adequate information to be able to independently monitor the institutions. Detailed guidelines have been issued from time to time to ensure banks' compliance with the accounting standards issued by the Institute of Chartered Accountants of India (ICAI). The Reserve Bank has issued guidelines to banks to enhance the level of transparency and disclosures with respect to their financial position.

2.91 The Joint Parliamentary Committee (JPC) on Stock Market Scam and Matters Relating Thereto in its report released in December 2002 had recommended that the comments made by the Reserve Bank in the inspection reports should be published in the annual reports of the banks along with the financial results to ensure greater transparency. In view of the sensitive nature of the disclosures and their impact on the interest of depositors, the JPC recommendations were examined by the Reserve Bank in consultation with the Standing Technical Advisory Committee on Financial Regulation (STACFR) and the Board for Financial Supervision (BFS). In this regard, the Reserve Bank also took into account the recommendations of the Committee on Banking Sector Reforms (1998), Advisory Group on Transparency in Monetary and Financial Practices (2000) and Committee on Procedures and Performance Audit on Public Services (2004). It was felt that disclosure of the details of the levy of penalty on a bank in public domain will be in the interests of the investors and depositors. It was also decided in November 2004 that strictures or directions on the basis of inspection reports or other adverse findings be placed in the public domain. While such disclosures would be made by the Reserve Bank through press releases, banks were advised to disclose penalty in the 'Notes on Accounts' to the balance sheet. With regard to strictures or directions by the Reserve Bank, there would be a press release by the Reserve Bank. The above policy came into operation with effect from November 1, 2004.

2.92 Best international practices require meaningful and appropriate disclosures of banks' exposures to risk and their strategy towards managing the risk. With a view to ensuring that the banks make meaningful disclosures of their derivative portfolios, a minimum framework for disclosures by banks on their risk exposures in derivatives was advised to the commercial banks. The guidelines included both qualitative and quantitative aspects to provide a clear picture of the exposure to risks in derivatives, risk management systems, objectives and policies. Banks were advised to make these disclosures as part of the 'Notes on Accounts' to the balance sheet with effect from March 31, 2005.

Securitisation of Standard Assets

2.93 With a view to ensuring healthy development of the securitisation market, the Reserve Bank issued draft guidelines on securitisation of standard assets on April 4, 2005 to banks, financial institutions and non-banking financial companies. The regulatory norms for capital adequacy, valuation, profit/loss on sale of assets, income recognition and provisioning for originators and service providers such as credit enhancers, liquidity support providers as also the accounting treatment for securitisation transactions and disclosure norms were laid down in the draft guidelines.

2.94 Under the proposed guidelines, for a transaction to be treated as securitisation, it must follow a two-stage process. In the first stage, there should be pooling and transferring of assets to a bankruptcy remote special purpose vehicle (SPV). In the second stage, repackaging and selling the security interests, representing claims on incoming cash flows from the pool of assets to the third party investors should be effected. For enabling the transferred assets to be removed from the balance sheet of the seller in a securitisation structure, the isolation of assets or 'true sale' from the seller or originator to the SPV would be an essential prerequisite. Therefore, an arm's length relationship between the originator/ seller and the SPV has to be maintained. In case the transferred assets do not meet the true-sale criteria, the assets would be deemed to be an on-balance sheet asset of the seller who would be required to comply with all applicable accounting and prudential requirements in respect of those assets. The SPV would also be required to meet the criteria to enable originators to avail off-balance sheet treatment for the assets transferred by them to the SPV and also to enable the service providers and investors in the pass-through certificate (PTCs) to avail of the regulatory treatment for their respective exposures in a securitisation structure. Further, in all cases of securitisation, the securities issued by the SPV should be independently rated by an external credit rating agency and such ratings are required to be updated at least semi-annually.

NPA Management by Banks

2.95 The Reserve Bank and the Central Government have initiated several institutional measures to contain the levels of NPAs. These include Debt Recovery Tribunals (DRTs), *Lok Adalats* (people's courts), Asset Reconstruction Companies (ARCs) and Corporate Debt Restructuring (CDR) mechanism. Settlement Advisory Committees have also been formed at regional and head office levels of commercial banks. Furthermore, banks can also issue notices under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002 for enforcement of security interest without intervention of courts. Thus, banks have a menu of options to resolve their NPA problem.

2.96 With a view to providing an additional option and developing a healthy secondary market for NPAs, guidelines on sale/purchase of non-performing assets were issued in July 2005 where securitisation companies and reconstruction companies are not involved. The draft guidelines cover the following broad areas: (i) procedure for purchase/sale of non-performing financial assets by banks, including valuation and pricing aspects; and (ii) prudential norms relating to asset classification, provisioning, accounting of recoveries, capital adequacy and exposure norms and disclosure requirements. The guidelines include several specific provisions: (i) a non-performing asset in the books of a bank shall be eligible for sale to other banks only if it has remained a non-performing asset for at least two years in the books of the selling bank and such selling should be only on a cash basis; (ii) a non-performing financial asset should be held by the purchasing bank in its books at least for a period of 15 months before it is sold to other banks; (iii) a bank may purchase/sell non-performing financial assets from/to other banks only on a 'without recourse' basis; (iv) banks should ensure that subsequent to sale of the non-performing financial assets to other banks, they do not have any involvement with reference to assets sold and do not assume operational, legal or any other type of risks relating to the financial assets sold; (v) a non-performing financial asset may be classified as 'standard' in the books of the purchasing bank for a period of 90 days from the date of purchase. Thereafter, the asset classification status of the account shall be determined by the record of recovery in the books of the purchasing bank with reference to cash flows estimated while purchasing the asset. The asset shall attract provisioning requirement appropriate to its asset classification status in the books of the purchasing bank; (vi) any recovery in respect of a non-performing asset purchased from other banks should first be adjusted against its acquisition cost. Recoveries in excess of the acquisition cost can be recognised as profit; (vii) the asset classification status of an existing exposure to the same obligor in the books of the purchasing bank will continue to be governed by the record of recovery of that exposure and hence may be different; (viii) for the purpose of capital adequacy, banks should assign 100 per cent risk weights to the non-performing financial assets purchased from other banks; (ix) in the case the non-performing asset purchased is an investment, then it would attract capital charge for market risks also; and (x) the purchasing bank should ensure compliance with the prudential credit exposure ceilings (both single and group) after reckoning the exposures to the obligors arising on account of the purchase.

Corporate Debt Restructuring Mechanism

2.97 A Special Group (Chairperson: Smt. S. Gopinath) was appointed to undertake a further review of the corporate debt restructuring (CDR) mechanism and suggest certain changes/ improvements in the existing scheme for enhancing its scope and to make it more efficient. In pursuance of the recommendations made by the Special Group, major modifications were proposed in the draft guidelines issued on May 6, 2005 in the existing CDR scheme. These included: (i) extension of scheme to corporate entities where banks and institutions have an outstanding exposure of Rs.10 crore or more from the earlier exposure of Rs.20 crore and above; (ii) requirement of support of 60 per cent of creditors by number in addition to the support of 75 per cent of creditors by value with a view to making the decision-making process more equitable; (iii) linking the restoration of asset classification prevailing on the date of reference to CDR Cell for implementation of package within three months from the date of approval of the package; (iv) restricting the regulatory concession in asset classification and provisioning requirement to the first restructuring where the package also has to meet certain norms relating to turnaround period and minimum sacrifice and funds infusion by promoters; (v) convergence in

the methodology for computation of economic sacrifice among banks and FIs; (vi) regulatory treatment of non-SLR instruments acquired while funding interest or in *lieu* of outstanding principal and valuation of such instruments; (vii) limiting the Reserve Bank's role to providing broad guidelines for the CDR system; (viii) enhancing balance sheet disclosures; (ix) pro-rata sharing of additional finance requirement; (x) including one-time settlement (OTS) as part of the CDR scheme to make the exit option more flexible; and (xi) discretion to the core group in dealing with wilful defaulters in certain cases.

Debt Recovery Tribunals

2.98 Debt Recovery Tribunals (DRTs) were set up under the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 for expeditious adjudication and recovery of debts due to banks and financial institutions. On the recommendation of the Reserve Bank, the Government of India set up a Working Group in July 2004 to improve the functioning of DRTs. The Working Group is expected to examine issues and recommend appropriate measures regarding: (a) the need to extend the provisions of the Recovery of Debts Due to Banks And Financial Institutions Act to cases for less than Rs.10 lakh; (b) redistribution of the jurisdiction of the various DRTs; (c) modification in the existing strength of the DRTs/Debt Recovery Appellate Tribunals (DRATs); and (d) legal and institutional provisions.

Lok Adalats

2.99 The Reserve Bank issued guidelines to commercial banks and financial institutions to enable them to make increasing use of the forum of *Lok Adalats*. In terms of the guidelines, banks could settle banking disputes involving an amount up to Rs.5 lakh through the forum of *Lok Adalats*. Further, banks were advised to participate in the *Lok Adalats* convened by various DRTs/DRATs for resolving cases involving Rs.10 lakh and above to reduce the stock of NPAs. The Central Government, in consultation with the Reserve Bank, decided to increase the monetary ceiling of cases to be referred to the *Lok Adalats* organised by Civil Courts. Accordingly, on August 3, 2004, the Reserve Bank enhanced the monetary ceiling of cases to be referred to *Lok Adalats* organised by Civil Courts to Rs.20 lakh as against the earlier ceiling of Rs.5 lakh.

Anti-Money Laundering Guidelines: Status

2.100 In recent years, prevention of money laundering has assumed importance in international financial relationships. In this context, in November 2004, the Reserve Bank revised the guidelines on 'know your customer' (KYC) principles in line with the recommendations made by the Financial Action Task Force (FATF) on anti-money laundering (AML) standards and combating financing of terrorism (CFT). Banks were advised to frame their KYC policies with the approval of their Boards and ensure they are compliant with its provisions by December 31, 2005. The salient features of the policy relate to the procedure prescribed with regard to customer acceptance, customer identification, risk management, monitoring as required under Prevention of Money Laundering Act (PMLA), 2002. The revised guidelines make the verification of the identity of the customer and address through independent source documents mandatory. Banks are also required to classify the accounts according to the risk perceived by the bank. However, in order to ensure that the inability of persons belonging to low income groups to produce documents to establish their identity and address does not lead to their financial exclusion and denial of banking services further, simplified procedure has been provided for opening of accounts for those persons who do not intend to keep balances above Rs.50,000 and whose total credit in one year is not expected to exceed Rs.1,00,000. In addition, the Reserve Bank issued instructions emphasising the obligation on banks to follow the provisions of the Foreign Contribution (Regulation) Act, 1976 in respect of acceptance of foreign donations on behalf of associations/organisations maintaining accounts with them.

Customer Service

Credit Card Facilities

2.101 In order to ensure orderly growth of the card segment of consumer credit and protect the interests of banks/NBFCs and their customers, the Reserve Bank constituted a Working Group on Regulatory Mechanism for Cards (Chairman: Shri R. Gandhi). The report of the Group was placed in public domain in April 2005. Taking into account the feedback received from the media, members of the public and others on the report of the Working Group, draft guidelines on credit cards were framed by the

Reserve Bank in June 2005 for all commercial banks/non-banking financial companies (NBFCs) with regard to their credit card operations.

2.102 The draft guidelines delineated the broad parameters that banks/NBFCs should, at the minimum, take into account with regard to: (a) issue of cards with respect to clear mentioning of Most Important Terms and Conditions (MITCs); (b) interest rates and other charges on customers; (c) corrective mechanism on account of wrongful billing; (d) use of Direct Sale Agents and other agents for outsourcing various credit card operations; (e) protection of customer rights especially in respect of right to privacy, customer confidentiality and fair practices in debt collection; (f) redressal avenues of customer grievances; and (g) internal control and monitoring systems of the banks/NBFCs for such card operations.

2.103 The draft guidelines further stipulate that each bank/NBFC must have a well documented policy and a 'Fair Practices Code' for credit card operations. The 'Fair Practices Code' for credit card operations released by the IBA in March 2005 could also be used by banks/NBFCs. The bank/ NBFCs code should, at the minimum, however, incorporate the relevant guidelines contained in the draft guidelines released by the Reserve Bank.

Customer Service Committee of the Board/ Standing Committee on Customer Service

2.104 The Reserve Bank had constituted a Standing Committee on Procedures and Performance Audit on Public Services (CPPAPS) [Chairman: Shri S. S. Tarapore] in December 2003. The Committee submitted four Reports, *viz.*, Reports on Foreign Exchange Transactions, Government Transactions Relating to Individuals, Banking Operations and Currency Management. Keeping in view the recommendations of the CPPAPS, all the public sector/private sector banks and select foreign banks were advised vide Governor's letter dated August 14, 2004 to constitute a Customer Service Committee of the Board with a view to strengthening the corporate governance structure in the banking system and also to bringing about ongoing improvements in the quality of customer service provided by bank. Furthermore, based on the recommendations of the Committee, banks were advised in April 2005 to take necessary action to convert the existing *Ad hoc* Committees into Standing Committees on Customer Service. It was felt that the *Ad hoc* Committee when converted as a permanent Standing Committee cutting across various departments could serve as a micro level executive committee driving the implementation process and providing relevant feedback, while the Customer Service Committee of the Board would oversee and review/modify the initiatives. Thus, the two committees would be mutually reinforcing.

Banking Ombudsman

2.105 With a view to enhancing the effectiveness of the Banking Ombudsman Scheme, banks were advised in April 2005 that Customer Service Committee of the Board should play a more active role with regard to complaints/grievances received by the Banking Ombudsmen of the various States. Furthermore, to ensure that the awards of the Banking Ombudsmen are implemented immediately and with active involvement of top Management, banks were also advised to: (i) place all the awards before the Customer Service Committee to enable it to address issues of systemic deficiencies existing in banks, if any, brought out by the awards; and (ii) place all the awards remaining unimplemented for more than three months with the reasons therefor before the Customer Service Committee to enable it to report to the Board such delays in implementation without valid reasons and for initiating necessary remedial action.

Banking Codes and Standards Board of India

2.106 The Committee on Procedures and Performance Audit of Public Services had recommended that Banking Codes and Standards Board of India (BCSBI) be set up as an independent organisation but strongly supported and fully funded by the Reserve Bank. Accordingly, in the Annual Policy Statement for 2005-06, it was proposed to set up an independent Banking Codes and Standards Board of India on the lines of the Banking Code of the British Bankers' Association of the UK in order to ensure that comprehensive code of conduct for fair treatment of customers is evolved and adhered to. The detailed modalities for setting up of the Board are being worked out.

Collection and Processing of Cheques

2.107 The Reserve Bank has been advising banks from time to time on issues relating to: (i) immediate credit of local/outstation cheques;

(ii) time frame for collection of local/outstation cheques; and (iii) interest payment for delayed collection. On a comprehensive review of the technological progress in payment and settlement systems and the qualitative changes in operational systems and processes undertaken by a number of banks, it was felt that prescription of a single set of rules may not be appropriate. Banks were, therefore, advised in November 2004 to formulate a comprehensive and transparent policy covering all the above three aspects, taking into account their technological capabilities, systems and processes adopted for clearing arrangements and other internal arrangements for collection through correspondents. Banks were also advised that adequate care be taken to ensure that the interests of small depositors are fully protected.

Grievances Redressal Mechanism

2.108 The Central Vigilance Commission (CVC) had expressed concerns regarding lack of redressal machinery in private sector banks. The issue was examined in detail and the Reserve Bank instructed the IBA to advise all the members to ensure, *inter alia*, that a suitable mechanism exists for receiving and addressing complaints from their customers/constituents and that the time frame is fixed for resolving the complaints received at different levels.

Settlement of Claims of Deceased Depositors

2.109 The Committee on Procedures and Performance Audit on Public Services had observed that the tortuous procedures, particularly those applicable to settlement of claim of a deceased depositor, caused considerable distress to family members. Accordingly, the Reserve Bank advised banks in June 2005 that while making payment to the survivor(s)/ nominee(s) of the deceased depositor, they should desist from insisting on production of a succession certificate, letter of administration or probate or obtain any bond of indemnity or surety from the survivor(s)/nominee(s), irrespective of the amount standing to the credit of the deceased account holder. Furthermore, in those cases where the deceased depositor had not made any nomination or for the accounts other than those styled as “either or survivor” (such as single or jointly operated accounts), banks were advised to adopt a simplified procedure for repayment to legal heir(s). In the case of term deposits, banks have been advised to incorporate a clause in the account opening form itself to the effect that in the event of the death of the depositor, premature termination of term deposits would be allowed. Furthermore, banks have been advised to obtain appropriate agreement/authorisation from the survivor(s)/nominee(s) with regard to treatment of pipeline flows. Banks were also advised to settle the claims in respect of deceased depositors and release payments to survivor(s)/nominee(s) within a period not exceeding 15 days from the date of receipt of the claim, subject to the production of proof of death of the depositor and suitable identification of the claim(s) to the bank’s satisfaction.

Door-step banking

2.110 In May 1983, banks were advised by the Reserve Bank not to extend any banking facilities at the premises of their customers without obtaining its prior permission. Several requests, however, were received from Government departments such as Railways requesting to make available banking services including collection of cash at their premises. Keeping this and representations from certain banks in view, it was decided in April 2005 that a scheme for providing services at the premises of a customer within the framework of Section 23 of the Banking Regulation Act, 1949 may be formulated by banks with the approval of their Boards and submitted to the Reserve Bank for approval. In order to ensure that Central and State Government departments are not inconvenienced, agency banks in the interregnum may continue to lift cash and collect credit instruments from their premises.

Government Business

2.111 Detailed guidelines were issued to all agency banks in respect of scheme for collection of dues of: (i) Central Board of Direct Taxes, (ii) Central Board of Excise and Customs, and (iii) Departmentalised Ministries Account, for reporting and accounting of March transactions for the financial year 2004-05.

2.112 All agency banks conducting Government business were advised that such business would qualify for payment of turnover commission only for the following items: (i) revenue receipts and payment on behalf of the Central/State Governments; (ii) pension payments in respect of Central Government and State Governments; (iii) payments made by banks to account holders

under the Compulsory Deposit Scheme; (iv) Special Deposit Scheme (SDS), 1975 and Public Provident Fund (PPF); and (v) any other item of work specifically advised by the Reserve Bank as eligible for turnover commission (*viz*., Relief Bonds/Savings Bonds).

2.113 With effect from November 1, 2004, agency banks were required to pay their own tax liabilities (TDS, Corporation Tax, *etc*.) to the Government account through their own branches only. Such payments should be indicated in the scrolls separately so as to distinguish them from other transactions. It was reiterated that the banks are not entitled for 'turnover commission' on transactions of the above type.

2.114 Banks issued comprehensive guidelines to take appropriate steps to mitigate any discrepancy in the *challan* data transmitted to Tax Information Network (TIN) and Physical *challan* sent to Zonal Accounts Office (ZAO) under On Line Tax Accounting System (OLTAS).

Remittance Facility to NRIs/PIOs

2.115 On May 13, 2005, the remittance facility to a non-resident Indian (NRI)/person of Indian origin (PIO) out of balances in the NRO account was further extended by allowing remittances up to US $ 1 million, per calendar year, under legacy/ inheritance acquired out of settlement. However, the existing guidelines regarding remittance of sale proceeds of immovable property to a citizen of Pakistan, Bangladesh, Sri Lanka, China, Afghanistan, Iran, Nepal and Bhutan would continue. In view of the recommendations of the Committee on Procedures and Performance Audit on Public Services (CPPAPS) it was decided that with effect from March 15, 2005, in addition to the earlier facility, a resident power of attorney holder would be permitted to remit, through normal banking channels, funds out of the balances in NRE/FCNR(B) account to the non-resident account holder provided specific powers for the purpose have been given.

Shifting of branches/offices – Procedural Rationalisation

2.116 In terms of the existing provisions, the banks cannot, without the prior approval of the Reserve Bank, open a new place of business in India or abroad or change, otherwise than within the same city, town or village, the location of the places of business. While the current policy for authorisation of overseas branches of Indian banks would continue, the branch authorisation policy was liberalised and rationalised in September 2005. With this objective, it was decided to put in place a framework for a branch authorisation policy which would be consistent with the medium-term corporate strategy of banks and public interest.

2.117 From the point of view of the public interest, the following aspects would be kept in view while processing the authorisation requests: (i) the Reserve Bank would, while considering applications for opening branches, give weightage to the nature and scope of banking facilities provided by banks to common persons, particularly in under-banked areas, actual credit flow to the priority sector, pricing of products and overall efforts for promoting financial inclusion, including introduction of appropriate new products and the enhanced use of technology for delivery of banking services; (ii) such an assessment would include policy on minimum balance requirements and whether depositors have access to minimum banking or "no frills" banking services, commitment to the basic banking activity, *viz*., acceptance of deposits and provision of credit and quality of customer service as, *inter alia*, evidenced by the number of complaints received and the redressal mechanism in place in the bank for the purpose; and (iii) the need to induce enhanced competition in the banking sector at various locations. In this regard, the regulatory comfort would also be relevant, which would encompass: (a) compliance with not only the letter of the regulation but also whether the bank's activities are in compliance with the spirit and underlying principles of the regulation; (b) the activities of the banking group and the nature of relationship of the bank with its subsidiaries, affiliates and associates; and (c) quality of corporate governance, proper risk management systems and internal control mechanisms.

2.118 As regards the procedural aspects, the existing system of granting authorisations for opening individual branches from time to time, would be replaced by a system of giving aggregated approvals, on an annual basis, through a consultative and interactive process. Bank's branch expansion strategies and plans over the medium-term would be discussed by the Reserve Bank with individual banks. The medium-term

framework and the specific proposals would, to the extent possible, cover the opening/closing/ shifting of all categories of branches/offices including the ATMs. These policy parameters would be applicable to foreign banks, in addition to the criteria which are specific to foreign banks and India's commitments at the WTO. ATMs would not be included in the number of branches for such computation.

Other Initiatives

2.119 Banks were asked to formulate a transparent and comprehensive Deposit Policy setting out the rights of the depositors in general and small depositors in particular. A Clean Note Policy was formulated and implemented to improve the quality of currency in circulation and ensure sufficient availability of fresh currency and coins. Various prescriptions with regard to arranging proper disclosures by banks relating to aspects such as maintenance of minimum balances in accounts, issue of cheque books, entries in pass books/statement of accounts, and formulation of transparent Cheque Collection Policy by banks have been introduced.

5. Supervision and Supervisory Policy

Board for Financial Supervision

2.120 The Board for Financial Supervision (BFS) was constituted in November 1994 as a committee of the Central Board to exercise 'undivided attention to supervision'. The BFS provides direction on a continuing basis on supervisory policies including governance issues and supervisory practices. It also provides direction on supervisory actions in specific cases. The BFS ensures an integrated approach to supervision of commercial banks, financial institutions, non-banking financial companies, urban co-operatives banks and primary dealers.

2.121 During 2004-2005, the BFS met 18 times as it had to devote more attention to the supervision of urban co-operative banks, considering the financial weaknesses observed in the sector. It also reviewed the monitoring with regard to frauds in banks and financial institutions (FIs) and house-keeping in public sector banks, including reconciliation of entries in inter-branch accounts, inter-bank accounts (also *Nostro* accounts) and balancing of the books of accounts. The Board also reviewed the monitoring of all India financial institutions and non-banking financial companies. Besides, delineating the course of action to be pursued in respect of institution-specific supervisory concerns, the Board provided guidance on several regulatory and supervisory policy matters. The Board also reviewed the financial performance of primary dealers (PDs) system as a whole and provided guidance. It also reviewed the monitoring done with regard to the performance of urban co-operative banks and district central co-operative banks.

2.122 Several policy initiatives were taken at the instance of BFS during the year. The guidelines on ownership and governance for private banks were issued in February 2005 (see paragraph 2.56). The Board suggested broad approaches to be adopted for improving the financial position and management of private sector banks. These included: (a) infusion of capital funds and examining merger options, depending upon the level of CRAR and net owned fund (NOF); (b) special attention to be devoted to banks where there are specific issues/legal cases/other problems constraining infusion of capital; and (c) banks having governance concerns because of dominant shareholding or other reasons to be closely supervised. The Board also clarified that 'fit and proper' criteria of directors in such banks should be complied with in letter and spirit.

2.123 In order to implement directions of the BFS, a detailed analysis of compliance with the guidelines on ownership and governance in private sector banks was undertaken. Discussions with individual banks were held to ascertain their plans for ensuring compliance with the guidelines. The due diligence carried out by the banks themselves in respect of their directors has been reviewed by the Reserve Bank and corrective action is being taken, wherever called for.

2.124 Apart from on-site inspections, the supervisory strategy of the Reserve Bank also involves three other approaches, *viz.*, off-site monitoring, the internal control systems in banks and use of external auditors. The on-site Annual Financial Inspection (AFI) system is based on the CAMELS (Capital adequacy, Asset quality, Management, Earnings, Liquidity and Systems and controls) CALCS (Capital adequacy, Asset quality, Liquidity, Compliance and Systems) model for Indian and foreign banks, respectively. A system of supervisory rating of banks based on CAMELS concept is being used to summarise the

performance of individual banks as also to assess the aggregate strength and soundness of the banking system. While inspection of the overseas operations of branches of Indian banks is left largely to the parent bank, a system of evaluation visits covering all branches functioning at different financial centres has been instituted as part of the initiatives taken to strengthen cross-border supervision.

2.125 The macro approach to financial supervision has helped the Reserve Bank to refine its regulatory as well as monetary policy stance so as to achieve the fine balance between growth and financial stability. At the same time, external auditors who are entrusted with the responsibility of statutory audit of annual accounts of banks are being increasingly used as an extended arm of the supervisory system. They are also required to verify and certify certain other aspects such as adherence by banks to statutory liquidity requirements, prudential norms relating to income recognition and classification of assets and provisioning. A system of concurrent 'on line' audit of business transactions of banks intended to cover at least 50 per cent business of the bank, besides 100 per cent audit of risk sensitive portfolios such as foreign exchange and investments, is in place.

Progress in Implementation of Risk Based Supervision

2.126 Several initiatives have been taken for a gradual roll out of the risk based supervision (RBS) process since the announcement made in the Monetary and Credit Policy of April 2000. There were two rounds of pilot run of RBS covering 23 banks in public sector, private sector (old and new) and foreign banks categories during 2003-2005. Evaluation of the findings of first pilot run revealed that the bank level preparedness for RBS/Risk Based Internal Audit (RBIA) process was very slow. There were certain overlaps under both the business and control risks. Several steps were, therefore, taken to streamline the RBS process. First, pending amendment to risk profile templates, changes were made in the structure of inspection report to capture and report business risk and control risk in one place. Second, a work book together with a sample on-site inspection report was designed to help the inspecting officers to undertake the RBS. Third, a resource group with officers from different departments of the Reserve Bank and the Executive Director as Chairperson is in existence to analyse various risk models employed by banks in India. Fourth, an internal group was formed to revisit the Risk Profile Templates (RPTs). The revised RPTs, new methodology for risk assessment and also the guidelines for arriving at the supervisory risk rating of the bank were discussed in the Conference of Regional Offices of the Reserve Bank held on July 22 and 23, 2005. The revised RPTs would be in place in the last quarter of the current inspection cycle (April-March).

2.127 A conference of the Chief Executives of banks was held in July 2004 to discuss the level of preparedness for moving towards implementation of Basel II norms as also RBIA/ RBS. In view of the various constraints faced by banks, the progress towards full-fledged RBS replacing AFI is expected to be slower than anticipated.

2.128 The RBS approach is based on the principle of differentiated supervision. Banks are differentiated on the basis of their risk profiles and the risks posed by them to the stability of the financial system. Banks with high risk, and within the banks, critical areas with high risk, receive more supervisory attention. The RBS thus helps in allocating supervisory resources more efficiently and focusing supervisory attention according to the risk profile of each institution. Evaluation of risk management systems in banks is the essence of the RBS.

Off-site Monitoring and Surveillance

2.129 The Reserve Bank instituted a state-of-the-art Off-site Monitoring and Surveillance (OSMOS) system for banks in 1995 as part of crisis management framework for Early Warning System (EWS) and as a trigger for on-site inspections of vulnerable institutions. The scope and coverage of off-site surveillance has since been widened to capture various facets of efficiency and risk management of banks. They were also advised to increase the level of utilisation of the INFINET for regulatory-cum-supervisory reporting.

2.130 It was decided that financial institutions not accepting public deposits but having asset size of Rs.500 crore and above would be subjected to limited off-site supervision by the Reserve Bank. Therefore, with effect from April 1, 2005, the existing system of off-site supervision was replaced by a simplified information system known as the

'Quarterly Return on Important Financial Parameters in respect of select Financial Institutions'.

2.131 While taking up on-site inspection of banks, data from the OSMOS system are used by the inspecting officers for assessing the performance of banks. On-line connectivity has been provided to all the Regional Offices having head offices of banks under their jurisdictions to enable them to access the data directly and generate standard reports. The system was revised to collect certain additional data on derivatives, interest rate risk in investment portfolio, capital charge for market risk and risk weights on housing loans and consumer credit. To identify areas requiring urgent supervisory action and initiate timely action, the time limit for submission of monthly returns was reduced to 15 days and for quarterly returns to 21 days, across all categories of banks from June 2005. To improve the data quality, several measures were initiated. These included: (a) modification of the 'guidance note on off-site returns' in the light of the latest revision of the system, relevant regulatory changes and common reporting mistakes observed in various returns; and (b) meetings with individual identified banks to highlight the mistakes committed in the returns, removing conceptual ambiguities and sensitising them to the importance of off-site returns.

Initiatives for Supervision of Financial Conglomerates

2.132 The financial sector in India is becoming increasingly complex due to the entry of some of the large banks into non-traditional financial activities such as merchant banking, insurance and mutual funds. A few non-banking financial intermediaries have also become large enough to cause systemic impact. The number of cross-border financial conglomerates operating in and out of India is also growing. From a regulatory perspective, the above developments have led to an appreciation of the limitations of the segmented approach to supervision in addressing the potential risks arising out of operations of financial conglomerates. The Working Group on Financial Conglomerates (Convenor: Smt. Shyamala Gopinath) in its Report submitted in May 2004, *inter alia*, suggested criteria for identifying financial conglomerates, a monitoring system for capturing intra-group transactions and exposures and a mechanism for inter-regulatory exchange of information in respect of financial conglomerates.

2.133 The Working Group has identified 22 financial conglomerates. As part of operationalisation of the monitoring mechanism, a pilot process envisaging submission of data/ information in the prescribed format by the designated entities (DEs) to their principal regulators [Reserve Bank, Securities and Exchange Board of India (SEBI) and Insurance Regulatory and Development Authority (IRDA)] followed by a dialogue between the DEs and the regulators on issues of concern has been set in motion. The reporting format was revised with effect from quarter ended December 31, 2004 to make the reporting system user-friendly, objective and granular. A system of half-yearly discussion with the Chief Executive Officer of financial conglomerates in association with other principal regulators has been introduced as a follow-up to the announcement in the Annual Policy Statement for 2005-06 to address outstanding issues/ supervisory concerns.

Credit Information Bureau of India Ltd. (CIBIL)

2.134 The compilation and dissemination of credit information covering data on defaults to the financial system has been undertaken by the Credit Information Bureau of India Ltd. (CIBIL) set up in 2001. Banks/FIs were advised to take immediate steps to ensure submission of periodical data to CIBIL and progress reports to the Reserve Bank. Boards of banks/FIs were also advised to oversee furnishing of requisite information of all borrowers to CIBIL and report compliance of the same to the Reserve Bank. The role of CIBIL in dissemination of credit information was clarified. CIBIL should move towards a sufficiently diversified ownership structure with no single entity owning more than 10 per cent of its paid-up capital.

2.135 As announced in the Annual Policy Statement for the year 2004-2005, CIBIL was advised to work out a mechanism in consultation with the Reserve Bank, SIDBI and IBA for development of a system of proper credit records to enable banks to determine appropriate pricing of loans to small and medium enterprises. CIBIL is currently in the process of exploring solutions in association with its technology partner Dun & Bradstreet Information Services India (P) Ltd. (D & B) either by modifying the existing system of CIBIL to segregate Small and Medium Enterprise (SME) data or creating a separate system for

drawing information from database systems of both CIBIL and D&B. It held discussions in this regard with IBA, SIDBI and the Reserve Bank. This proposed SME solution will be in a position to provide consolidated report comprising SME loan related data, SME vendor payment related data and a consolidated SME score. CIBIL is expecting to operationalise the projects within 18-24 months.

2.136 With a view to strengthening the legal mechanism and facilitating credit information bureaus to collect, process and share credit information on borrowers of banks/FIs, a draft Credit Information Companies (Regulation) Bill was introduced in the Parliament. The Bill was passed by the Rajya Sabha and the Lok Sabha in May 2005 and received the assent of the President in June 2005. The Bill empowers CIBIL to collect information relating to all borrowers and confers upon the Reserve Bank the power to determine policy in relation to functioning of credit information companies and also giving directions to credit information companies.

Monitoring of Frauds

2.137 With a view to reducing the incidence of frauds, the Reserve Bank advised banks in October 2002 to look into the existing mechanism for vigilance management in their institutions and remove the loopholes, if any, with regard to fixing of staff accountability and completion of staff side action in all fraud cases within the prescribed time limit, which would act as a deterrent. Banks were also urged to bring to the notice of the Special Committee of the Board constituted to monitor large value frauds and the actions initiated in this regard.

2.138 A Technical Paper on Bank Frauds covering various aspects such as nature of frauds, present arrangement for follow-up of frauds, international legal framework relating to frauds, possible further measures with regard to legal and organisational perspectives was prepared and placed in the BFS meeting held on April 8, 2004. The Technical Paper recommended the constitution of a separate Cell to monitor frauds not only in commercial banks but also in financial institutions, Local Area Banks, urban co-operative banks and non-banking finance companies. As the proposal was accepted by the BFS, a separate Fraud Monitoring Cell (FrMC) was constituted on June 1, 2004 under the overall administrative control of the Department of Banking Supervision. The FrMC is expected to adopt an integrated approach and pay focused attention on the frauds reported by financial entities mentioned above.

2.139 A Master Circular dated October 18, 2002 on “Frauds – Classification and Reporting” was revised on August 7, 2004 and was placed on the Reserve Bank’s website. The formats in the Master Circular have been revised according to the requirements of Fraud Reporting and Monitoring System (FRMS) package. With a view to having an integrated approach and ensure uniformity in reporting requirements for all the institutions under the ambit of Fraud Monitoring Cell, the Master Circular was made applicable to FIs and local area banks (LABs) as well.

Modification in Format of Declaration of Indebtedness from Statutory Auditors

2.140 Statutory auditors of banks were required to provide a declaration to banks in which they are undertaking audit to the effect that no credit facility (including guaranteeing any facilities availed of by third party) was availed of by the proprietor/any of the partners of the audit firm/ members of his/their families or by the firm/ company in which he/they are partner/s or Director/s from any other bank/financial institution. Banks were also advised that while appointing their statutory central/branch auditors, they should obtain a declaration from the concerned audit firms duly signed by their main partner/proprietor to the effect that credit facilities, if any, availed of from other banks/FIs by them/their partners/members of family or by the firm/company in which they are partners/ Directors or the credit facilities from such institutions guaranteed by them on behalf of third parties had not turned non-performing in terms of the prudential norms of the Reserve Bank.

2.141 The format of declaration of indebtedness to be obtained from the partners/proprietors of audit firms to be appointed as statutory auditors of banks was modified in January 2005 to include that neither the proprietor/main partner nor any of the partners/members of their families or the firm/company in which they are partners/directors has been declared as a wilful defaulter by any bank/financial institution.

Outsourcing by Banks

2.142 Banks, the world over, are increasingly outsourcing a significant part of their regulated and unregulated activities from specialist providers which they would have traditionally conducted in-house. The opportunities for such outsourcing of activities have increased significantly in recent years with the evolving and improving communication systems and information technology. Although outsourcing can have a positive impact on a bank's cost efficiency and allow it to access specialist expertise that would ordinarily not be available to it internally, it may also expose the bank to certain risks, which if not managed adequately, could be a matter of regulatory and supervisory concern (Box II.13).

Compliance Function

2.143 The compliance function at banks, as noted by the Basel Committee, is now more formalised and more visible. The Committee has noted that regardless of how the compliance function is organised within a bank, it should be independent and sufficiently resourced; its

Box II.13: Outsourcing by Banks

'Outsourcing' may be defined as use of a third party (either an affiliated entity within a corporate group or an entity that is external to the corporate group) to perform activities on a continuing basis that would normally be undertaken by the bank itself. Third party or service provider refers to the entity that is undertaking the outsourced activity on behalf of the bank. There are some key risks in outsourcing such as strategic risk, reputation risk, compliance risk, operational risk, exit strategy risk, counterparty risk, country risk, contractual risk, access risk, concentration risk and systemic risk. It would be imperative for the bank outsourcing its activities to ensure effective management of these risks.

The failure of a service provider in providing a specified service, a breach in security/ confidentiality, or non-compliance with legal and regulatory requirements by either the service provider or the outsourcing bank can lead to financial losses for the bank and could also lead to systemic risks within the entire banking system in the country. Hence, its board of directors and management of bank need to provide direction and guidance to banks to adopt sound and responsive risk management practices for effective oversight, due diligence and management of risks arising out of such outsourcing activities.

Some outsourcing arrangements, if disrupted, have the potential to significantly impact bank's business operations, reputation or profitability. Such arrangements are considered 'material outsourcing'. Banks should use qualitative judgement to assess whether or not an outsourcing arrangement that is in existence or being planned, is to be considered 'material outsourcing' or not.

Before entering into, or significantly changing, an outsourcing arrangement, a bank should: (i) analyse how the arrangement will fit into its organisation and reporting structure; (ii) consider whether the agreement establishing the outsourcing arrangement will allow it to monitor and control its operational risk exposure relating to the service provider; (iii) conduct appropriate due diligence of the service provider's financial position and expertise; (iv) consider how it will ensure a smooth transition of its operations from its current arrangements to a new or changed outsourcing arrangement (including what will happen on the termination of the contract); and (v) consider any concentration risk implications such as the business continuity implications that may arise if a single service provider is used by several banks.

The bank should require its service providers to develop and establish a robust framework for documenting, maintaining and testing business continuity and recovery procedures. Outsourcing often leads to the sharing of facilities operated by the service provider. The bank should ensure that service providers are able to isolate the bank's information, documents and records, and other assets. This is to ensure that in adverse conditions, all documents, records of transactions and information given to the service provider, and assets of the bank can be removed from the possession of the service provider in order to continue its business operations, or deleted, destroyed or rendered unusable.

The bank should have in place a management structure to monitor and control its outsourcing activities. A bank that has entered into or is planning material outsourcing, or is planning to vary any such outsourcing arrangements, should adhere to the regulatory and supervisory requirements. It is imperative for the bank, when performing its due diligence in relation to outsourcing, to consider all relevant laws, regulations, guidelines and conditions of approval, licensing or registration. The engagement of service providers in a foreign country exposes a bank to country risk - economic, social and political conditions and events in a foreign country that may adversely affect the bank. Such conditions and events could prevent the service provider from carrying out the terms of its agreement with the bank. To manage the country risk involved in such outsourcing activities, the bank should take into account and closely monitor government policies and political, social, economic and legal conditions in countries where the service provider is based.

Reference:

Bank for International Settlements (2005), 'Outsourcing in Financial Services', Basel Committee of Banking Supervision, February.

Box II.14: Compliance and the Compliance Function

Compliance risk is defined as the risk of legal or regulatory sanctions, material financial loss, or loss to reputation of a bank or other entity as a result of its failure to comply with laws, regulations, rules, related self-regulatory organisation standards, and codes of conduct applicable. Compliance risk differs from the litigation risk with a counterparty as it does not deal with credit institutions' responsibility on their contractual obligations but with negative consequences of non-compliances with rules of public order. Banks over the years have seriously under-invested in effective compliance measures. Very few have automated or integrated regulatory compliance processes, and for those institutions that do utilise some kind of information technology, it generally is rudimentary and applied late in the transaction lifecycle.

The compliance function must, by its very nature, be independent of a bank's operational activities and it must report directly to a very senior level, but its activities must be subject to scrutiny by internal audit or inspection teams. To address these issues, compliance function in a bank could be strengthened by several ways as indicated below:

- Perhaps the single most important ingredient of an effective compliance program is the commitment of bank's board of directors and management. This commitment includes communicating to all employees that compliance is taken seriously and giving the compliance personnel the time and resources to perform their compliance duties.
- The second step is to structure the bank's compliance function. Should one person or a committee be responsible for compliance? In almost all cases, a compliance committee is preferable to an individual.
- After establishing the structure and membership of the committee, the program has to be finalised. A written Rule book of the committee's duties is recommended because it creates a formal structure for the compliance function. The Rule book should: (i) outline the committee's specific duties and responsibilities; and (ii) establish the committee's authority in carrying out compliance responsibilities.
- The committee should establish a program to train employees in all areas of compliance.
- The bank needs to test all areas of compliance to some degree at least once each year. More frequent testing is necessary for high-risk areas and for areas in which the bank has experienced problems. To ensure objectivity, the bank should make sure testing is conducted by someone not involved in the day-to-day operations of the department being tested.
- The bank should hold employees accountable for compliance with regulations.

Compliance problems can lead to all types of repercussions for banking institutions such as fines by the regulators, poor ratings by the regulators that harm the bank's reputation, forced changes in practices that could be costly, more frequent regulatory inspections, forced restrictions from certain bank activities and lawsuits. In some cases, the bank's legal entity could be terminated and all officers and directors could be banned from similar roles not only in other banks, but even in other corporations. In certain instances, officers and directors may face criminal charges.

Reference:

1. McCabe, I. Michael (2005), 'How to Align your Organisation's Business Processes with its Compliance Strategy', (IBM).
2. Hyde, Lorraine (2003), 'FDIC Adopts Risk-Based Approach to Compliance Exams', (RSM McGladrey, Inc.).

responsibilities should be clearly specified, and its activities should be subject to periodic and independent review by the internal audit function.

2.144 Regulation of financial institutions, particularly of banks, is carried out by a combination of three approaches. The first involves the imposition of minimum prudential standards and the monitoring of compliance. The second involves the supervisor assessing, on the basis of qualitative and quantitative information supplied by banks and the quality of a bank's internal risk-management procedures. The third approach is to rely on disclosure of information to the public. The task of the supervisors, according to the Basel Committee would become easier if the compliance function in the bank is fully established. The compliance function seeks to pay greater attention to compliance risk by encouraging the spread of a compliance culture (Box II.14). The importance of setting up compliance function in banks has assumed added significance after the Reserve Bank's decision to disclose the penalties imposed on the banks in the public domain with effect from November 2004.

6. Consultative Process in Policy Formulation

2.145 With a view to ensuring timely and effective implementation of the measures as relevant, the Reserve Bank has adopted a consultative approach before introducing policy measures. Suitable mechanisms have been instituted to deliberate upon various issues so that the benefits of financial efficiency and stability percolate to the common person and the services of the Indian financial system can be benchmarked against international best standards in a transparent manner. Over the years, the reports of various working groups and committees have emerged as a major source of two-way communication from the Reserve Bank. On all important issues, working

groups are constituted or technical reports are prepared, generally encompassing a review of the international best practices, options available and the way forward. The memberships of the groups/committees are either internal or external to the Reserve Bank or mixed. Draft reports are often placed in public domain and final reports take account of inputs, in particular, from industry associations and self-regulatory organisations.

Web-Based Communication

2.146 The Annual Policy Statements and their Mid-term Reviews communicate the stance on monetary policy of the Reserve Bank for the following six months to one year. An important feature of the communication policy of the Reserve Bank is the almost real-time dissemination of information through its website. The auction results under the Liquidity Adjustment Facility of the day are posted on the website by 12.30 p.m. the same day, while by 2.30 p.m. the reference rates of select foreign currencies are also placed on the website. By the next morning, the press release on money market operations is issued. Every Saturday, by 12 noon, the Weekly Statistical Supplement is placed on the website providing fairly detailed information on the financial sector. All the regulatory and administrative circulars of different Departments of the Reserve Bank are placed on the website within half an hour of their finalisation.

2.147 The Reserve Bank has also instituted a mechanism of placing draft versions of important guidelines for comments of the public at large before finalisation. To further this consultative process and with a specific objective of making the regulatory guidelines more user-friendly, a Users' Consultative Panel has been constituted comprising the representatives of select banks and market participants. The panel provides feedback on regulatory instructions at the formulation stage to avoid any subsequent ambiguities and operational glitches.

Resource Management Discussion

2.148 Resource Management Discussions meetings are held by the Reserve Bank with select commercial banks prior to the policy announcements. These meetings not only focus on perception and outlook of the bankers on the economy, liquidity conditions, credit flow, development of different markets and directions of interest rates, but also on issues relating to developmental aspects of banking operations. In line with the practice that has evolved since 1998, these meetings were held with 9 select banks (including two private banks and one foreign bank) during March 2005. Several macro as well as micro issues, covering quantitative projections on assets and liabilities of the banks, cost of funds, returns and spreads besides expectations about inflation and output growth were discussed during these meetings. Suggestions relating to monetary policy measures, regulation and supervision of banks, and reforms and development of the financial sector were received during these discussions, which were taken into consideration while formulating the Annual Policy Statement for 2005-06.

Standing Technical Advisory Committee on Financial Regulation

2.149 A Technical Advisory Committee on Money, Foreign Exchange and Government Securities Markets (TAC) reconstituted in March 2004 has emerged as a key consultative mechanism amongst the regulators and various market players including banks. The Committee has been crystallising the synergies of experts across various fields of the financial market and thereby acting as a facilitator for the Reserve Bank in steering reforms in the money market, the Government securities market and the foreign exchange market.

2.150 In order to further strengthen the consultative process in the regulatory domain and to place such a process on a continuing basis, the Reserve Bank constituted a Standing Technical Advisory Committee on Financial Regulation in November 2003 on the lines similar to the TAC. The Committee consists of experts drawn from academia, financial markets, banks, non-bank financial institutions and credit rating agencies. The Committee examines the issues referred to it and advises the Reserve Bank on desirable regulatory framework on an on-going basis for banks, non-bank financial institutions and other market participants.

2.151 Similarly, a Standing Advisory Committee on urban co-operative banks (UCBs) has been activated to advise on structural, regulatory and supervisory issues relating to them and to facilitate the process of formulating future approaches for this sector. Similar mechanism is being worked out for non-banking finance companies.

2.152 For ensuring periodic formal interaction on policy issues concerning various regulators, there is a High Level Co-ordination Committee on Financial and Capital Markets (HLCCFCM) with the

Governor, Reserve Bank of India as the Chairman and the Secretary of the Ministry of Finance, the Chairman of SEBI and the Chairman of IRDA as the members. This Committee has authorised the constitution of several standing committees to ensure co-ordination in regulatory frameworks at an operational level.

2.153 With a view to further strengthening the consultative process in monetary policy, the Reserve Bank of India has set up a Technical Advisory Committee on Monetary Policy in July 2005 with external experts in the areas of monetary economics, central banking, financial markets and public finance. The Committee meets at least once in a quarter to review macroeconomic and monetary developments and advise the Reserve Bank on the stance of monetary policy.

7. Financial Markets

2.154 Financial markets are at the core of the transmission mechanism of monetary policy. In India, financial markets have been developed with a specific emphasis on increasing allocative efficiency of resources and promoting financial stability. The emphasis has been on strengthening the price discovery process, easing restrictions on transactions, reducing transaction costs and enhancing systemic liquidity. Several measures were initiated during 2004-05 to develop the markets further along sound lines.

Developments in the Money Market

2.155 The money market performs two broad functions. One, it enables banks to tide over their short-term liquidity mismatches at an efficient market-clearing price. Two, it serves as the focal point for central bank intervention for influencing liquidity conditions and signalling the outlook for interest rates. In recent years, policy initiatives have endeavoured to facilitate balanced development among different market segments, develop a pure inter-bank money and repo market, reduce uncollateralised exposures in the call money market and facilitate the emergence of a regular term structure.

2.156 To review the recent developments and current status of money market in the context of evolving monetary policy framework, fiscal scenario, regulatory regime and extent of financial integration, domestic as well as external, a Technical Group on Money Market was constituted. The Group in its Report submitted in May 2005 made several recommendations for furthering the development of the money Market (Box II.15).

Box II.15: Report of the Technical Group on Money Market

The Group recommended that the policy thrust should be to encourage collateralised market, develop the rupee yield curve, ensure transparency and better price discovery, provide avenues for better risk management and strengthen monetary operations. Keeping this in view, the Group made recommendations relating to the call/notice money market, repo/CBLO, term money, certificate of deposit (CD), commercial paper (CP), FRAs/IRS, Mumbai Inter-Bank Offer Rate (MIBOR)-linked short-term papers and timing of the LAF. The main recommendations of the Group are set out below:

- The Reserve Bank should migrate from OF (Owned Fund) to capital funds (sum of Tier-I and Tier-II capital) as the benchmark for fixing prudential limits for the call/notice money market for scheduled commercial banks.
- The Reserve Bank may, however, continue with the present norm associated with co-operative banks (*i.e.*, aggregate deposit), PDs (*i.e.*, net owned fund) and non-banks (*i.e.*, 30 per cent of their average daily lending during 2000-01).
- Transactions in the call/notice money market should be conducted on an electronic negotiated quote driven platform.
- Banks and PDs with appropriate risk management systems in place and balance sheet structure may be allowed more flexibility to borrow in the call/notice money market.
- Upon accomplishing the call/notice money market into a pure inter-bank one, larger freedom in lending in the call/notice market should be afforded to banks and PDs.
- Consequent upon coming into effect of the Fiscal Responsibility and Budget Management (FRBM) Act 2003, there would be a need to broad-base the pool of securities to act as collateral for repo and CBLO markets.
- The possibility of conducting repo transactions on an electronic, anonymous order driven trading system be explored.
- Term money market transactions should be compulsorily reported on NDS platform to improve transparency. Term money market transactions on an electronic, negotiated quote driven platform should be introduced.
- The maturity period of CDs be reduced to 7 days in line with that of CPs and fixed deposits.
- Asset-backed CPs be introduced in the Indian market.
- Appropriate amendment to the Reserve Bank of India Act, 1934 be carried out to provide legal clarity to the OTC derivatives.
- Regulatory issues pertaining to new instruments such as MIBOR-linked short-term papers need to be addressed for an orderly development of the market.
- Late hour intra-day LAF as and when warranted in future be explored.

Certain recommendations of the Group were accepted for implementation and several measures were initiated in the Annual Policy Statement announced in April 2005.

2.157 In consonance with the declared policy of phased withdrawal of non-bank participants, barring PDs from the call/notice money market, effective the fortnight beginning June 11, 2005, non-bank participants were allowed to lend, on an average, in a reporting fortnight, up to 10 per cent of their average daily lending in the call/notice money market during 2000-01. Effective August 6, 2005 non-bank participants were completely phased out from the call/notice money market. In order to prevent imprudent leveraging of funds, effective April 30, 2005, the benchmark for fixing prudential limits on exposures to the call/notice money market in the case of scheduled commercial banks was linked to their capital funds (sum of Tier-I and Tier-II capital).

2.158 During the year, further steps were taken to broaden the scope of negotiated dealing system (NDS) platform with a view to enhancing transparency and price discovery as also to foster greater market integrity. From April 30, 2005, all NDS members were required to report their term money deals on NDS platform. Further, a screen-based negotiated quote-driven system for all dealings in call/notice and term money market transactions was proposed in the Annual Policy Statement for 2005-06. An electronic trading platform for conduct of market repo operations in Government securities, in addition to the existing voice based system, was also proposed. Further, it was proposed to facilitate automated value-free transfer of securities between market participants and the Clearing Corporation of India Ltd. (CCIL) for development of the CBLO segment.

2.159 With a view to augmenting the instruments available to banks to manage their liquidity, the minimum maturity period of CDs was reduced from 15 days to 7 days with effect from April 28, 2005. Earlier, in the Mid-term Review of Annual Policy Statement for 2004-05, the minimum maturity period of CP was reduced from 15 days to 7 days with effect from October 26, 2004, in order to provide an option to issuers to raise short-term resources through CP as also an avenue to investors in the form of quality short-term papers. In order to enhance transparency and facilitate wider dissemination, information on CP issuance such as issue date, maturity date, issue amount discount/interest rate, unconditional and irrevocable guarantee and credit rating of the guarantor, as reported by the Issuing and Payment Agents (IPAs) on the NDS platform, has been made available on the website of the Reserve Bank with effect from July 1, 2005.

2.160 A Group formed within the Fixed Income Money Market and Derivates Association of India (FIMMDA) to recommend and standardise various market practices with a view to achieving the settlement of CP at least on a T+1 basis submitted its Report recently. The Group recognised that this would be possible after full operationalisation of the RTGS system. With a view to harmonising the stamp duty applicable on issuance of CP and bringing the Indian CP market closer to international standard, the Union Budget for 2005-06 proposed to rationalise the stamp duty and apply it uniformly regardless of the initial class of investor.

Developments in the Government Securities Market

2.161 As the debt manager to the Government, the development of a deep and liquid market for Government securities is of critical importance to the Reserve Bank for facilitating the process of price discovery and reducing the cost of Government debt. The Reserve Bank has taken several structural and development measures for deepening and widening the Government securities market. In recent years, the approach to the development of Government securities market has focused on greater transparency, risk free settlement, liquidity, and broad-based participation. Significant steps taken by the Reserve Bank in the recent period include elongation of maturity, development of new benchmark Government securities by consolidating new issuances in key maturities, enhancing fungibility and liquidity by re-issuances of the existing loans, promoting retailing of Government securities, introduction of floating rate bonds, announcement of a calendar for conducting auctions and enhanced transparency of the central Government's borrowing programme.

2.162 The Reserve Bank continued its efforts to further deepen and broaden the Government securities market during 2004-05. Additional measures were undertaken to improve functional efficiency through upgraded technological infrastructure. These were accompanied by an assessment of the risk management systems in place under the new institutional arrangements. A

number of initiatives were taken to modernise the operations relating to Government securities. First, it was decided to standardise the settlement system for such transactions on a T+1 basis. Second, the Reserve Bank reiterated its desire to resort to multiple and uniform price methods flexibly in the auction of Government securities. Third, it was proposed to expand the permitted structure of PD business to include banks, which fulfil certain minimum criteria subject to safeguards and in consultation with banks, PDs and the Government. Fourth, in order to enhance liquidity in the Government securities market, sale of Government securities allotted in primary issues with and between constituent's subsidiary general ledger (CSGL) account holders on the same day was permitted. Prior to this relaxation, the sale of Government securities allotted in primary issues could be entered into on the same day only between entities maintaining SGL account with the Reserve Bank. Fifth, non-scheduled urban co-operative banks (UCBs) and listed companies having gilt accounts with scheduled commercial banks were allowed to participate in market repo facility in Government securities subject to eligibility criteria and safeguards.

2.163 The Fiscal Responsibility and Budget Management (FRBM) Act, 2003 ushered in significant changes in the contextual setting and operating framework for the conduct of monetary policy, public debt management and regulatory oversight of the Government securities market by the Reserve Bank. Recognising that the participation of the Reserve Bank in the primary issues of Government securities will stand withdrawn with effect from April 1, 2006 under the FRBM Act, the Mid-term Review of Annual Policy Statement for the year 2004-05 emphasised that "open market operations (OMO) would become a more active instrument, warranting a review of processes and technological infrastructure consistent with market advancements". To address these emerging needs and to equip the Reserve Bank as well as market participants appropriately, an Internal Technical Group on Central Government Securities Market was constituted (Box II.16). Earlier, another Group (Chairman: Dr. R.H. Patil) had examined the role of primary dealers (PDs) in the Government securities market. These reports were discussed in the TAC and based on their recommendations the Annual Policy Statement for 2005-06 proposed to consolidate debt and build up large liquid securities in consultation with the Government while continuing the programme of re-issuances for improving liquidity and pricing in the market. Post-FRBM, the Reserve Bank would reorient Government debt management operations, while simultaneously strengthening monetary operations. This would entail functional separation between debt management and monetary operations within the Reserve Bank. For

Box II.16: Report of the Technical Group on Central Government Securities Market

The major recommendations of the Group are set out below:

- The Reserve Bank may keep the option open to participate in the secondary market as considered appropriate with a view to containing excessive volatility and promote orderly market conditions as well as to improve market liquidity in Government securities.
- PDs may be permitted to underwrite the entire 100 per cent of the notified amount of each auction.
- PDs may be vested with market making obligations, in both the wholesale segment and the retail or mid segment. The selection among PDs, of eligible secondary market counterparties for RBI operations, may be done on the basis of relative secondary market performance in both wholesale and retail segments.
- Measures such as active consolidation of securities, introduction of short selling of Government securities in a phased manner and with appropriate safeguards, introduction of 'when issued' market and a securities borrowing window for PDs would facilitate development and enhance efficiency and liquidity of the secondary markets for Government securities.
- Permitted Structures for PD business be expanded to include banks directly undertaking PD activity as a department with independent subsidiary books of account. Simultaneously, exposure of stand-alone PDs to non-Government securities as well as off-balance sheet business should be limited.
- Certain accounting practices be changed such as permitting banks to charge appreciation as well as depreciation on securities in the 'available for sale' (AFS) category to equity instead of profit and loss account, adoption of fair value accounting so as to recognise both gains and losses in the case of the 'held for trading' portfolio and introduction of comprehensive accounting standards covering all derivative instruments.
- The security settlement system be integrated with the RTGS. Appropriate changes to NDS system be carried out to accommodate the changes proposed in the Report.
- Primary and open market operations (OMO) auctions be routed through CCIL.
- An effective performance monitoring and surveillance module, either on NDS or as a stand-alone be put in place.

this purpose, it was indicated that the Reserve Bank would hold discussions with market players on the modalities and procedures of market operations.

2.164 As indicated in the Annual Policy Statement for 2004-05, a discussion paper for re-introduction of the Capital Indexed Bonds (CIBs) with improvised features was put on the websites of the Reserve Bank and the Central Government for comments. In this regard, market conventions for secondary market trading and settlement of the bonds were finalised in consultation with Fixed Income Money Market and Derivatives Association of India (FIMMDA) and Primary Dealers Association of India (PDAI) during the year. Suitable modifications carried out in the PDO-NDS trading, clearing and settlement system are being tested. As indicated in the Mid-term Review of Annual Policy Statement for 2004-05, it is expected that CIBs could be introduced during 2005-06 in consultation with the Government.

2.165 As the implementation of the recommendation of the Twelfth Finance Commission (TFC) would have major implications for the market borrowing programme, the Annual Policy Statement for 2005-06 indicated that the Reserve Bank would facilitate smooth transition of the process in consultation with the Central and the State Governments. As a first step, consultations were held with State Finance Secretaries on April 8, 2005. Subsequently, a Technical Group on Borrowings by State Governments (Chairperson: Smt. Shyamala Gopinath) was constituted by the Central Government with members drawn from the Ministry of Finance, Government of India, the Reserve Bank and the State Governments. The Group is expected to submit its report shortly,

2.166 It has been the endeavour of the Reserve Bank to improve the facilities for trading and settlement in the Government securities market. The introduction of the Negotiated Dealing System (NDS) in February 2002 was a major step in this direction. In comparison with the pre-NDS period, the entire reporting and settlement process for Government securities has been fully automated leading to substantial benefits in terms of time and efficiency. However, the trading functionality of NDS was hardly used. To further improve the trading capabilities of the NDS system, the Reserve Bank formally launched an electronic order matching trading module for Government securities on its Negotiated Dealing System (RBI-NDS-GILTS-Order Matching Segment or NDS-OM) on August 1, 2005 (Box II.17). The NDS-OM system, in the first phase, would accommodate the trading requirements of all banks, PDs, and financial institutions regulated by the Reserve Bank that hold current NDS membership. Other NDS members would be extended access in the next phase. To start with, the system would support dealing in all Central Government and State Government securities for T+1 settlement which would then be subsequently upgraded in order to facilitate trading in discounted instruments such as Treasury Bills. As on September 30, 2005, 117 members were participating in NDS-OM. The transaction volume on NDS-OM accounts for 60-70 per cent of the total outright transactions of Government dated securities in the secondary market.

Developments in the Foreign Exchange Market

2.167 The Reserve Bank has undertaken a number of measures for the development of the spot as well as forward segments of the foreign exchange market. The roadmap for reforms in the foreign exchange market in India was laid by the Expert Group on Foreign Exchange Markets in India (Chairman: Shri O.P. Sodhani) in 1995. With the objective of providing greater operational flexibility, banks were given freedom to fix their own open exchange position limit. Depending upon the asset liability profile, dealing expertise and

Box II.17: Trading in Government Securities – Order Matching Segment

The NDS-OM system has the following salient features:

- Purely order driven with all orders being matched based on a strict price/time priority.
- An anonymous order matching system wherein identity of counter parties is not revealed. Clearing Corporation of India Ltd. (CCIL) is the central counterparty to each trade executed on the system.
- Allows straight-through processing (STP); trades executed will flow straight to CCIL in a ready-for-settlement stage.
- Provides functionalities for order management (placing, modifying or cancelling orders), trade related queries, activity log, market information and analytics (such as YTM computation).
- Order Matching system is an additional facility available to the participants who continue to have the option of using the current reporting and trading platform of the NDS. The settlements of both the systems are, however, integrated.

Box II.18: Foreign Exchange Exposure Norms of Commercial Banks in India

The foreign exchange exposure norms for banks authorised to deal in foreign exchange, *i.e.*, authorised dealers (ADs) are set out below:

Positions and Gaps:

- The Reserve Bank has stipulated foreign exchange exposure limits in the form of Net Overnight Open Position Limit (including gold) (OPL) and Aggregate Gap Limit (AGL) for banks. The OPL and AGL are required to be approved by the Reserve Bank.
- The Boards of Directors of ADs are required to frame an appropriate policy and fix suitable limits for various treasury functions.

Investments in Overseas Markets:

- ADs can undertake investments in overseas money market instruments (including any debt instrument whose life to maturity does not exceed one year as on the date of purchase) and/or debt instruments issued by a foreign state with a residual maturity of less than one year, up to the limits approved by their Board of Directors. The instruments, however, are to be rated at least as AA (-) by Standard & Poor/FITCH IBCA or Aa3 by Moody's. For the purpose of investments in debt instruments other than the money market instruments of any foreign state, the Boards of banks may lay down country ratings and country-wise limits separately, wherever necessary.
- ADs may also invest the undeployed FCNR(B) funds in overseas markets in long-term fixed income securities provided the maturity of the securities invested in does not exceed the maturity of the underlying FCNR(B) deposits.
- ADs can also invest surplus in *Nostro* accounts through overnight placement and investments with their overseas branches/correspondents subject to adherence to the gap limits approved by the Reserve Bank.

Overseas Foreign Currency Borrowings:

- The aggregate limit for almost all categories of overseas foreign currency borrowings of ADs is placed at 25 per cent of their unimpaired Tier-I capital or USD 10 million (or its equivalent), whichever is higher. Funds so raised may be used for purposes other than lending in foreign currency to constituents in India and repaid without reference to the Reserve Bank. As an exception to this rule, ADs are permitted to use borrowed funds as also foreign currency funds received through swaps for granting foreign currency loans for export credit subject to certain stipulations. Besides this, subordinated debt placed by head offices of foreign banks with their branches in India as Tier-II capital is also treated outside the above limit.

Gold Transactions

- Only banks authorised by the Reserve Bank can deal in gold. Such banks can enter into forward contracts in India for buying and selling gold with those banks which are authorised to import gold and with their constituents (exporters of gold products, jewellery manufacturers and trading houses) in respect of the underlying sale/purchase and loan transactions in gold with them. The tenor of such contracts, however, should not exceed six months.
- Banks may use exchange-traded and over-the-counter hedging products available overseas to manage the price risk. However, while using products involving options, it needs to be ensured that there is no net receipt of premium, either direct or implied.

Vostro Accounts

- The aggregate limit for temporary overdrawals in *vostro* account of overseas branches/correspondents is Rs.5 crore in aggregate for meeting normal business requirements.

other relevant factors, authorised dealers (ADs) in foreign exchange were accorded freedom to fix their own gap limits for more efficient management of their assets and liabilities (Box II.18).

2.168 In order to review comprehensively the initiatives taken by the Reserve Bank from time to time in the foreign exchange market and to identify areas for further improvement, an internal Technical Group was constituted. The Group, which submitted its Report in June 2005, reviewed foreign market liberalisation in select emerging markets and examined the current regulatory regime in the light of liberalisation in related sections to identify areas for further liberalisation. The Group noted that although the external sector is fundamentally stronger and more resilient than ever before, some of the pre-conditions for further liberalisation laid down by the Tarapore Committee on Capital Account Convertibility are yet to be achieved. In order to embark upon further deregulation of the foreign exchange market, including relaxation of the remaining capital controls, an enabling environment is needed for the reforms to proceed on a sustainable basis. In this context, liberalisation of various sectors of the economy has to proceed in tandem to derive synergies of the reform process. The Group also took into account the risks associated with internationalisation of the rupee and concluded that a gradual and need-based approach would be more suited to the prevailing conditions (Box II.19).

2.169 Based on the recommendations of the Technical Group, the Annual Policy Statement for the year 2005-06 initiated several measures. First, cancellation and rebooking of all eligible forward contracts booked by residents, irrespective of tenor,

Box II.19: Report of the Internal Technical Group on Foreign Exchange Market

The Group has proposed a number of measures for implementation in the short-term for resident entities, banks and non-residents. The Group made the following major recommendations:

Resident Entities:

- In order to provide greater flexibility to resident entities for dynamically managing their exposures, to further the development of the forward segment of the market and to bring about uniformity with respect to booking of such contracts, all forward contracts booked by residents, regardless of tenor, may be allowed to be cancelled and rebooked freely.
- Foreign currency-rupee swaps booked to hedge genuine foreign currency exposures may also be permitted to be rebooked/reinstated on cancellation.
- Corporates with derived foreign exchange exposures arising out of rupee-foreign currency swaps may be permitted to hedge the interest rate risk and cross currency exposures (not involving the rupee).
- Corporates may be permitted to sell/write covered call and put options subject to adequate accounting standards and risk management systems being in place.

Banks:

- Banks would be required to put in place a customer suitability and appropriateness policy.
- Banks may be permitted to provide capital on the actual overnight open exchange position maintained by them, rather than on their open position limits.
- Banks may be given the freedom to decide on the period of crystallisation of unpaid export bills; the exchange gain and loss on crystallisation may be passed on to exporters symmetrically.
- Banks having expertise in managing commodity price risk and hence specifically authorised by the Reserve Bank in this regard may be allowed to approve commodity hedging proposals from their corporate customers.
- The closing time for inter-bank foreign exchange market in India may be extended by one hour from 4.00 PM to 5.00 PM.
- Forex data, including traded volumes for derivatives such as foreign currency-rupee options may be made available to the market on a regular basis.

Non-Resident Entities:

- The Group was of the view that as at present apart from US dollar (US$), Pound sterling (GBP), Euro and Japanese yen (JPY), Foreign Currency Non-Resident (FCNR) (B) deposits may also be accepted in Canadian dollar (CAD), Australian dollar (AUD) and New Zealand dollar (NZD).

were permitted. Second, in order to guard against international price fluctuations in tradables, banks were allowed to approve proposals for commodity hedging in international exchanges from their corporate customers. Third, the closing time for inter-bank foreign exchange market in India was extended by one hour up to 5.00 p.m. Fourth, it was proposed to disseminate additional information, including traded volumes for derivatives such as foreign currency-rupee options to the market.

2.170 With a view to further liberalising the norms for raising resources abroad as also ensuring better effective use of foreign exchange reserves, it was decided to raise the ceiling of overseas investment by Indian entities in overseas joint ventures and/or wholly owned subsidiaries from 100 per cent to 200 per cent of their net worth under the automatic route. Concurrently, in order to further liberalise the procedure, the authorised dealers (ADs) were accorded general permission to open foreign currency accounts of the project offices set up in India by foreign companies and operate the accounts flexibly. Earlier, ADs were required to obtain approval of the Reserve Bank.

8. Payment and Settlement Systems

2.171 The payment and settlement systems are at the core of financial system infrastructure in a country. A well-functioning payment and settlement system is crucial for the successful implementation of monetary policy and maintaining the financial stability. Central banks have therefore, always maintained a keen interest in the development of a payment and settlement system as part of their responsibilities for monetary and financial stability (Box II.20). In India, the development of a safe, secure and sound payment and settlement system has been the key policy objective. In this direction, the Reserve Bank, apart from performing the regulatory and supervisory functions, has also been making efforts to promote functionality and modernisation of the payment and settlement systems on an on-going basis.

2.172 In order to provide focused attention to the payment and settlement systems, the Reserve Bank constituted the Board for regulation and supervision of Payment and Settlement Systems (BPSS) as a

Box II.20: Payment and Settlement System and its Oversight: The Role of Central Banks

Central banks are involved in payment and settlement systems in a number of ways. They (i) provide settlement accounts, (ii) oversee core payment arrangements, and (iii) operate, provide and use various payment services. Central banks are also responsible for providing safe settlement of assets for several systems, especially the systemically important large value/retail ones.

A safe and efficient payment system is the prerequisite for smooth functioning of the financial markets. The conduct of monetary policy in an effective manner requires safe and efficient payment and settlement systems to facilitate transfer of funds and securities between the central bank and other participants in the financial system. An efficient and stable payment and settlement system is also a pre-condition for inter-bank money markets and other short-term credit markets through which monetary policy is transmitted. In addition, developments in the payment and settlement systems that affect the speed and realisation/availability of funds for further deployment could influence the overall demand for money in the economy.

By linking financial institutions together for the purpose of transferring monetary claims and settling payment obligations, payment and settlement system becomes a channel through which financial risks are transmitted across financial institutions and markets. Well designed and efficiently managed systems, therefore, help in maintaining financial stability by reducing uncertainty of settlement. Settlement failures which spread to other payment and settlement systems through the contagion effect not only undermine the smooth functioning of the financial markets, but can also adversely affect the public confidence in money and efficacy of the instruments and systems used to transfer money.

Central banks regulate and supervise payment and settlement systems with the objective of promoting safety and efficiency by monitoring the existing and planned systems, assessing them against the stated objectives and, where necessary, inducing change. The concept of central bank oversight of payment and settlement systems has become more distinct and formal in recent years as part of a growing concern with financial stability as also with the increasing role of private participants in providing payment and settlement systems. The increasing attention by the central banks also reflects the large increase in the value of transfers cleared and settled, the increasing centralisation of transactions around a small number of key systems and the growing technological complexity. The systemic risk could increase if the design of key systems does not adequately address various payment and settlement risks.

References:

1. Bank for International Settlements (2005), Central Bank Oversight of Payment and Settlement Systems, May.
2. Bank for International Settlements (2005), Consultative Report on General Guidance for Payment System Development, May.

Committee of its Central Board. The Reserve Bank of India (Board for regulation and supervision of Payment and Settlement Systems) Regulations, 2005 were notified in the Gazette of India on February 18, 2005. The BPSS is headed by the Governor of the Reserve Bank with the Deputy Governor in-charge of Payment and Settlement Systems as the Vice-Chairman and the other Deputy Governors and two members of the Central Board of the Reserve Bank as members. The Executive Directors in-Charge of the Department of Payments and Settlement Systems (DPSS) and Financial Market Committee and Legal Adviser-in-Charge are permanent invitees. The Board also has an external expert as a permanent invitee.

2.173 Functions and powers of the BPSS include formulating policies relating to the regulation and supervision of all types of payment and settlement systems, setting standards for existing and future systems, authorising the payment and settlement systems and determining criteria for membership. The National Payments Council, which was set up in 1999, has been designated as a Technical Advisory Committee of the BPSS. To assist the BPSS in performing its functions, a new department, the Department of Payments and Settlement Systems (DPSS), was set up in the Reserve Bank in March 2005.

2.174 The BPSS has met three times since its constitution in March 2005. The Board at its meetings, *inter alia*, has emphasised that: (i) payment system services in India should be taken to a level comparable with the best in the world; (ii) appropriate legal infrastructure may be created as early as possible; (iii) a plan be drawn up to “leapfrog” from cash to electronic modes of payment, wherever possible; (iv) cheque clearing system would have to be made more efficient through cheque truncation system; and (iv) usage of the Real Time Gross Settlement (RTGS) System be increased both in terms of opening additional branch outlets and more number of transactions being put through.

2.175 For modernising the payment and settlement systems in India, a three-pronged approach has been adopted with due emphasis on consolidation, development and integration. The consolidation of the existing payment systems involves the strengthening of computerised cheque clearing and expanding the reach of Electronic Clearing Services (ECS) and Electronic Funds Transfer (EFT). The retail payment system was

given an impetus with the introduction of a new facility, Special Electronic Funds Transfer (SEFT) System covering about 169 centres of the country. The critical elements of the development strategy involve opening of new clearing houses, inter-connection of clearing houses through the Indian Financial Network (INFINET), development of RTGS system, Centralised Funds Management System (CFMS), Negotiated Dealing System (NDS) and the Structured Financial Messaging System (SFMS). Integration of various payment products with the systems of individual banks has been another thrust area. The focus has been on a high degree of standardisation within a bank and seamless interface across banks.

2.176 With the implementation of RTGS, the paper-based inter-bank clearing has been discontinued in a phased manner beginning with the closure of inter-bank clearing at Mumbai in November 2004. All RTGS member banks have now been settling their inter-bank transactions only through RTGS. Non-RTGS member banks have been asked to make use of the electronic platform as customers of some RTGS participants. At present, there are 109 direct participants (the Reserve Bank, 94 scheduled banks and 14 Primary Dealers) of which 84 banks are offering RTGS based customer services at more than 11,280 branches in 508 towns/cities across the country. The target is to have RTGS based customer services in 15,000 bank branches by March 2006.

2.177 Electronic Clearing Service for bulk and repetitive credit-push payments such as salary, pension, dividend and interest, and credit-pull transactions such as payment of utility bills, insurance premia and instalment repayment of loans is already available at 45 centres across the country. In order to make available ECS at more centres, bank operated cheque processing centres (CPCs) have been advised by the Reserve Bank to commence ECS operations at the earliest. Banks already operating ECS services have also been advised to have a uniform two-day processing cycle at all the centres and also adhere to the return clearing on the same day as the presentation. In order to encourage electronic funds transfer systems, the processing charges for all the electronic funds transfer services have been waived till March 31, 2006. The maximum cap on value per transaction has been removed for ECS, EFT and SEFT.

2.178 With the operationalisation of the cheque processing system at Ranchi, Guwahati, Thiruchirapalli, the number of centres with automated cheque clearing system has gone up to 43. Magnetic Ink Character Recognition (MICR) technology being used at these centres for automatic listing and sorting of cheques and arriving at the settlement position of member banks now covers 86 per cent in volume and 87 per cent in value of the total clearing turnover in the country. During the year, plans for setting up of MICR processing centres at 17 more cities/ towns were approved. This would take the total number of cities with MICR clearing to 60 and coverage of MICR to over 90 per cent in terms of both value and volume. The transition period from moving over to MICR based clearing from a non-MICR based cheque system generally takes two years in a city because member banks continue to issue the available stock of non-MICR cheques. In order to give a lead time, banks have been advised to issue MICR cheques irrespective of whether cheque clearing centres use MICR cheque format or not. The use of MICR cheques would help in capturing cheque data in a standardised manner on computing platform. It would also facilitate introduction of a nation-wide cheque truncation system.

2.179 Although the Reserve Bank has undertaken several measures to minimise settlement risk and enhance the efficiency in retail deferred net settlement (DNS) system, it has potential for credit, liquidity and operational risks thereby leading to settlement failures. A Working Group which examined the operational implications of the risk mitigation mechanism for retail payments recommended the need for setting up of a guarantee fund for large value systems among the retail systems, with a specific focus on the ‘high value clearing system’.

2.180 In the recent period, the Reserve Bank has taken a number of initiatives to strengthen the institutional, technological and procedural framework for the payment and settlement systems. To carry forward these initiatives in an integrated and cohesive manner, a Vision Document for 2005-08 has been prepared after taking into consideration the feedback from the various stakeholders such as banks, technology solution providers, members of public and other experts in the field. The Vision Document sets out the roadmap for implementing the vision for

payment and settlement systems within the next three years. The key themes of the action plans identified in the Vision Document are safety, security, soundness and efficiency (Triple-S and E). While safety in payment and settlement systems relates to risk reduction measures, security implies confidence in the integrity of the payment systems. All payment systems are envisaged to be on a sound footing with adequate legal backing for operational procedures and transparency norms**.** Efficiency enhancements are envisaged by leveraging the benefits of technology for cost effective solutions (Box.II.21).

9. Technological Developments and Other Infrastructural Issues

2.181 Most of the initiatives regarding technology during 2004-05 were aimed at providing better and more efficient customer service by offering multiple options to the customer. The death of distance, which is a by-product of technology, has become a reality in the banking sector. Technology is also playing a key role in banks' strategy for gaining a competitive edge.

2.182 Many banks have commenced the process of setting up core banking solutions, which are at various stages of implementation. While such systems are already in place in respect of new private sector banks, foreign banks and a few old private sector banks, public sector banks are also quickly moving to set up such processes. This would benefit the customer in the banking sector. Computerisation of the business of banks has been receiving high importance. The public sector banks have already crossed the 70 per cent level of computerisation of their business. The directive from the Central Vigilance Commission (CVC) to achieve 100 per cent computerisation has resulted in renewed vigour towards computerisation of branches.

2.183 Networking has been receiving focused attention by banks. This activity is also being monitored by the Reserve Bank. Most banks have their own corporate networks to facilitate inter-branch and branch-controlling office communication in an electronic mode. Inter-bank and inter-city communication takes place through the Indian Financial Network (INFINET). As part of the INFINET, the terrestrial lines have been augmented to provide for increased data transfer capabilities. All these have resulted in the dependence of banks on network-based computing which has benefited the customer.

Box II.21: Vision Document for Payment Systems – 2005-08

The main action points for payment and settlement systems, 2005-08 as set out in the Vision Document are indicated below:

During the first year, *i.e.*, 2005-06, focus would be on: (i) pursuing with Indian Banks' Association and major banks for setting up of a national level entity which will operate all retail payment systems in the country; (ii) operationalising National Settlement System for all clearings at four metro centres by December 2005; (iii) finalising the proposed Electronic Funds Transfer (EFT) regulations; (iv) implementing Stage-2 of RTGS System, *i.e.*, Integrated Accounting System (IAS)-RTGS rollout during which all inter-bank transactions at all major centres would be settled on RTGS platform and paper-based inter-bank clearing will be closed; (v) pursuing with RTGS participants to cover all their networked branches under RTGS framework paving way for RTGS-based customer related transactions at about ten thousand branches in the country; (vi) implementing image-based Cheque Truncation System (CTS) at the National Capital Region (NCR) on a pilot basis; (vii) preparing minimum standard of operational efficiency at MICR Cheque Processing Centre (CPC); (viii) making available EFT facility at 500 capital market intensive centres as identified by BSE and NSE; (ix) setting up Customer Facilitation Centre (CFC) at the Reserve Bank for various segments of national payment systems; (x) public disclosure from each payment service provider of its standards, terms and conditions under which the payment will be effected and also compensation policy and procedure for any deficiency in services including the setting up of CFC; (xi) drafting the Red Book on Payment Systems in India; and (xii) drafting a comprehensive legislation on payment system.

During the second year, *i.e.*, 2006-07, it is envisaged to: (i) complete the tasks initiated during 2005-06; (ii) extend MICR clearing to 20 additional identified centres; (iii) ensure that every cheque issued follows MICR format and standards; (iv) implement EFT systems at a national level through the new retail payment institution; (v) make all payment systems in India compliant with the Core Principles for Systemically Important Payment Systems (SIPS); (vi) increase the reach of payment services by means of tie-up and collaboration with other large coverage entities such as the post offices; and (vii) facilitate government payments and receipts through electronic mode.

The third year, *i.e.*, 2007-08 would harness on: (i) creating off-city back-up arrangements for large value national payment systems such as RTGS and G-Sec Clearing; (ii) making fully functional the new organisation for retail payment systems with all such payment under its umbrella; (iii) regulating various payment systems; (iii) ensuring cheque truncation based clearing at Mumbai, Chennai and Kolkata; and (iv) covering National Settlement System at all major clearing houses/ clearing organisations in the country.

INFINET also provides for safe and secure transmission of electronic messages with the use of Public Key Infrastructure (PKI) which has the legal backing of Information Technology Act, 2000. It also provides for messages to flow in a structured environment, using the SFMS, which provides for inter-operability of messages so that straight through processing (STP) is achieved.

2.184 Another major development witnessed during the year was the growth in multiple delivery channels to customers such as internet-based banking, mobile banking and anywhere banking. This has benefited the customers and the banks alike. While customers have now a wide variety of options to choose from, banks have been able to reduce costs which have had a positive impact on their profitability.

2.185 These developments have, however, also posed certain challenges. In a world where geographical barriers are losing significance, it is essential that security is given prime importance in a trans-national scenario where large sums of money are at stake. While the challenges relating to physical security could be confronted with relative ease, the position is much more complicated in respect of IT security. It is widely accepted that security is as effective as the weakest link in a chain. The Reserve Bank, has therefore, provided guidelines on information system (IS) security as also IS audit which banks can use for their benefit. These are generic in nature and do not have any prescriptive tones.

2.186 There are at present a number of security standards available for different financial applications; most of them are internationally accepted and part of the ISO standards. These international standards such as the BS7799 have been accepted by the Reserve Bank (Box II.22). Banks, however, could also put in place measures which conform to their own policies and ensure regular and periodical audit.

Service Branch

2.187 Banks were earlier permitted to open service branches/regional collection centres for facilitating clearing and allied works. Taking into account the changes brought in as a result of introduction of technology and the need to cut down operational costs while enhancing customer service, it was decided by the Reserve Bank in September 2004 to allow banks to open branches that would attend exclusively to data processing, verification and processing of documents, issuance of cheque books, demand drafts on requests received from other branches and other functions incidental to banking business having no interface with customers. It was further decided to issue licences for such branches under the 'service branch' category. Accordingly, a 'service branch' could attend to clearing and allied banking activity which may include processing

Box II.22: BS7799 Standards

BS 7799 is comprehensive in its coverage of security issues, containing a significant number of control requirements. Compliance with it is, thus, a major task for most organisations. By following this standard, financial institutions including banks can ensure compliance to most of the information security requirements. The objectives of these standards are:

- To provide management direction and support for information security, which is a base prerequisite for BS7799.
- To manage information security within the organisation, maintain the security of organisational information processing facilities and information assets accessed by third parties, and to maintain the security of information when the responsibility for information processing has been outsourced to another organisation.
- To maintain appropriate protection of corporate assets and ensure that information assets receive an appropriate level of protection.
- To reduce risks of human error, theft, fraud or misuse of facilities and minimise the damage from security incidents and malfunctions and learn from such incidents.
- To ensure the correct and secure operation of information processing facilities, minimise the risk of systems failures, to protect the integrity of software and information and maintain the integrity and availability of information processing and communication.
- To control access to information, prevent unauthorised access, detect unauthorised activities and ensure information security when using mobile computing and tele-networking facilities.
- To ensure security is built into operational systems, to prevent loss, modification or misuse of user data in application systems.
- To counteract interruptions to business activities and critical business processes from the effects of major failures or disasters.
- To prevent breaches of any criminal or civil law, statutory, regulatory or contractual obligations and of any security requirements, ensure compliance of systems with organisational security policies and standards and minimise interference to/from the system audit process.

Box II.23: Financial Sector Technology Vision Document

The Vision document focuses on four major areas, *viz*., IT for regulation and supervision, IT and Institute for Development and Research in Banking Technology (IDRBT), IT for the Financial Sector and IT for Government related functions.

The Vision Document envisages emerging challenges in the form of implementation of standardisation across a variety of hybrid systems at different financial entities, need for decision support systems and the technology to facilitate risk based off-site supervision. It envisions common inter-operable web-based structures for transmission of data relating to regulatory functions and the use of a single centralised database for all information, apart from hiving off the operation of non-critical functions by the Reserve Bank.

The Vision Document visualises the IDRBT to be a premier research institute, concentrating on research and development for the banking and financial sector, providing educational/training facilities and hiving off business related activities.

Recognising the requirements of IT for the financial sector, the Vision Document elucidates the thrust areas of the Reserve Bank by providing generic information on various standards and approaches, IS Audit and requisite focus on business continuity plans. The Vision Document proposes that specific attention would be devoted to percolation of technology efforts to all types of banks and all sections of the customers in the banks with specific reference to the rural areas and the use of affordable technology products which can be easily used by the target clientele with inter-shareable resources.

The document also details the use of IT in the Government sector transactions (which has the largest potential to grow significantly in the years to come), with specific attention on the need for business process re-engineering, changes in rules and procedures for aligning them with e-governance in a manner so as to achieve implementable objectives.

centres, back office functions and those incidental to banking business. It was further clarified that 'service branch' shall not include a call centre or a phone banking facility or any other facility that involves customer interface. Banks were also permitted to shift their rural branches within the block/service area without obtaining prior approval of the Reserve Bank, subject to complying with: (i) both the existing and proposed centres should be within the same block and service area of the branch; and (ii) the relocated branch would be able to cater adequately to the banking needs of the villages allocated under the Service Area Approach.

2.188 The Reserve Bank released the draft Financial Sector Technology Vision document on May 6, 2005. It provides a broad overview of the thrust areas of the direction provided by the Reserve Bank in respect of IT for the financial sector for more than two decades and sets out a roadmap for 2005-08 (Box II.23).

10. Legal Reforms in the Banking Sector

2.189 An efficient financial system requires a regulatory framework with well-defined objectives, adequate and clear legal framework and transparent supervisory procedure. This, in turn, requires comprehensive legislations to enable the regulatory authorities to discharge their responsibilities effectively. The Reserve Bank has, therefore, been making constant efforts to upgrade and strengthen the legal framework in tune with the changing environment.

Recent Acts Enacted by the Parliament

2.190 The Enforcement of Security Interest and Recovery Debts Laws (Amendment) Act, 2004 (Act No.30 of 2004) has amended the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI), the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 and the Companies Act, 1956. By this amendment Act, the SARFAESI Act has been amended, *inter alia*, to: (i) enable the borrower to make an application before the Debt Recovery Tribunal against the measures taken by the secured creditor without depositing any portion of the money due; (ii) provide that the Debt Recovery Tribunal shall dispose of the application as expeditiously as possible within a period of 60 days from the date of application; and (iii) enable any person aggrieved by any order made by the Debt Recovery Tribunal to file an appeal before the Debt Recovery Appellate Tribunal after depositing with the Appellate Tribunal fifty per cent of the amount of debt due from him as claimed by the secured creditor or as determined by the Debt Recovery Tribunal, whichever is less.

2.191 The Credit Information Companies (Regulation) Act, 2005 is aimed at providing for regulation of credit information companies and to facilitate efficient distribution of credit. The Act will come into force after it is notified by the Government in the official Gazette. After the Act comes into force, no company can commence or carry on the business of credit information

without obtaining a certificate of registration from the Reserve Bank. The Act sets out procedures for obtaining certificate of registration, the requirements of minimum capital and management of credit information companies. The Act also empowers the Reserve Bank to determine policy in relation to functioning of credit information companies and to give directions to such companies, credit institutions and specified users. The Act also lays down the functions of credit information companies, powers and duties of auditors, obtaining of membership by credit institutions in credit information companies, information privacy principles, alterations of credit information files and credit reports, regulation of unauthorised access to credit information, offences and penalties, obligations as to fidelity and secrecy. Other salient features of the Act include settlement of disputes between credit institutions and credit information companies or between credit institutions and their borrowers. The Act also provides for amendment of certain enactments so as to permit disclosure of credit information.

Bills introduced in the Parliament

2.192 The Government Securities Bill, 2004 introduced in the Lok Sabha on December 21, 2004, proposes to consolidate and amend the law relating to Government securities and its management by the Reserve Bank. The Bill provides for: (i) empowering the Reserve Bank to prescribe the form for transferring Government securities; (ii) holding of Government promissory notes by Trusts; (iii) simple procedure for recognising title to Government securities up to rupees one lakh with an enabling power to the Central Government to enhance the said limit up to rupees one crore; (iv) micro films, facsimile copies of documents, magnetic tapes and computer printouts to be admissible as evidence; and (v) suspension of the holders of subsidiary general ledger account from trading with the facility of that account in the event of misuse of the said facility. Other salient features of the Bill include enabling creation of pledge, hypothecation or lien in respect of Government securities; empowering the Reserve Bank to call for information, cause inspection and issue directions as well as make regulations with the previous approval of the Central Government for carrying out the purposes of the Bill.

2.193 The Reserve Bank of India (Amendment) Bill 2005 and the Banking Regulation (Amendment) Bill 2005 tabled in the Parliament in May 2005, were subsequently referred to the Standing Committee on Finance. The Reserve Bank of India (Amendment) Bill, 2005 seeks to amend the Reserve Bank of India Act, 1934. The Bill includes provisions for: (i) defining the expressions 'derivative', 'repo' and 'reverse repo'; (ii) empowering the Reserve Bank to deal in derivatives, to lend or borrow securities and to undertake repo or reverse repo; (iii) removing the lower floor and upper ceiling of CRR and to provide flexibility to the Reserve Bank to specify CRR; (iv) empowering the Reserve Bank to specify derivatives which may be traded outside stock exchange (OTC Derivatives) between bank and other institutions to be specified by the Reserve Bank for removing the ambiguity regarding their legal validity; and (v) empowering the Reserve Bank to lay down policy and issue directions to any agency dealing in various kinds of contracts in respect of Government securities, money market instruments, derivatives and to inspect such agencies.

2.194 The Banking Regulation (Amendment) Bill, 2005 mainly contains amendments to the Banking Regulation Act, 1949. The proposed amendments, *inter alia*, include: (i) redefining the term 'approved securities' as the securities issued by the Central Government or State Government and the securities specified by the Reserve Bank; (ii) enabling banking companies to issue preference shares as per the guidelines framed by the Reserve Bank; (iii) inserting new section requiring prior approval of the Reserve Bank for acquisition of five per cent or more of shares and voting rights of a banking company by any person and empowering it to stipulate the terms and conditions for grant of such approvals and concurrently removing the restriction on voting rights; (iv) removing the restriction on voting rights; (v) empowering the Reserve Bank to grant exemption to any banking company from the provisions of Section 20 in respect of the restriction on entering into any commitment for granting any loan or advance to any company in which a director of the banking company is interested; (vi) doing away with the lower floor of 25 per cent in respect of SLR and empowering the Reserve Bank to specify SLR without any floor subject to the existing ceiling of 40 per cent; (vii) empowering the Reserve Bank to direct banking companies to disclose financial

statements or to furnish the same to the Reserve Bank along with such other statements and information relating to the business or affairs of their associate enterprises and also to cause their inspection to be made; (viii) empowering the Reserve Bank to supercede the Board of a banking company; and (ix) empowering the Reserve Bank to order special audit of the accounts of a co-operative bank in public interest.

Bills under consideration of the Government

2.195 Payment and Settlement Systems Bill seeks to designate the Reserve Bank as the authority to regulate payment and settlement systems. The Bill *inter alia*, contains: (i) provisions for compulsory requirement of an authorisation by the Reserve Bank to operate payment system; (ii) empowering the Reserve Bank to regulate and supervise the payment systems by determining standards, calling for information, returns and documents; (iii) audit and inspection by entering the premises where payment systems are being operated; (iv) issue directions; and (v) providing for settlement and netting to be final and irrevocable at the determination of the amount of money, securities or foreign exchange payable by participants by overriding other laws.