertake insurance business as agents of insurance companies on a fee basis, without any risk participation subject to satisfaction of some eligibility criteria. This facility was later extended to financial institutions in November 2001. With effect from October 2002, commercial banks were allowed to undertake referral business through their network of branches with the prior approval of the IRDA and the Reserve Bank. The requirement of such approval from the Reserve Bank was dispensed with in September 2003. In August 2003, a decision was taken to allow financially strong scheduled primary (urban) co-operative banks having a minimum net worth of Rs.100 crore and complying with certain other norms to undertake insurance business as corporate agents without risk participation. In February 2004, it was decided to allow NBFCs registered with the Reserve Bank to take up insurance agency business on a fee basis and without risk participation, without the approval of the Reserve Bank subject to certain conditions.

Exposure Norms

2.69 The Reserve Bank has prescribed regulatory limits on banks' exposure to individual and group borrowers in India to avoid concentration of credit, and has advised banks to fix limits on their exposure to specific industries or sectors for ensuring better risk management. In addition, banks are also required to observe certain statutory and regulatory exposure limits in respect of advances against investments in shares, debentures and bonds. The exposure ceiling limits is fixed in relation to banks' capital funds. The applicable limit is 15 per cent of capital funds in the case of a single borrower and 40 per cent in the case of a group of borrowers. Credit exposure to borrowers belonging to a group may exceed the exposure norm of 40 per cent of the bank's capital funds by an additional 10 per cent (*i.e.*, up to 50 per cent), provided the additional credit exposure is on account of extension of credit to infrastructure projects. Credit exposure to a single borrower may exceed the exposure norm of 15 per cent of bank's capital funds by an additional 5 per cent (*i.e.*, up to 20 per cent) provided the additional credit exposure is on account of infrastructure. Banks, may in exceptional circumstances, with the approval of their Boards, consider enhancement of the exposure to a borrower up to a further 5 per cent of capital funds.

2.70 Investment of banks/FIs in equity shares and preference shares eligible for capital status, subordinated debt instruments, hybrid debt capital instruments and other instruments approved in the nature of capital, which are issued by other banks/FIs and are eligible for capital status for the investee bank/FI, should not exceed 10 per cent of the investing bank's capital funds (Tier-I plus Tier-II). Banks/FIs should not acquire any fresh stake in a bank's equity shares, if by such acquisition, the investing bank's/FI's holding exceeds 5 per cent of the investee bank's equity capital.

2.71 In view of the growing need for putting in place proper risk management system for identification, assessment and containing risks involved in the banking business, and also with a view to sensitising the banks in this regard, the Reserve Bank has been issuing instructions/guidance notes on various risks for the benefit of banks. However, a recent review revealed that though the advances by banks to the housing sector, particularly to the land developers and builders, are on the rise, a corresponding control mechanism, for managing the risks involved was not adopted by majority of the banks. The position relating to risk management, reporting requirements and balance sheet disclosures in respect of real estate exposure of banks was, therefore, further reviewed and on June 29, 2005, the Reserve Bank issued a set of instructions for the guidance of banks. In terms of these guidelines, banks should have a Board mandated policy in respect of their real estate exposure. The policy may include exposure limits, collaterals to be considered, margins to be kept, sanctioning authority/level and sector to be financed, though the actual limits/margins may vary from bank to bank depending upon the individual bank's portfolio size, risk appetite and risk containing abilities. The policy should also include risk management system to be put in place for containing risks involved in this sector, including price risk and a monitoring mechanism to ensure that the policy stipulations are being followed by field level functionaries and that the exposure of banks to this sensitive sector is within the stipulated limits. Further, banks may disclose their gross exposure to the real estate sector as well as the details of the break-up as mentioned in direct and indirect exposure in real estate in their annual reports.

2.72 In order to encourage the flow of finance for venture capital, banks were advised that their investment in venture capital (including units of dedicated Venture Capital Funds meant for Information Technology) would be over and above the ceiling of 5 per cent of the banks' total outstanding advances (including Commercial Paper) as on March 31 of the previous year prescribed for the capital market.

2.73 The instruction that banks have to limit their commitment by way of unsecured guarantees was withdrawn to enable banks to formulate their own policies on unsecured exposures. With a view to ensuring uniformity in approach and implementation, 'unsecured exposure' was defined as an exposure where the realisable value of the security was not more than 10 per cent, *ab initio*, of the outstanding exposure. 'Exposure' includes all funded and non-funded exposures (including underwriting and similar commitments). 'Security' means tangible security properly charged to the bank and does not include intangible securities such as guarantees and comfort letters.

Implementation of the New Capital Adequacy Framework (Basel II norms)

2.74 Given the financial innovations and growing complexity of financial transactions, the Basel Committee on Banking Supervision released the New Capital Adequacy Framework (Basel II) on June 26, 2004 which is based on three pillars of minimum capital requirements, supervisory review and market discipline. The revised framework has been designed to provide options to banks and banking systems, for determining the capital requirements for credit risk, market risk and operational risk and enables banks/supervisors to select approaches that are most appropriate for their operations and financial markets. The revised framework is expected to promote adoption of stronger risk management practices in banks. Under Basel II, banks' capital requirements will be more closely aligned with the underlying risks in banks' balance sheets. One of the important features of the revised framework is the emphasis on operational risk (Box II.11).

Box II.11: Measurement of Operational Risk under Various Approaches

Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputational risks. Operational risk differs from other banking risks in that it is typically not directly taken in return for an expected reward but is implicit in the ordinary course of corporate activity and has the potential to affect the risk management process. The Basel Committee identified seven types of operational risk events that have the potential to result in substantial losses. These are: (i) internal fraud; (ii) external fraud; (iii) employment practices and workplace safety; (iv) clients, products and business practices; (v) damage to physical assets; (vi) business disruption and system failures; and (vii) execution, delivery and process management. The potential losses, in turn, vary according to the business line within the bank in which the event occurs.

Management of specific operational risks is not new. It has always been important for banks to try to prevent fraud, maintain the integrity of internal controls, reduce errors in transaction processing and so on. However, what is relatively new is the thrust on operational risk management as a comprehensive practice comparable to the management of credit risk and market risk. To manage operational risk, banks are gradually gearing to develop risk assessment techniques that are appropriate to the size and complexities of portfolios, their resources and data availability.

The New Capital Adequacy Framework has put forward various options for calculating operational risk capital charge in a "continuum" of increasing sophistication and risk sensitivity and increasing complexity. The three options for calculating operational risk capital charge are: (a) Basic Indicator Approach, (b) Standardised Approach, and (c) Advanced Measurement Approach (AMA).

Under the Basic Indicator Approach, which banks in India would have to, at the minimum, adhere to, banks would need to hold capital for operational risk equal to the average over the previous three years of a fixed percentage (denoted by alpha and set at 15 per cent by the BCBS) of a single indicator (currently proposed as positive annual gross income). Figures for any year in which annual gross income is negative or zero need to be excluded from both the numerator and denominator while calculating the average.

Under the Standardised Approach, banks' activities are divided into eight business lines against each of which, a broad indicator is specified to reflect the size or volume of banks' activities in that area. Within each business line, the capital charge is calculated by multiplying the indicator by a factor (beta) assigned to that business line. The total capital charge under the Standardised Approach is calculated as the simple summation of the regulatory capital charges across each of the business lines.

A supervisor can choose to allow a bank to use the Alternative Standardised Approach (ASA). Under the ASA, the operational risk capital charge/methodology is the same as for the Standardised Approach except for two business lines – retail banking and commercial banking. For these business lines, loans and advances multiplied by a fixed factor 'm' replace gross income as the exposure indicator. The betas for retail and commercial banking are the same as in the Standardised Approach.

The Basel Committee has been less prescriptive in respect of the advanced measurement approaches which can be based on an estimate of operational risk derived from a bank's internal risk measurement system, *albeit* subject to qualitative and quantitative standards set by the Committee, and are, therefore, expected to be more risk sensitive than the other two approaches. AMA calculations are generally based on a framework that divides a bank's operational risk exposures into a series of business lines and operational risk event types.

2.75 Under Basel II, increased capital should not be viewed as the only option for addressing increased risks confronting the bank. Other means of addressing risk must also be considered such as strengthening risk management, applying internal limits, strengthening level of provisions and reserves and improving internal controls. The Second Pillar of the Revised Framework on Supervisory Review Process is intended not only to ensure that banks have adequate capital to support all their risks, but also to encourage banks to develop and use better risk management techniques in monitoring and managing the risks (Box II.12).

2.76 With a view to ensuring migration to Basel II in a non-disruptive manner given the complexities involved, a consultative approach is being followed. Accordingly, a Steering Committee was constituted comprising senior officials from 14 banks (public, private and foreign) and representatives of the Reserve Bank and the IBA. On the basis of the recommendations of the Steering Committee, the Reserve Bank released draft guidelines for implementation of Basel II in India on February 15, 2005. In terms of the draft guidelines, banks are required to adopt standardised approach for credit risk and basic indicator approach for operational risk. The standardised duration method would continue to be applied to arrive at the capital charge for market risk. Banks would need the Reserve Bank's approval for migration to advanced approaches of risk measurement.

2.77 All scheduled commercial banks (except regional rural banks), both at the solo level (global position) and the consolidated level, will be required to implement the revised capital adequacy framework with effect from March 31, 2007. With a view to ensuring smooth transition to the revised framework and providing opportunity to banks to streamline their systems and strategies, banks in India are required to commence a parallel run of the revised framework with effect from April 1, 2006.

2.78 Several measures have been undertaken by the Reserve Bank to prepare the banking system to make a smooth migration to Basle II. Following the amendment to the Banking Companies (Acquisition and Transfer of Undertakings) Act in 1994, several public sector banks (PSBs) have raised capital both in India and abroad through Global Depository Receipts (GDRs). Several PSBs have also raised subordinated debt through the private placement route for inclusion under Tier-II capital. There is a proposal to allow banks to raise subordinated debt from the capital market to augment their capital base by making suitable amendment to the

Box II.12: Basel II and Risk Management with Special Emphasis on Pillar II

The Pillar II of Basel II, *i.e.*, Supervisory Review Process recognises the responsibility of bank management in developing an internal capital adequacy assessment process and setting capital targets that are commensurate with bank's risk profile and control environment. Supervisors are expected to evaluate how well banks are assessing their capital needs relative to risk and to intervene where appropriate.

There are three main areas that are relevant under Pillar II. First, risks considered under Pillar I that are not fully captured by the Pillar I process such as credit concentration risk. Second, certain risks that have not been taken into account by Pillar I process such as interest rate risk in the banking book, business and strategic risk. Third, factors external to the bank, such as business risk cycle effects. An important aspect of Pillar II is the assessment of compliance by banks, on an on-going basis, with the minimum standards and disclosure requirements prescribed for the advanced approaches under Pillar I, particularly the Internal Rating Based framework for credit risk and Advanced Measurement Approaches for operational risk.

The Basel Committee on Banking Supervision has identified four key principles of supervisory review. These are:

- Banks should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels. The fundamental elements of this assessment include policies and procedures designed to ensure that the bank identifies, measures, and reports all material risks - a process that relates capital to the level of risk.
- Supervisors should review and evaluate banks' internal capital adequacy assessments and strategies, as well as their ability to monitor and ensure their compliance with regulatory capital ratios. Supervisors should take appropriate supervisory action if they are not satisfied with the result of this process. The supervisors should assess the degree to which internal targets and processes incorporate the full range of material risks faced by the bank.
- Supervisors should expect banks to operate above the minimum regulatory capital ratios and should have the ability to require banks to hold capital in excess of the minimum. Pillar I capital requirements will include a buffer for uncertainties surrounding the Pillar I regime that affect banks. Bank-specific uncertainties will be treated under Pillar II.
- Supervisors should seek to intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular bank and should require rapid remedial action if capital is not maintained or restored.

Banking Regulation Act, 1949. Concurrently, a series of regulatory initiatives were taken by the Reserve Bank relevant for Basel II. First, concerted efforts were made to ensure that the banks have suitable risk management framework oriented towards their requirements dictated by the size and complexity of business, risk philosophy, market perceptions and the expected level of capital. Second, Risk Based Supervision (RBS) was introduced in 23 banks on a pilot basis. Third, the Reserve Bank has been encouraging banks to formalise their Internal Capital Adequacy Assessment Programme (ICAAP) in alignment with their business plans and performance budgeting system. This, together with the adoption of the RBS would aid in factoring the Pillar II requirements under Basel II. Fourth, there has been a marked improvement in the area of disclosures (Pillar III), so as to have greater transparency in the financial position and risk profile of banks. Similarly, capacity building for ensuring the regulator's ability for identifying and permitting eligible banks to adopt Internal Ratings Based/Advanced Measurement approaches was given due priority.

2.79 The draft Guidance Note on management of operational risk was placed on the Reserve Bank's website on March 11, 2005 for wider access and feedback. After considering the feedback received, final guidance note was issued on October 14, 2005. It is expected that the design and architecture of operational risk management would depend on the size and complexity of capital, and hence, the exact approach would differ from bank to bank. As such, the systems, procedures and tools prescribed in the Guidance note are only indicative.

Income Recognition, Asset Classification and Provisioning

2.80 The asset classification norms whereby assets are classified into four categories, *viz*., standard assets, sub-standard assets, doubtful assets and loss assets, were prescribed with appropriate provisioning requirements for each category of assets. The concept of 'past due' in the identification of non-performing assets (NPAs) was dispensed with effect from March 2001, and the 90-day delinquency norm was adopted for the classification of NPAs with effect from March 2004.

2.81 As a major step towards tightening of prudential norms, banks were advised in May 2002 that from the year ended March 2005, an asset would be classified as doubtful if it remained in the sub-standard category for 12 months as against the earlier norm of 18 months. Banks were, however, permitted to phase out the additional provisioning consequent upon the reduction in the transition period from sub-standard to doubtful assets from 18 months to 12 months, over a four year period, commencing from the year ended March 2005 with a minimum of 20 per cent each year.

2.82 In June 2004, the Reserve Bank advised banks to adopt graded higher provisioning in respect of: (a) secured portion of NPAs included in 'doubtful' for more than three years category; and (b) NPAs which have remained in 'doubtful' category for more than three years as on March 31, 2004. Provisioning ranging from 60 per cent to 100 per cent over a period of three years in a phased manner, from the year ended March 31, 2005 has been prescribed. However, in respect of all advances classified as 'doubtful for more than three years' on or after April 1, 2004, the provisioning requirement has been stipulated at 100 per cent. The provisioning requirement for unsecured portion of NPAs under the above category was retained at 100 per cent.

2.83 Asset classification and provisioning requirements in respect of State Government guaranteed exposures were delinked from the invocation of State Government guarantee. In terms of the revised norms prescribed in August 2004, loans and advances and investments backed by State Government guarantee would attract asset classification and provisioning norms if interest and/ or principal or any other amount due to the bank remained overdue for more than 180 days for the year ended March 31, 2005 and for more than 90 days from the year ending March 31, 2006.

2.84 Banks were advised that while fixing the repayment schedule in case of rural housing advances granted to agriculturists under *Indira Awas Yojana* and Golden Jubilee Rural Housing Finance Scheme, they may ensure that the interest/instalment payable on such advances is linked to crop cycles.

Investment Norms

2.85 With effect from September 2, 2004, banks were allowed to exceed the limit of 25 per cent of total investments limit under 'held to maturity' (HTM) category provided that the excess comprises

only SLR securities and the total SLR securities held in the 'HTM' category are not more than 25 per cent of their demand and time liabilities (DTL). To facilitate this, banks were allowed to shift SLR securities to the 'HTM' category once more during 2004-05 as a one-time measure. The non-SLR securities held as part of 'HTM' would, however, remain in that category and no fresh non-SLR securities would be permitted to be included in the 'HTM' category.

2.86 Banks are allowed to shift investments to/ from 'HTM' category with the approval of their Boards once a year. Similarly, banks could shift investments from 'available for sale' category to 'held for trading' category. Shifting of investments from 'held for trading' category to 'available for sale' category is allowed only under exceptional circumstances. Transfer of scrips from one category to another, under all circumstances, is to 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 transfers has to be fully provided for.

Capital Adequacy Norms

2.87 As a follow-up to the announcement made in the Mid-term Review of Annual Policy Statement for the year 2004-05, it was decided to increase the risk weight for capital adequacy purposes on housing loans extended by banks to individuals, which are fully secured by mortgage of residential properties and investments in mortgage backed securities (MBS) of housing finance companies (HFCs), recognised and supervised by National Housing Bank (NHB), from 50 per cent to 75 per cent. In the case of MBS of HFCs to be eligible for 75 per cent risk weight, only assets qualifying for 75 per cent risk weight were to back securities issued by the special purpose vehicle (SPV). The risk weights for commercial real estate exposure were kept unchanged at 100 per cent. Further, it was also decided to increase the risk weight on consumer credit, including personal loans and credit cards receivables from 100 per cent to 125 per cent. Since capital to risk weighted assets ratio (CRAR) is to be maintained on an on-going basis, banks were also advised that risk weights as indicated above would be applicable on all outstanding exposures. Subsequently, with effect from July 26, 2005, the risk weight on banks' exposure to the commercial real estate was increased from 100 per cent to 125 per cent on an on-going basis.

2.88 With a view to encouraging banks to move towards early compliance with the guidelines for maintenance of capital charge for market risks, it was earlier decided that banks, which have maintained capital of at least 9 per cent of the risk weighted assets for both credit risk and market risk for both 'HFT' and 'AFS' categories, may treat the balance in excess of 5 per cent of securities included under 'HFT' and 'AFS' categories in the 'investment fluctuation reserve' (IFR) as Tier-I capital. Banks satisfying the above criteria were allowed to transfer the amount in excess of 5 per cent in the IFR to statutory reserves. This transfer was to be made as a 'below the line' item in the profit and loss appropriation account.

2.89 Subsequently, it was decided in October 2005 that banks which have maintained capital of at least 9 per cent of the risk weighted assets for both credit risk and market risks for both 'HFT' and 'AFS' categories as on March 31, 2006, would be permitted to treat the entire balance in the IFR as Tier-I capital. For this purpose, banks may transfer the balance in the IFR reserve 'below the line' in the profit and loss appropriation account to Statutory Reserve, General Reserve or balance of Profit and Loss account. In the event provisions created on account of depreciation in the 'AFS' or 'HFT' categories are found to be in excess of the required amount in any year, the excess should be credited to the profit and loss account and an equivalent amount (net of taxes, if any and net of transfer to statutory reserves as applicable to such excess provision) should be appropriated to an investment reserve account in Schedule 2 – 'reserves and surplus' under the head 'revenue and other reserves' and would be eligible for inclusion under Tier-II within the overall ceiling of 1.25 per cent of total risk weighted assets prescribed for general provisions/ loss reserves.

Transparency and Disclosures

2.90 The stability of a financial system stands enhanced when institutions and markets function on the basis of informed decisions. Adequate disclosure of information should act as a deterrent to excessive risk-taking and minimise adverse selection and moral hazard problems. Market discipline is believed to increase with interest from outside stakeholders such as depositors, creditors and investors. It is desirable to have greater transparency to ensure that the stakeholders have