Chapter II

Policy Developments in Commercial Banking

Introduction

2.1 Globalisation, financial deregulation and improvement in technology have had a profound effect on the financial landscape in recent years. These developments have intensified competition and resulted in financial engineering through product innovation and business strategies. While market participants have now greater scope to diversify risk and manage it efficiently, this has also posed new risks and challenges to the financial system. Growth of financial firms across different business lines and across national boundaries has made the task of designing appropriate policies more challenging. Regulatory and supervisory policies are, therefore, constantly assessed regarding their capabilities to meet the challenges of containing systemic risk in the financial system. The main challenge for the supervisory authorities has been to maintain financial stability without curtailing the incentive to innovate.

2.2 Keeping in view the changing landscape in the financial sector, the Reserve Bank has been suitably foscusing its regulatory and supervisory framework to promote a stable and efficient financial sector. The main focus of the Reserve Bankís recent regulatory and supervisory initiatives has been on prudential regulation and financial infrastructure broadly in line with international best practices. However, while focusing on a globally competitive and the robust banking sector, the Reserve Bank has also emphasised financial inclusion, whereby banking services are accessed easily by the under-privileged sections of the society. The overall approach to reforms has been sequenced and arrived at through consultative process with all the stakeholders. Various reform measures initiated from time to time have imparted resilience to the financial system.

2.3 The Reserve Bank had indicated on February 15, 2005 that banks in India would start implementing Basel II with effect from March 31, 2007. Several initiatives, therefore, were taken during the year to facilitate the smooth transition to Basel II. The Reserve Bank permitted banks to raise capital through new instruments to enable them to meet capital requirements prescribed under Basel II. The Reserve Bank also issued a guidance note for operational risk management. Taking into account the state of preparedness of the banking system, however, it was announced in the Mid-term Review of the Annual Policy for 2006-07 on October 31, 2008 that Indian banks with presence outside India and foreign banks operating in India would be required to migrate to Basel II framework with effect from March 31, 2008, while all other Indian banks would be encouraged to migrate to these norms by March 31, 2009.

2.4 With a view to providing basic banking services to common man, the Reserve Bank took several measures to incentivise banks. Improvement in customer service was another area of focus of the Reserve Bankís regulatory policy during 2005-06.

2.5 This Chapter provides an account of various policy measures undertaken by the Reserve Bank in the Indian commercial banking sector during 2005-06 (July-June) and major policy developments during 2006-07 (up to October 31, 2006). The stance of monetary policy as evolved during the year together with monetary policy measures is presented in Section 2, followed by a review of the measures initiated in the area of credit delivery in Section 3. Initiatives taken in the areas of prudential regulation and supervision are set out in Section 4 and Section 5, respectively. Section 6 details policy developments in the area of financial markets, *i.e.*, the money market, the Government securities market and the foreign exchange market. This is followed by an account of the measures initiated in the area of customer service by banks in Section 7. Section 8 elaborates the policy initiatives on financial inclusion. Policy measures relating to payment and settlement systems and technological developments are outlined in Section 9 and Section 10, respectively. Section 11 details the measures undertaken to strengthen the legal infrastructure.

2. Monetary and Credit Policy

2.6 The framework for the monetary, structural and prudential measures that are initiated during the course of the year is provided in the policy Statements comprising Annual Policy Statement in April, Mid-term Review in October/November and two quarterly reviews in January and July.

2.7 Consistent with the overall objectives of achieving growth while ensuring price and financial stability, monetary management during the year had to be proactive in keeping pace with the evolving domestic and international challenges, arising out of increasing sophistication of domestic financial markets and its integration with international markets. Overall activity in the banking sector, as in the rest of the financial system, was influenced by slight change in emphasis of priorities in the stance of monetary policy during 2005-06. A shift in the underlying trends of macroeconomic and financial conditions necessitated timely rebalancing of weights assigned to the key objectives of growth, adequate liquidity, price and financial stability, inflationary expectations and interest rate environment throughout the year. The uncertainty surrounding global economic prospects was amply reflected in the Annual Policy Statement for 2005-06 and Quarterly Reviews thereof. The relative emphasis on growth in the Annual Policy Statement of April 2005 gave way to increasing considerations for price stability in the hierarchy of policy priorities in the Mid-term Review of October 2005. Financial stability emerged as a key concern in the January review and continued to be a priority in the policy matrix right till the Mid-term Review of Annual Policy for 2006-07 (October 2006). By April 2006, however, growth regained eminence and began to share equal emphasis with price stability in the policy stance (Box II.1).

2.8 In April 2005, the Reserve Bank faced two major challenges, *viz.*, (a) reining in inflationary expectations so as to ensure stability in the financial markets and to maintain appropriate levels of financing conditions to lend support to the ongoing growth momentum; and (b) appropriate liquidity management in the context of budgeted Government borrowings in the backdrop of strong credit growth. Accordingly, the Annual Policy Statement for the year 2005-06 emphasised the maintenance of appropriate liquidity in the system, ensuring macroeconomic and price stability, and stabilisation of inflation expectations. The Reserve Bank sought to moderate inflation expectations by a demonstrable commitment to price stability. The policy rate, *i.e.*, the reverse repo rate under the Liquidity Adjustment Facility (LAF) was raised by 25 basis points while maintaining the repo rate at 6.0 per cent, thereby reducing the spread between reverse repo and repo rates to 100 basis points. The financial markets responded positively to the monetary policy stance. In response to resurgence of capital flows, the cap on Market Stabilisation Scheme (MSS) was retained at Rs.80,000 crore, in order to modulate liquidity conditions during 2005-06.

2.9 In the ensuing months, the balance of risks appeared tilted to the external sector with widening global imbalances, persistent currency misalignments, upward trajectory of the policy rate in the US, and high and volatile international prices of oil. In addition, there were pressures from domestic factors in the form of overhang of liquidity, rising credit growth due to sustained industrial growth and capacity pressures, widening trade deficit, infrastructural constraints and delayed monsoon. The initiation of monetary and fiscal measures to mitigate the impact of the administered oil price hike in June 2005, sustained corporate earnings and profits, and moderate inflation favoured *status quo* in the monetary policy stance in the First Quarter Review of Annual Policy Statement in July 2005.

2.10 In the following period, several factors posed risks to the outlook on inflation and growth such as credit quality, rising asset prices, high and volatile international oil prices with a substantial permanent component, the widening trade deficit and the upturn in the international interest rates. The Mid-term Review in October 2005 reaffirmed the stance set out in the Annual Policy Statement while placing greater emphasis on price stability. Recognising that without an immediate policy response, it would be difficult to contain inflation within the projected range of 5.0-5.5 per cent, the fixed reverse repo and the repo rates under the LAF were increased in the Mid-term Review by 25 basis points while retaining the spread between the rates at 100 basis points.

2.11 In the following quarter, inflation expectations stabilised in a manner consistent with policy projections. First, demand pull factors

Box II.1: Stance of Monetary Policy during April 2005 to October 2006

Annual Policy Statement, 2005-06 (April 2005) and the First Quarter Review (July 2005)

ï Provision of appropriate liquidity to meet credit growth, and support investment and export demand in the economy while placing equal emphasis on price stability.

ï Consistent with the above, to pursue an interest rate environment that is conducive to macroeconomic and price stability, and maintaining the momentum of growth.

ï To consider measures in a calibrated manner, in response to evolving circumstances, with a view to stabilising inflationary expectations.

Mid-term Review of Annual Policy Statement, 2005-06 (October 2005)

ï Consistent with emphasis on price stability, provision of appropriate liquidity to meet genuine credit needs, and support export and investment demand in the economy.

ï Ensuring an interest rate environment that is conducive to macroeconomic and price stability and maintaining the growth momentum.

ï To consider measures in a calibrated and prompt manner in response to evolving circumstances with a view to stabilising inflationary expectations.

Third Quarter Review of Annual Policy Statement, 2005-06 (January 2006)

ï To maintain the emphasis on price stability with a view to anchoring inflationary expectations.

ï To continue to support export and investment demand in the economy for maintaining the growth momentum by ensuring a conducive interest rate environment for macroeconomic, price and financial stability.

ï To provide appropriate liquidity to meet genuine credit needs of the economy with due emphasis on quality.

ï To consider responses, as appropriate, to evolving circumstances.

Annual Policy Statement, 2006-07 (April 2006)

ï To ensure a monetary and interest rate environment that enables continuation of the growth momentum consistent with price stability while being in readiness to act in a timely and prompt manner on any signs of evolving circumstances impinging on inflationary expectations.

ï To focus on credit quality and financial market conditions to support export and investment demand in the economy for maintaining macroeconomic, in particular, financial stability.

ï To respond swiftly to evolving global developments.

First Quarter Review of Annual Policy Statement, 2006-07 (July 2006)

ï To ensure a monetary and interest rate environment that enables continuation of the growth momentum while emphasising price stability, with a view to anchoring inflationary expectations.

ï To reinforce the focus on credit quality and financial market conditions to support export and investment demand in the economy for maintaining macroeconomic and, in particular, financial stability.

ï To consider measures as appropriate to the evolving global and domestic circumstances impinging on inflationary expectations and the growth momentum.

Mid-term Review of Annual Policy Statement, 2006-07 (October 2006)

ï To ensure a monetary and interest rate environment that supports export and investment demand in the economy so as to enable continuation of the growth momentum while reinforcing price stability with a view to anchoring inflation expectations.

ï To maintain the emphasis on macroeconomic and, in particular, financial stability.

ï To consider promptly all possible measures as appropriate to the evolving global and domestic situation.

remained reasonable, although there was a significant pick-up in overall activity. The modest ebbing of crude prices from their highs in August-September 2005 and the softening of global prices of agricultural products also mitigated the pressures from imported inflation. Second, the widening of the trade deficit on account of high crude prices and buoyant industrial demand for imported inputs was adequately financed by capital flows. The rupee appreciated against the US dollar by about 2.0 per cent between early November 2005 and mid-January 2006. Third, appropriate and flexible liquidity management by the Reserve Bank matched financial market sentiments, enabling market expectations on inflation to evolve synchronously with the policy stance. This was reflected in decline in the overhang of liquidity by about Rs.60,500 crore between September 2005 and January 2006. In response to the needs of market participants, the Reserve Bank introduced a second LAF with effect from November 28, 2005, as an additional instrument to fine-tune liquidity management.

2.12 The Third Quarter Review of January 24, 2006 noted that risks to growth and stability were high emanating from rising domestic demand, the incomplete pass-through of crude prices into domestic prices and global developments. Emphasising the need to consolidate the gains of recent high growth, the monetary policy stance placed greater emphasis on price stability and towards containing inflation expectations. Developments in the ensuing months vindicated the policy response as inflation was contained and inflationary expectations stabilised.

2.13 An important aspect in the conduct of monetary policy in the latter period of 2005-06 was the modulation of liquidity in tune with the evolving situation. Pressures on liquidity, which were in evidence in the fourth quarter of 2005-06 (January-March 2006) were partly frictional, arising from seasonal and transient factors such as the redemption of India Millennium Deposit (IMD), and partly cyclical, associated with the upturn in credit demand. Since mid-January 2006, the recourse of market participants to primary liquidity support from the Reserve Bank suggested that there was also some overlap between frictional and cyclical liquidity on account of two factors. First, some market participants had not prepared for the liquidity implications of the movements in the interest rate cycle as also the one-off impact of IMD redemption and, as a consequence, found themselves facing a shortage of liquidity as well as eligible securities with which to access the Reserve Bankís liquidity facilities or even the collateralised money market. Second, the banking system as a whole was significantly overdrawn in order to sustain the credit disbursements. Consequently, mismatches between the sources and uses of funds became persistent, forcing them to seek recourse to borrowing and rolling over, on an overnight basis, thereby putting pressure on interest rates and liquidity conditions.

2.14 The Annual Policy Statement for 2006-07 announced in April 2006 had stated that in the context of macroeconomic developments and the global scenario, it was necessary to be in readiness to act as warranted by the challenges posed by the evolving situation given the unfolding of the risks. Risks to both growth and stability from domestic and global factors were, however, recognised with the balance of risks tilted towards the global factors. The adverse consequences of further escalation of international crude prices and/or of disruptive unwinding of global imbalances were seen as likely to be pervasive across economies, including India. Moreover, in a situation of global tightening of monetary policy, India could not afford to be out of step. Therefore, the overall stance of monetary policy for 2006-07 assigned more weight to global factors than before while also keeping in view the dominance of domestic factors. The Reserve Bank indicated its resolve to act in a timely and prompt manner on any sign of heightened inflationary expectations. A key element was the focus on credit quality, even while supporting export and investment demand and macroeconomic and financial stability.

2.15 After the announcement of the Annual Policy Statement, the edging up of inflation across the world and marked and heightened volatility in the financial markets posed a threat to the domestic economy which, thus far, had been spared of turbulence in the debt and foreign exchange markets. These developments, viewed in the light of the prevailing monetary and credit environment underscored a compulsion for swift action, as indicated in the Annual Policy Statement. Accordingly, on June 8, 2006 the LAF reverse repo/repo rates were increased by 25 basis points while retaining the spread between the repo and the reverse repo rate at 100 basis points.

2.16 In the First Quarter Review of 2006-07, it was underlined that while the prevailing assessment pointed to the domestic economy exhibiting strong fundamentals and displaying considerable resilience, at the same time, there was continued evidence of demand pressures, especially continuing high growth that could exert upward pressure on prices when associated with supply shocks. These pressures were indicated to have the potential to impact stability and inflationary expectations. It was noted that while domestic developments dominate the economy, global factors tend to gain more attention than before. The global outlook for growth was positive but downside risks with regard to inflation and re-pricing of risks in financial markets needed to be recognised. Hence, it was felt necessary to strike a balance between reinforcing the resilience of the domestic economy and global risks. The Review also noted that both domestic and global factors were delicately balanced in terms of growth *vis-‡-vis* price stability with the likely possibility of identified downside risks materalising in the near term than before. Accordingly, the need for careful and continuous monitoring of both global and domestic factors was reflected in the stance of the First Quarter Review of the Annual Statement for 2006-07. On balance, a modest pre-emptive action in monetary policy was considered appropriate, while being ready to respond flexibly and promptly by closely monitoring the domestic developments.

2.17 In the Mid-term Review of Annual Policy Statement released on October 31, 2006, it was indicated that the Reserve Bank will ensure to maintain appropriate liquidity in the system so that all legitimate requirements of credit are met, particularly for productive purposes, consistent with the objective of price and financial stability. In view of the prevailing current macroeconomic and overall monetary conditions, the fixed repo rate under the LAF was raised by 25 basis points from 7.0 per cent to 7.25 per cent. The reverse repo rate, the Bank Rate and the CRR were left unchanged. As a result, the spread between the repo and reverse repo rate increased to 125 basis points. Several measures were also announced to (i) further develop and integrate financial markets, with a view to enhancing allocative efficiency; (ii) improve and expand credit delivery oriented towards financial inclusion and extension of financial services to the under-privileged segments of the population; (iii) strengthen the capital base of banks with a view to preparing them to migrate to Basel II norms and implement prudential measures in consonance with international best practices in the financial sector; and (iv) keep up the pace of liberalisation of the external sector within the framework for fuller capital account convertibility recommended by the Committee (Chairman: Shri S.S. Tarapore) appointed by the Reserve Bank with the objectives of promoting economic growth, improving financial sector efficiency and providing opportunities for diversification of investments by residents (Box II.2).

Statutory Pre-emptions

2.18 Since June 1991, there has been a distinct move away from the use of direct instruments of monetary policy to market-based indirect instruments. As a result, the statutory pre-emptions in the form of cash reserve ratio (CRR) and statutory liquidity ratio (SLR) have been significantly reduced in phases. The SLR was progressively brought down from the peak rate of 38.5 per cent of net demand and time liabilities (NDTL) in February 1992 to the statutory minimum of 25 per cent by October 1997. While the stipulated level of SLR has remained unchanged since then, banks on their own volition have been holding investments in Government and other approved securities in excess of the stipulated level. During 2005-06, while banks considerably reduced their holding of SLR securities because of upturn in the interest rate cycle and surge in credit demand, it was still higher than the statutory minimum level at 31.3 per cent at end-March 2006. In terms of volume, such holdings above the minimum SLR level amounted to Rs.1,45,297 crore.

2.19 Pursuing the medium-term objective of reducing the CRR, the Reserve Bank had reduced the CRR progressively from the peak of 15 per cent of NDTL in 1992 to 4.5 per cent by 2003. The CRR, however, was raised by one-half of one percentage point of NDTL in two stages of 0.25 percentage points each to 4.75 per cent effective September 18, 2004 and further to 5.0 per cent effective October 2, 2004 to combat inflationary expectations. The CRR has remained unchanged since then. However, the recent amendment to Section 42 of the RBI Act, 1934, in June 2006, vests the Reserve Bank with the power to prescribe CRR for scheduled banks without any floor or ceiling rate. Further, the amendment removes the statutory minimum CRR and the Reserve Bank cannot pay interest on any portion of CRR balances of banks once the Act comes into force (see Box II.28, Section 11).

Interest Rate Structure

2.20 Consistent with the growing market orientation of monetary policy operations and the increasing reliance on indirect instruments of monetary control, rationalising and refining the interest rate structure in the economy has been a key objective of financial sector reforms initiated by the Reserve Bank in the early 1990s. Deregulation of interest rates has helped in improving the competitiveness of the financial system and resource allocation process through efficient price discovery, besides strengthening the transmission mechanism of monetary policy. All interest rates have been deregulated except (i) savings deposit accounts, (ii) non-resident Indian (NRI) deposits, (iii) small loans up to Rs.2 lakh, and (iv) export credit.

Box II.2: Major Policy Announcements in the Mid-Term Review of Annual Policy for the Year 2006-07

1. Monetary Measures

ï Bank Rate left unchanged at 6.0 per cent.

ï Repo Rate under the LAF increased by 25 basis points from 7.0 per cent to 7.25 per cent effective October 31, 2006. Reverse Repo Rate left unchanged at 6.0 per cent.

ï The cash reserve ratio (CRR) left unchanged at 5.0 per cent.

2. Government Securities Market

ï ëWhen Issuedí trading to be extended in the case of fresh issues of Central Government securities on a selective basis.

ï Scheduled commercial banks and primary dealers are allowed to cover their short positions in Central Government securities within an extended period of five trading days and to deliver a shorted security by borrowing it through the repo market.

3. Foreign Exchange Market

ï Resident individuals allowed to remit up to US $ 50,000 per financial year for any current or capital account transaction or a combination of both, as against the earlier limit of US $ 25,000.

ï Large turnkey/project exporters/service exporters with satisfactory track record allowed to operate one foreign currency account with inter-project transferability of funds/machinery in any country, subject to specified reporting requirements.

ï Large turnkey/project exporters/service exporters with good track record allowed to deploy their temporary cash surpluses in either short-term bank deposits or AAA-rated short-term paper abroad, subject to monitoring by the authorised dealer bank(s).

ï Prepayment of ECB up to US $ 300 million, as against the earlier limit of US $ 200 million, to be allowed by authorised dealer banks without prior approval of the Reserve Bank subject to the stipulated minimum average maturity period as applicable to the loan.

ï Authorised dealer banks to allow remittances on behalf of their customers up to 15 per cent of the average annual sales/ income or turnover during the last two financial years or up to 25 per cent of their net worth, whichever is higher, for initial expenses, and allow remittances up to 10 per cent of the average annual sales/income or turnover during the last two financial years for recurring expenses. They are also allowed to permit remittances for acquisition of immovable property for the overseas office, within these limits.

ï The existing limit of US $ 2 billion on investments in Government securities by foreign institutional investors (FIIs) to be enhanced to US $ 2.6 billion by December 31, 2006 and further to US $ 3.2 billion by March 31, 2007.

ï The extant ceiling of overseas investment by mutual funds of US $ 2 billion enhanced to US $ 3 billion.

ï Authorised dealer banks are permitted to issue guarantees/letters of credit for import of services up to US $ 100,000 where the guarantee is intended to secure a direct contractual liability arising out of a contract between a resident and a non-resident.

ï The lock-in period eliminated for sale proceeds of the immovable property credited to the NRO account, provided the amount being remitted in any financial year does not exceed US $ one million.

4. Credit Delivery Mechanisms

ï Consistent with the notification of the Micro, Small and Medium Enterprises Development Act, 2006, the definition of small-scale industry and micro and small enterprises engaged in providing or rendering of services for the purpose of priority sector lending modified.

ï Banks to formulate a transparent policy, with approval of their boards, for providing One Time Settlement facility to those farmers whose accounts have been rescheduled/restructured due to natural calamities as also those who have defaulted on account of circumstances beyond their control.

5. Prudential Measures

ï Foreign banks operating in India and Indian banks having presence outside India are allowed to migrate to the Standardised Approach for credit risk and the Basic Indicator Approach for operational risk under Basel II with effect from March 31, 2008. All other scheduled commercial banks are to migrate to these approaches under Basel II in alignment with them but in any case not later than March 31, 2009.

ï Prudential limit on credit and non-credit facilities to Indian Joint Ventures/Wholly Owned Subsidiaries abroad extended by banks enhanced from the existing 10 per cent to 20 per cent of unimpaired capital funds (Tier I and Tier II capital).

6. Financial Inclusion

ï For opening small accounts, banks need to seek only a photograph of the account holder and self-certification of address.

ï Outstanding balances in these accounts at any time will be limited to Rs.50,000 and the total transactions limited to Rs.2,00,000 in one year.

7. Payment and Settlement Systems

ï Banks urged to harmonise their IT-based initiatives to ensure that the objective of greater financial inclusion is achieved.

8. Urban Co-operative Banks

ï UCBs registered in States that have signed Memorandum of Understanding with the Reserve Bank and those registered under the Multi-State Co-operative Societies Act, 2002 are allowed to convert existing extension counters into full-fledged branches.

ï The Reserve Bank to place a model draft Fair Practices Code for consideration of Task Forces for UCBs set up in the States that have signed MoU for deliberation and adoption.

9. Non-Banking Financial Companies

ï NBFCs allowed to issue co-branded credit cards with banks without risk sharing; and to market and distribute mutual fund products as agents of mutual funds.

ï NBFCs engaged in financing real/physical assets supporting economic activity such as automobiles and general purpose industrial machinery to be re-grouped as asset financing companies.

10. Committee on Financial Sector Assessment

ï The Committee on Financial Sector Assessment to undertake a self-assessment of financial sector stability and development.

Bank Rate and Repo/Reverse Repo Rate

2.21 The Bank Rate (BR) was reactivated in April 1997 as a signaling mechanism to convey the stance of monetary policy. The rates of various standing facilities of the Reserve Bank were linked to the BR. The BR has served well as a signaling rate for the medium-term.

2.22 In the recent period, however, short-term liquidity adjustment is being conducted through the repo/reverse repo rates under the LAF. The LAF scheme is being operated through overnight fixed rate repo and reverse repo from November 1, 2004. In view of the changing macroeconomic and overall monetary conditions, reverse repo and repo rates were regularly revised (Table II.1).

Deposit Rates

2.23 The interest rates on domestic term deposits, except for saving bank accounts, have been deregulated since October 1997. Banks are now free to determine their own deposit rates depending on commercial judgment, subject to the approval of their boards. Banks have also been given the freedom to decide the rates on various non-resident deposits, subject to the ceiling prescribed by the Reserve Bank. Banks were also allowed to offer differential rates of interest on wholesale domestic term deposits of Rs.15 lakh and above, *i.e.*, the interest rate offered on the wholesale domestic term deposits can differ from those offered on the retail domestic term deposits.

2.24 The interest rate on savings bank deposits is regulated by the Reserve Bank and is currently prescribed at 3.5 per cent per annum. Based on a review of prevailing monetary and interest rate conditions, including a careful consideration of the suggestions received from the Indian Banksí Association (IBA), the Annual Policy Statement for 2006-07 considered it appropriate to maintain *status quo* while recognising that the deregulation of savings bank deposit rate was essential for product innovation and price discovery in the long run.

Table II.1: Repo and Reverse Repo Rate
(since April 2005)

(per cent)

	Effective Date	Repo Rate	Reverse Repo Rate
1	2	3	4
1.	April 29, 2005	6.00	5.00
2.	October 26, 2005	6.25	5.25
3.	January 24, 2006	6.50	5.50
4.	June 9, 2006	6.75	5.75
5.	July 25, 2006	7.00	6.00
6.	October 31, 2006	7.25	6.00

2.25 The ceiling on interest rates on non-resident external rupee deposits (NRE) and foreign currency non-resident (Bank) [(FCNR(B)] deposits are linked to the LIBOR/SWAP rates and are reviewed regularly, depending on the monetary and macroeconomic developments. In response to the upturn in international interest rates and the firming up of forward premia in the domestic foreign exchange market, interest rate differentials on NRE deposits turned progressively unattractive. Accordingly, the ceiling interest rate on NRE deposits for one to three year maturity was increased in November 2005 and again in April 2006. The ceiling interest rate on FCNR(B) deposits was raised for the respective currency/maturities on March 28, 2006 (Table II.2).

2.26 On July 26, 2005, banks were allowed to accept FCNR(B) deposits denominated in Canadian and Australian dollars in addition to the four currencies, *viz.*, US dollar, pound sterling, euro and yen, up to a maximum maturity period of five years. In February 2006, banks were advised that the Foreign Exchange Dealers Association of India (FEDAI) would quote/display the LIBOR/SWAP rates to be used for fixing interest rates on NRI deposits in order to ensure uniformity and transparency. FEDAI publishes the deposit rates for five maturities in six currencies prevailing on the last working day of each month.

Table II.2: Ceiling Interest Rate Prescriptions for NRE/FCNR(B) Deposits

	Earlier Ceiling	Revised Ceiling
1	2	3
NRE deposit	LIBOR/ SWAP rates plus 75 basis points (close of business on November 17, 2005)	LIBOR/ SWAP rates plus 100 basis points (close of business on April 18, 2006)
FCNR (B) deposit	LIBOR/ SWAP rates minus 25 basis points (close of business on April 29, 2002)	Within the ceiling of LIBOR/SWAP rates (close of business on March 28, 2006)

Note: Dates in brackets indicate effective dates for change in the rates.

Lending Rates

2.27 The lending rates have been gradually deregulated beginning October 1994. The lending rates currently regulated by the Reserve Bank are the ceiling rates for export credit and small loans up to Rs.2 lakh.

2.28 The scheme for export credit has been under constant review with a view to ensuring that the Indian exporters have access to bank credit at internationally competitive terms so as to support export promotion. In this context, the Working Group to Review Export Credit (Chairman: Shri Anand Sinha) in its Report submitted in May 2005 recommended that the interest rates in respect of export credit in foreign currency may be raised by 25 basis points, *i.e.*, to LIBOR + 100 basis points for the first slab and additional 200 basis points for the second slab, subject to the condition that the banks will not levy any other charges in any manner under any name such as service charge and management charge, except for recovery towards out-of-pocket expenses incurred. Accordingly, the ceiling interest rate on export credit in foreign currency was increased by 25 basis points with effect from April 18, 2006. Similar changes were effected in interest rates in cases where EURO LIBOR/ EURIBOR have been used as benchmarks.

2.29 The Reserve Bank currently announces the ceiling rates on pre-shipment rupee export credit up to 180 days and post-shipment rupee credit up to 90 days, linked to the Benchmark Prime Lending Rate (BPLR). The validity of the reduction in the interest rate ceiling to 250 basis points below BPLR on pre-shipment rupee export credit up to 180 days and post-shipment rupee export credit up to 90 days was extended up to October 31, 2006.

2.30 In order to help farmers obtain credit at a reasonable rate, the Union Budget, 2006-07 proposed provision of short-term credit to farmers up to Rs.3 lakh, at interest rate of 7 per cent per annum with effect from 2006-07, with the Government agreeing to provide budgetary resources to co-operative banks appropriately.

3. Credit Delivery

2.31 A critical issue facing the banking sector is the flow of credit to all productive sectors of the economy. Therefore, it has been the endeavour of the Reserve Bank to create a conducive environment for banks to provide adequate credit to all productive sectors at reasonable cost. In continuance with the general focus on sectoral credit allocation, especially to the priority sector, the Reserve Bank took several measures to improve credit delivery mechanism during the year. Several relief measures were also initiated by the Reserve Bank to mitigate the impact of natural calamities/disasters that struck the country during the year. Special plans were worked out for improving credit flow to trade and industry in the State of Jammu and Kashmir. The priority sector norms were further fine-tuned to focus on implementation of various Government schemes, improvement in credit delivery channels for small and marginal borrowers, inclusion of additional channels within the priority sector and simplified norms for NPA resolution. For improving the flow of credit to the agriculture sector, a follow-up action was taken in line with the recommendations of the Advisory Committee on Flow of Credit to Agriculture and Related Activities from the Banking System (Chairman: Prof. V.S. Vyas) and the measures announced in the Union Budget for 2006-07. A debt restructuring mechanism for small and medium enterprises (SMEs) and ëone time settlementí scheme for SME accounts were devised subsequent to the announcement made by the Union Finance Minister for stepping up credit to SMEs.

Priority Sector Lending[1]

2.32 A target of 40 per cent of net bank credit has been stipulated for lending to the priority sector by domestic scheduled commercial banks, both in the public and private sectors. Within this, sub-targets of 18 per cent and 10 per cent of net bank credit, respectively, have been stipulated for lending to agriculture and weaker sections, respectively. A target of 32 per cent of

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

net bank credit has been stipulated for lending to the priority sector by foreign banks. Of this, the aggregate credit to small scale industries should not be less than 10 per cent and to the export sector not less than 12 per cent of the net bank credit.

2.33 In order to align bank credit to the changing needs of the society and enhance the flow of credit to the priority sector, the following policy initiatives were taken during 2005-06:

(i) Banks were advised that fresh investments made by them on or after July 1, 2005 in venture capital would not be eligible for classification under priority sector lending. Investments already made up to June 30, 2005 would not be eligible for classification under priority sector lending with effect from April 1, 2006.

(ii) Detailed guidelines were issued to banks for stepping up credit to SMEs.

(iii) A One-time Settlement Scheme for recovery of NPAs below Rs. 10 crore for SME accounts were communicated to public sector banks for implementation.

(iv) Banks were advised to ensure restructuring of debt of all eligible SMEs at terms which are, at least as favourable as the Corporate Debt Restructuring mechanism in the banking sector.

(v) In order to offer small borrowers an opportunity to settle their NPA accounts with banks and to become eligible for fresh finance, banks were advised in December 2005 to provide a simplified mechanism for one-time settlement of loans where the principal amount is equal to or less than Rs.25,000 and which have become ëdoubtful or loss assetsí as on September 30, 2005. In the case of loans granted under Government-sponsored schemes, banks were advised to frame separate guidelines following a State-specific approach to be evolved by the State Level Bankersí Committee (SLBC).

(vi) Banks were allowed in December 2005 to introduce a General Credit Card (GCC) Scheme for issuing general credit cards to their constituents in rural and semi-urban areas, based on the assessment of income and cash flow of the household, and without any insistence on security and the purpose or end-use of the credit. Banks could utilise the services of local post offices, schools, primary health centres, local government functionaries, farmersí associations/clubs, well established community-based agencies and civil society organisations for sourcing of borrowers for issuing cards. To incentivise the implementation of the scheme, fifty per cent of the credit outstanding under loans for general purposes under GCC scheme was made eligible for classification as indirect finance to agriculture within the priority sector.

(vii) Banks were advised that loans to power distribution corporations/companies, emerging out of bifurcation/restructuring of State Electricity Boards (SEBs), for reimbursement of the expenditure already incurred by them for providing low tension connection from step-down point to individual farmers for energising their wells, may also be classified as indirect finance to agriculture.

Credit to Agriculture and Allied Activities

2.34 In line with the announcement made by the Central Government in June 2004 to double the flow of credit to agriculture in three years, the Union Budget, 2005-06 proposed to increase the flow of credit to agriculture by 30 per cent during the year. Keeping this in view, the Reserve Bank took several measures to enhance credit flow to agriculture. As against a target of Rs.1,05,000 crore to the agriculture sector for 2004-05, banks (including co-operative banks and RRBs) disbursed Rs.1,15,243 crore, a growth of 32.0 per cent over the actual disbursement of Rs.86,981 crore during 2003-04. For 2005-06, banks were advised to increase the flow of credit to agriculture to Rs. 1,42,000 crore. As against this target, the disbursement by all banks during 2005-06 was Rs.1,57,480 crore, a growth of 37.0 per cent over the disbursement during the previous year.

2.35 Most of the recommendations of the Advisory Committee on Flow of Credit to Agriculture and Related Activities from the Banking System (Chairman: Prof V.S. Vyas), set up by the Reserve Bank to examine the problems relating to agricultural credit have been implemented by the Reserve Bank and NABARD (Box II.3).

Box II.3: Advisory Committee on Flow of Credit to Agriculture and Related Activities from the Banking System ñ A Status Report

The Advisory Committee on Flow of Credit to Agriculture and Related Activities from the Banking System (Chairman: Prof V.S. Vyas) had made 99 recommendations. Out of these, 31 recommendations were accepted by the Reserve Bank and communicated to banks for implementation. These included *inter alia*: (i) waiving margin/security requirements on agricultural loans up to Rs.50,000 and in the case of agri-clinics, up to Rs.5 lakh; (ii) providing loan for storage facilities, irrespective of location under priority sector lending; (iii) including of investment by banks in securitised assets in agriculture under the priority sector; (iv) revising NPA norms for agricultural finance; (v) dispensing with the Service Area Approach except for the Government sponsored schemes; (vi) reviewing systems and procedures of banks to make lending cost-effective as well as saving avoidable expenses for borrowers; (vii) exploring the financing models for oral lessees such as self-help groups (SHG) and joint liability groups (JLG); (viii) preparing long-term plans in consultation with the State governments for wasteland/ watershed development and providing resource support; (ix) posting technical staff at head/controlling offices and changing the mindset of bankers with regard to agricultural lending; (x) appointing of direct selling agents by banks, subject to guidelines as approved by their boards; (xi) formulating time-bound programme for using IT in general branches; (xii) constituting local advisory committees for branch/group of branches comprising users of banksí services as members; and (xiii) restructuring of loans in the absence of *Annewari*.

Four of Committeeís recommendations were not accepted by the Reserve Bank. These were: i) restricting the framework of special agricultural credit plan (SACP) of direct lending to the agricultural sector, comprising both production and investment credit, while banks could have their own separate review mechanism for indirect lending to agriculture; (ii) retaining the earlier norm of 180 days default for classifying a loan as NPA for loans to agriculture and allied activities; (iii) considering only the account with default for NPA classification and not the outstandings, when a farmer has availed both production and investment loans; and (iv) holistic monitoring of the entire rural credit situation by NABARD.

Action on 43 other recommendations has already been initiated by NABARD. These mainly included: (i) constituting a core group of bank and state government officials as well as experts from agriculture universities to look into the scope of communication and information technologies in transforming agriculture; (ii) making *Kisan* credit cards (KCC) ATM-enabled and convertible to smart card with a view to reduce transaction costs and improve customer service; (iii) restructuring of farm loans at reasonable rates of interest; (iv) offering SHGs need-based savings and credit products, and possibility of offering them credit cards similar to KCC and *Swarojgar* credit cards; (v) ensuring that institutions lending to MFIs determine the rate of interest charged to their clients on a cost plus reasonable margin basis; (vi) focusing on promotional initiatives to create replicable models with a clear built-in exit strategy that will improve credit absorption, outreach of the formal banking system, production process, productivity, and sensitisation of the formal credit delivery system in rural areas; and (vii) reviewing the refinance products of NABARD in line with market expectations.

Seven recommendations were accepted by the Ministry of Finance, Government of India. These mainly related to: (i) introduction of negotiable warehousing receipt system; (ii) reduction of stamp duty in connection with agricultural loans; (iii) legal recognition of rights of tenant farmers and sharecroppers; and (iv) extending financial support in collecting dues as the Securitisation and Asset Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002,

Six recommendations were not accepted by the Ministry of Finance, Government of India. These were: (i) increasing their direct lending by all public and private sector banks to agriculture to 12 per cent of net bank credit in the next two years and to 13.5 per cent in the two years thereafter; (ii) reckoning indirect lending to agriculture to the extent of 6.0 per cent in the first two years for assessing banksí performance against the 18 per cent target; (iii) allowing competitive external commercial borrowings to NABARD for justifiable purposes; and (iv) differing imposition of corporate income tax on NABARD for five years and a review in this respect in 2007. Two recommendations have been referred to the Ministry of Agriculture and the Ministry of Rural Development. These related to suggestions in respect of (i) banksí associating with contract farming and putting in place a mechanism for proper certification of produce quality to avoid disputes; and (ii) need to relook into the design of the *Swarnajayanti Gram Swarojgar Yojana* (SGSY) and moderating the timing and quantum of subsidies to make it more effective.

Six recommendations concerned RRBs. These mainly related to the restructuring of the RRBs through merger, amalgamation and consolidation, and alternative models for effective implementation. These recommendations are at various levels of implementation.

2.36 In December 2005, banks were advised that officers-in-charge of Small Farmersí Agri-Business Consortium (SFAC) at the State level and nodal officers of SFAC may be invited in the Sub-Committee of State Level Bankersí Committee (SLBC) as ëspecial inviteesí to discuss the problems, if any, faced in the implementation of Scheme for establishment of agri-clinics/agri-business in rural areas.

2.37 The Union Budget for the year 2006-07 announced the interest relief at two percentage points on the principal amount up to Rs.1 lakh on crop loans availed of by the farmers for *Kharif* and *Rabi* seasons 2005-06. Accordingly, banks were advised on March 9, 2006 to credit the amount of relief to the borroweri accounts before March 31, 2006 and thereafter seek reimbursement. For this purpose, out of a grant of Rs.1,700 crore, funds aggregating Rs.840 crore were placed with NABARD and claims of Rs.375 crore have been reimbursed to public and private sector banks as on October 31, 2006.

2.38 Consequent upon the announcement made by the Union Finance Minister in his Budget Speech for the year 2006-07, the public sector banks and regional rural banks were advised that with effect from *Kharif* 2006-07, Government will provide interest rate subvention of 2 per cent per annum to them in respect of short-term production credit up to Rs.3 lakh provided to farmers. This amount of subvention is calculated on the amount of crop loan disbursed from the date of disbursement/drawal up to the date of payment or up to the due date, *i.e.*, March 31, 2007 for the *Kharif* and June 30, 2007 for the *Rabi*, respectively, whichever is earlier. This subvention is available on the condition that they make available short-term credit at ground level at 7 per cent per annum. In the case of RRBs, this is applicable only to short-term production credit disbursed out of their own funds and excludes such credit as supported by refinance from NABARD.

2.39 The All-India Debt and Investment Survey (NSS Fifty-Ninth Round) revealed that the share of money lenders in total dues of rural households increased from 17.5 per cent in 1991 to 29.6 per cent in 2002. Considering that high indebtedness to money lenders can be an important reason for distress of farmers, it was decided in the Annual Policy Statement for the year 2006-07 to set up a Technical Group (Chairman: Shri S.C. Gupta) to review the efficacy of the existing legislative framework governing money lending and its enforcement machinery in different States. The Group is also expected to make recommendations to the State Governments for improving the legal and enforcement framework in the interest of rural households.

Relief Measures for Persons Affected by Natural Calamities

2.40 The Reserve Bank had issued standing guidelines to banks in August 1984 and June 1998 for providing relief in areas affected by natural calamities. These guidelines, *inter alia*, permitted banks to convert/reschedule loans for periods ranging from three to nine years depending upon the successive crop failure/intensity of damage to crops, banks were also allowed to grant fresh crop loans to affected farmers, relax the security and margin norms, and provide consumption loans to the affected persons.

2.41 In view of the loss of life and property caused by *Tsunami* in December 2004 in the States of Andhra Pradesh, Tamil Nadu, Kerala, and the Union Territories of Pondicherry, and Andaman and Nicobar Islands, the convenor banks of respective State Level Bankersí Committees in the concerned States/Union Territories were advised to assess the situation and take immediate measures to provide appropriate relief to the affected people in terms of the standing guidelines. A Task Force (Chairman: Shri V. Leeladhar) was also constituted on December 27, 2004 to monitor the progress of relief and rehabilitation measures through banks and to constantly review the situation.

2.42 The relief package evolved by the Government of India for the write-off of outstanding debt of *Tsunami* affected persons in the Union Territory of Andaman and Nicobar Islands was not implemented although the average amount involved was very small. As a follow up of the discussions held by the Governor of the Reserve Bank with bankers and senior officials of the Union Territory of Andaman and Nicobar Islands at Port Blair in February 2006, an Empowered Task Force (ETF) was constituted to accelerate resolution of relief measures to *Tsunami* affected borrowers, adopting a bank-specific approach. Taking note of the revival package announced by the Government of India for small traders and businessmen in Andaman and Nicobar Islands, the Task Force made certain additional recommendations (Box II.4).

2.43 A spate of natural calamities during 2005-06, *viz.*, floods in Maharashtra (July 2005), earthquake in Jammu and Kashmir (October 2005) and unprecedented rainfall in Tamil Nadu (November/December 2005) affected the lives of people. In all these cases, the Reserve Bank advised the convener bank of the State Level Bankersí Committee to assess the situation and take immediate measures to provide appropriate relief to the affected people in terms of the standing guidelines on relief measures by banks in areas affected by natural calamities. The measures included: rescheduling/restructuring of existing loans; accounting for such loans as current dues; non-compounding of interest;

Box II.4: Additional Relief Measures for Persons Affected by the *Tsunami*

The additional recommendations made by the Task Force (Chairman: Shri B. Mahapatra) to provide relief measures for persons affected by *Tsunami* are set out below:

ï Since the extent of damage and destruction of life and property in Southern group of islands and entire Nicobar district was much more severe compared to the damage in the Northern group of islands, there should be a complete waiver of all loans, irrespective of outstanding amounts in the Southern group of islands.

ï Housing loans in the personal segment, not covered by insurance claim payment, may be considered for relief, as applicable to respective outstanding amounts envisaged in the revival package of the Government of India.

ï The borrowers with outstanding loans of above Rs.5 lakh in the Northern group of islands, except those under personal segment and covered by financial securities, should be given interest remission on the balance outstanding as on December 26, 2004 for one year up to December 31, 2005, subject to a minimum benefit of Rs.1.80 lakh. Housing loans were also recommended to be included to the extent they were not covered by insurance claim payments.

ï The entire additional burden arising out of implementation of the above recommendations may be considered by banks/other financial institutions at their option.

The Union Territory Level Bankersí Committees (UTLBC) convener bank for Union Territory of Andaman and Nicobar Islands was advised in May 2006 to bring the recommendations of the Task Force to the notice of the banks in the Union Territory for early implementation. Progress made in this regard is required to be invariably monitored in the quarterly UTLBC meetings.

The Ministry of Home Affairs, Government of India, announced a revival package of Rs. 57.5 crore for small traders and businessmen in Andaman and Nicobar Islands, who had suffered direct and indirect losses due to the devastation caused by *Tsunami* on December 26, 2004, were granted loans by commercial banks/other financial institutions. The Government of India has since revised the revival package to Rs. 79.5 crore. Out of the total package, 66.7 per cent is borne by the Government of India, while the remaining 33.3 per cent is borne by banks/financial institutions.

offering financial assistance to artisans, self-employed, traders, tiny and small scale industrial units affected by the unprecedented calamity; increasing the limit of consumption loans; and granting financial assistance for the purpose of repairs/reconstruction of dwelling units.

2.44 The Reserve Bank has issued guidelines/ instructions to banks from time to time for providing relief to bank customers in areas affected by natural calamities. These guidelines are largely confined to agricultural and priority sector loans. However, during natural calamities such as *Tsunami*, heavy rains, floods and earthquakes in some parts of the country, a number of banking activities were affected such as functioning of ATMs, opening of accounts of small customers, operations of accounts in the absence of documents and failure of computer networks. Therefore, the Mid-term Review of the Annual Policy Statement for 2005-06 announced that an Internal Working Group would look into the whole gamut of issues involved and suggest suitable revisions and additions to the existing guidelines to make them comprehensive. Accordingly, the Reserve Bank constituted an Internal Working Group (Chairman: Shri G. Srinivasan). The Group, which submitted its final report on June 12, 2006, made several recommendations to provide relief in areas affected by natural calamities (Box II.5).

2.45 Based on the recommendations of the Group, the Reserve Bank issued some additional guidelines to banks on August 9, 2006 to provide special relief measures in areas affected by natural calamities. The guidelines included: (i) operating from temporary premises in areas where the bank branches are affected by natural calamity and are unable to function normally; (ii) waiving the penalties relating to accessing accounts such as fixed deposits to satisfy customerís immediate requirements; (iii) restoring the functioning of ATMs at the earliest and putting in place arrangements for allowing customers to access other ATM networks and mobile ATMs; (iv) simplifying the procedure for opening of new accounts for persons affected by natural calamities; (v) restructuring the existing loans; and (vi) enhancing the limit on consumption loans. Further, banks were advised on September 4, 2006 that the instructions on moratorium, additional collateral for restructured loans and asset classification in respect of fresh finance would be applicable to all affected restructured borrowal accounts, including accounts of industries and trade, besides agriculture.

2.46 Banks were advised in July 2006 to ensure that loan accounts of farmers, which are overdue as on July 1, 2006, be rescheduled on the lines of the package of ëRelief Measures to the Vidarbha Region in Maharashtraí announced by the Honíble

Box II.5: Internal Working Group on Special Relief Measures by Banks in areas affected by Natural Calamities

The Internal Group (Chairman: Shri G. Srinivasan) made the following recommendations:

- To allow opening of new accounts.
- Customers of one bank to be allowed to use ATM networks of other banks for cash withdrawals with charges being borne by the parent bank.
- To increase daily cash withdrawal limits from ATMs.
- To dispense cash through mobile ATMs.
- To defer payments and waiving of late fees and penalties related to the non-payment of the dues in respect of credit card holders residing in areas affected by natural calamity for a period of one to two months.
- To avoid reporting of adverse credit information by credit card issuing banks.
- To raise consumption loan limit from Rs.250 to Rs.10,000 without any collateral, with a provision for further enhancement to Rs.25,000 at the bankís discretion.
- To allow freezing of loan accounts and lowering of interest rates.
- To formulate a full-fledged comprehensive business continuity plan which should include opening of temporary branches for a period of 30 days, opening of satellite offices, extension counters or mobile banking facilities, alternative arrangements for supply of currency notes in the affected areas, opening of repositories at post offices and treasuries, and facilitating expeditious opening of bank accounts.
- To set up a control room/helpline at the SLBC convenor bank and a helpline each in the Reserve Bank and nodal offices of banks in affected areas.

Prime Minister and the interest thereon (as on July 1, 2006) be waived. Fresh finance was to be ensured to such farmers. The total amount of credit of Rs.1,275 crore envisaged to be released by banks was allocated by Bank of Maharashtra (as SLBC Convenor) among the banks functioning in the districts.

2.47 Some parts of the country witnessed the *Avian flu* (bird flu). Keeping in view the loss of income that had occurred due to culling of birds as well as steep fall in the demand for poultry products and their prices, banks were advised on April 4, 2006 to consider extending the relief to poultry units financed by them. Banks were advised that principal and interest due on working capital loans as also instalments and interest on term loans, which had fallen due for payment on/after the onset of bird flu, *i.e.*, February 1, 2006 and remaining unpaid be converted into term loans. The converted loans were required to be recovered in instalments based on projected future inflows over a period of up to three years with an initial moratorium of up to one year. The remaining portion of the term loan was required to be rescheduled with a moratorium period up to one year, depending upon the cash flow generating capacity of the unit. The reschedulement/conversion was to be completed by June 30, 2006. The borrower was made eligible for fresh need-based finance. The relief measures as above were extended to all accounts of poultry industry, which were classified as standard accounts as on March 31, 2006.

2.48 Guidelines were also issued to banks on May 23, 2006 on the scope of subvention, its calculation and disbursement. The Central Government had placed Rs.80 crore with the Reserve Bank for reimbursing the claims submitted by banks. For this purpose, claims aggregating Rs.75 crore were reimbursed to public sector banks, private sector banks and foreign banks.

Credit Flow to Small and Medium Industries

2.49 Unlike large industries, which have access to various domestic and international sources of finance, small and medium enterprises (SMEs) are dependent largely on bank finance. However, credit to the SME sector has tended to stagnate in recent years. This is a cause of concern given the importance of small scale industries in the overall economy, especially its employment generating potential. The Reserve Bank, therefore, has been making constant efforts to increase the credit flow to SMEs.

2.50 In pursuance to the announcement made by the Union Finance Minister for stepping up credit to small and medium enterprises, public sector banks were advised in August 2005 to take measures to improve the flow of credit to the SME sector. A reporting and monitoring system for the same was also prescribed (Box II.6).

2.51 Consequent upon the announcement made by the Union Finance Minister on August 10, 2005, a one-time settlement scheme for recovery of NPAs

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

In pursuance of the recommendations of the Internal Group on Credit Flow to the SME sector (Chairman: Shri C.S. Murthy), the Union Finance Minister had announced certain measures in the Parliament on August 10, 2005 for stepping up credit to SMEs. As a follow-up to the announcement made, all public sector banks were advised on August 19, 2005 to take the following measures:

ï Units with investment in plant and machinery in excess of SSI limit and up to Rs.10 crore may be treated as Medium Enterprises (MEs). Only SSI financing will be included in the priority sector.

ï All banks may fix self-targets for financing the SME sector so as to reflect a higher disbursement over the immediately preceding year, while the sub-targets for financing tiny and smaller units to the extent of 40 per cent and 20 per cent, respectively, may continue. Banks may arrange to compile data on outstanding credit to the SME sector as on March 31, 2005 as per new definition showing the break up separately for tiny, small and medium enterprises.

ï Banks may initiate necessary steps to rationalise the cost of loans to the SME sector by adopting a transparent rating system with cost of credit being linked to the credit rating of an enterprise.

ï In order to increase the outreach of formal credit to the SME sector, all scheduled commercial banks, including regional rural banks may make concerted efforts to provide credit cover on an average to at least 5 new small/ medium enterprises at each of their semi-urban/urban branches per year.

ï Based on the guidelines issued on lending to the SSI sector, the boards of directors of banks may formulate comprehensive and more liberal policies than the existing ones in respect of loans to the SME sector. Till such time banks formulate such a policy, the current instructions of the Reserve Bank will be applicable to advances granted/to be granted by banks to SME units.

ï In view of the benefits accruing on account of cluster based approach for financing the SME sector, banks may treat it as a thrust area and increasingly adopt the same for SME financing.

ï Banks may ensure specialised SME branches in identified clusters/centres with preponderance of medium enterprises to enable SME entrepreneurs to have an easy access to the bank credit and to equip bank personnel to develop requisite expertise. The existing specialised SSI branches may also be redesignated as SME branches.

ï For wider dissemination and easy accessibility, the policy guidelines formulated by boards of banks as well as the instructions/guidelines issued by the Reserve Bank may be displayed on the respective websites of banks as well as on website of SIDBI. Banks may also prominently display all the facilities/schemes offered by them to small entrepreneurs at each of their branches.

The above measures, except setting up of specialised SME branches in identified clusters/centres with preponderance of medium enterprises, were communicated to all banks for necessary action - private, foreign, regional rural and local area - in August 2005.

The Reserve Bank has constituted empowered committees at the Regional Offices to review the progress in SME financing and rehabilitation of sick SSI and ME units, and coordinate with other banks/financial institutions and the State Governments in removing bottlenecks, if any, to ensure smooth flow of credit to the sector. These regional level committees may decide the need to have similar committees at cluster/district levels.

below Rs.10 crore for SME accounts was formulated and advised for implementation by public sector banks (Box II.7).

2.52 In pursuance of the announcement made by the Union Finance Minister for improving flow of credit to small and medium enterprises, detailed guidelines on debt restructuring mechanism for units in the SME sector were issued†on September 8, 2005 to all scheduled commercial banks to ensure restructuring of debt of all eligible SMEs at terms which are, at least, as favourable as the corporate debt restructuring

Box II.7: One-Time Settlement Scheme for SME Accounts

The one-time settlement scheme for recovery of NPAs below Rs.10 crore provides for a simplified, non-discretionary and non-discriminatory mechanism for one-time settlement of chronic NPAs in the SME sector. The scheme, however, does not cover cases of wilful default, fraud and malfeasance. The scheme covers all NPAs in the SME sector, which have become ëdoubtfulí or ëlossí as on March 31, 2004 with outstanding balance of Rs.10 crore and below on the date on which the account was classified as ëdoubtfulí. The scheme also covers NPAs classified as ësub-standardí as on March 31, 2004, which have subsequently become ëdoubtfulí or ëlossí where the outstanding balance was Rs.10 crore or below on the date on which the account was classified as ëdoubtfulí. The scheme covers cases in respect of which banks have initiated action under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 and also cases pending before courts/Debt Recovery Tribunals (DRTs)/Board for Industrial and Financial Reconstruction (BIFR), subject to consent decree being obtained from the courts/DRTs/BIFR. The last date for receipt of applications from borrowers was March 31, 2006. The processing under the revised guidelines was required to be completed by June 30, 2006.

mechanism in the banking sector. These guidelines are applicable to the following entities, which are viable or potentially viable: (i) all non-corporate SMEs, irrespective of the level of dues to banks; (ii) all corporate SMEs, which are enjoying banking facilities from a single bank, irrespective of the level of dues to the bank; and (iii) all corporate SMEs, which have funded and non-funded outstanding debt†up to Rs.10 crore under multiple/consortium banking arrangement. Accounts involving wilful default, fraud and malfeasance, and accounts classified by banks as ëloss assetsí are not eligible for restructuring under these guidelines. However, banks should review, especially the old cases, where the manner of classification of a borrower as a wilful defaulter was not transparent, and admit deserving cases, subject to the approval of their board of directors, for restructuring. In respect of BIFR cases, banks were required to ensure completion of all formalities in seeking approval from Board for Financial and Industrial Reconstitution (BIFR) before implementing the package. Banks were advised to decide on the acceptable viability benchmark, consistent with the unit becoming viable in 7 years and the repayment period for restructured debt not exceeding 10 years. Banks were required to work out the restructuring package and implement the same within a maximum period of 60 days from date of receipt of requests.

2.53 As announced by the Reserve Bank in the Annual Policy Statement for 2005-06, a scheme for Small Enterprises Financial Centres (SEFCs) was worked out in consultation with the Ministry of SSI, the Ministry of Finance, SIDBI, IBA and select banks, and circulated to all scheduled commercial banks for implementation. The Scheme encouraged banks to establish mechanisms for better coordination between their branches and those of SIDBI, which are located in the clusters identified by the Ministry of SSI, for co-financing of the SME sector (including tiny and the services sector). Under the SEFCs Scheme, SIDBI has executed Memoranda of Understanding with 16 banks so far (Bank of India, UCO Bank, Yes Bank, Bank of Baroda, Oriental Bank of Commerce, Punjab National Bank, Dena Bank, Andhra Bank, Indian Bank, Corporation Bank, Industrial Development Bank of India Ltd., Indian Overseas Bank, Union Bank of India, State Bank of India, State Bank of Saurashtra and Federal Bank).

2.54 With a view to ensuring larger flow of credit to trade and industry in the State of Jammu and Kashmir on the one hand and bringing about appropriate changes in the monitoring mechanism on the other, the position in regard to relaxations/concessions announced from time to time was reviewed. A comprehensive package of concessions/credit relaxations to borrowers/customers was announced in April 2004 for immediate implementation by banks operating in the State of Jammu and Kashmir. The package covered, *inter-alia*, sanction of increased working capital facilities depending on the merits of each case; review of all borrowal accounts within a period of 3 months; encouraging finance against accepted usance bills; offering concessional service tariffs for remittances; honouring small fixed deposit receipts (up to Rs.10,000) of the Kashmiri migrants at the designated branches without verifying details from the branch of origin against indemnity bond, where necessary; allowing rescheduling of the repayment programme in deserving cases; and extension of liberal acceptance of credit/letter of credit facilities to facilitate purchases on credit. In March 2006, these concessions/relaxations were made operative for a further period of one year, *i.e.*, up to March 31, 2007.

Export Credit

2.55 In pursuance of the recommendations of the Working Group to Review Export Credit (Chairman: Shri A. Sinha), scheduled commercial banks (excluding RRBs) were advised in February 2006 to review their existing procedure for export credit, Gold Card Scheme (GCS), export credit for non-star exporters and certain other aspects. The review of existing procedure for export credit was required to include the following: (i) attitudinal change in the approach to small and medium exporters; (ii) putting in place a control and reporting mechanism for early disposal of application; (iii) raising all queries in one shot while processing applications as opposed to piece-meal queries; (iv) facilitating training along with SSI/export organisations; (v) devising of a simplified loan application form by IBA; (vi) evolving guidelines to obviate need for collateral security; and (vii) promoting coordination between banks and exporters through the mechanism of State Level Export Promotion Committees (SLEPCs), which have been reconstituted as sub-committees of the SLBCs.

2.56 The review of the GCS is required to include: (i) completing the process of issuance of cards to all eligible exporters within a period of three months and confirming the compliance to the Reserve Bank;

and (ii) simplifying the procedure by IBA and implementing the exemption granted under the GCS of all deserving Gold Card holder exporters from the Packing Credit Guarantee Sectoral schemes of Export Credit and Guarantee Corporation (ECGC) on the basis of their track record. Banks were advised to post nodal officers at Regional/Zonal Offices and major branches having substantial export credit for attending to the credit related problems of SME exporters. Banks were also required to consider extending export credit at rates lower than the ceiling rates prescribed by the Reserve Bank taking into account the cost of funds, margin requirements and risk perception. Banks were asked to give priority for the foreign currency export credit requirements of exporters over foreign currency loans to non-exporter borrowers.

Expert Group on Credit-Deposit Ratio

2.57 In order to monitor the credit-deposit (CD) ratio and to draw up monitorable action plans (MAPs) to increase the CD ratio, banks were advised in November 2005 to set up special sub-committees (SSCs) of District Level Co-ordination Committee (DLCC) in the districts having CD ratio of less than 40. The districts having CD ratio between 40 and 60 will be monitored under the existing system by the DLCC. The number of districts with CD ratio of less than 40 declined to 180 at the end of June 2006 from 196 at end-December 2005. Special sub-committees of DLCC have been formed in 133 districts out of 180 districts to draw up monitorable action plans to increase the CD ratio.

4. Prudential Regulation

2.58 As a part of the ongoing efforts to strengthen the banking system through adoption of policies aimed at both improving the financial strength of the banks and bringing about greater transparency in their operations, the Reserve Bank initiated various measures during the year. Strengthening the capital base of banks with a view to preparing them to migrate to Basel II norms and putting in place the appropriate financial architecture for risk management continued to be the focus of attention of the Reserve Bank. Guidelines were issued for capital charge for market risk, raising of capital through innovative and hybrid instruments and management of operational risk. Risk mitigation measures continued through enhancement of risk weights for certain sectors, higher provisioning for standard assets, business continuity plans and guidelines on outsourcing of financial services. Accounting standards and disclosure norms were strengthened further with a view to improving governance and bringing them in alignment with the international norms. Banks were accorded greater flexibility to manage their assets by permitting securitisation of standard assets and allowing sale/purchase of NPAs. The corporate debt restructuring (CDR) scheme was modified.

Capital Adequacy

2.59 The Reserve Bank is committed to the adoption of Basel II by the banks and had earlier indicated March 31, 2007 as the intended date for adoption by all commercial banks. Taking into account the state of preparedness of the banking system, however, it was decided to provide banks some more time to put in place appropriate systems so as to ensure full compliance with Basel II. Foreign banks operating in India and Indian banks having presence outside India are to migrate to the standardised approach for credit risk and the basic indicator approach for operational risk under Basel II with effect from March 31, 2008. All other scheduled commercial banks are encouraged to migrate to these approaches under Basel II in alignment with them but in any case not later than March 31, 2009. The Steering Committee of banks would continue to interact with banks and the Reserve Bank, and guide the smooth implementation of Basel II. They are required to follow standardised approach for credit risk and basic indicator approach for operational risk.

2.60 In view of transition to the new capital adequacy framework, banks would need to further shore up their capital funds to meet the requirements under the revised Framework. Under Basel II, the capital requirements are not only more sensitive to the level of credit risk, but are also applicable to operational risks. Thus, banks would need to raise additional capital for Basel II requirements, as well as to support the expansion of their balance sheets. For smooth transition to Basle II and with a view to providing banks in India additional options for raising capital funds, banks were advised in January 2006 that they could augment their capital funds by issue of additional instruments such as (i) innovative perpetual debt instruments (IPDI) eligible for inclusion as Tier I capital; (ii) debt capital instruments eligible for inclusion as Upper Tier II capital; (iii) perpetual non-cumulative preference shares eligible for inclusion as Tier I capital; and (iv) redeemable cumulative preference shares eligible for inclusion as Tier II capital. Detailed guidelines for instruments at (i) and (ii) above have already been issued (Box II.8). Guidelines for instruments at (iii) and (iv) will be issued separately in due course.

2.61 The Basel Committee on Banking Supervision (BCBS) had undertaken the Fifth Quantitative Impact Study (QIS-5) to assess the impact of adoption of the revised Framework. Eleven Indian banks, accounting for about 50 per cent of market share (by assets), participated in the QIS-5 exercise. An empirical analysis indicates that the combined capital adequacy ratio of these banks is expected to come down by about 100 basis points when these banks apply Basel II norms for standardised approach for credit risk and basic indicator approach for operational risk. Although

Box II.8: Enhancement of Banksí Capital Raising Options for Capital Adequacy Purposes

I. Innovative Perpetual Debt Instruments

The innovative perpetual debt instrument (IPDI), which is perpetual in nature, is allowed to be issued up to 15 per cent of total Tier I capital. While IPDI is not allowed to be issued with a ë*put option*í, it could be issued with ë*call option*í and ë*step up option*í. However, c*all option* can be exercised after the instrument has run for at least ten years and with the prior approval of the Reserve Bank. S*tep-up option* could be exercised only once during the whole life of the instrument, in conjunction with the call option, after the lapse of ten years from the date of issue. Further, the step-up should not be more than 100 basis points. As this instrument is eligible to be included as Tier I capital, it would have ë*loss absorption*í feature. Interest due on IPDI is not payable and is also non-cumulative in case the CRAR of the issuing bank is less than regulatory minimum prescribed or the impact of such payment results in bankís CRAR falling below or remaining below the minimum regulatory requirement prescribed. However, banks would be allowed to pay interest due with the prior approval of the Reserve Bank even when the payment of interest results in net loss/increase, provided CRAR remains above the regulatory norm. As regards s*eniority of claim*, the claims of investors in innovative instruments will be superior to the claims of investors in equity shares and subordinated to the claims of all other creditors. Investment in these instruments by FIIs and NRIs are allowed within an overall limit of 49 per cent and 24 per cent, of the issue, respectively, subject to the investment by each FII not exceeding 10 per cent of the issue and investment by each NRI not exceeding 5 per cent of the issue.

Investment in IPDI raised in Indian rupee by FIIs is outside the ECB limit for rupee denominated corporate debt (currently US $ 1.5 billion) fixed for investment by FIIs in corporate debt instruments. Banks could also augment their capital fund to issue IPDI in foreign currency, without approval of the Reserve Bank, subject to terms and conditions. Not more than 49 per cent of the eligible amount can be issued in foreign currency.

II. Upper Tier II Instruments

The amount of Upper Tier II instruments issued by a bank along with other components of Tier II capital cannot exceed 100 per cent of Tier I capital and these instruments shall have a minimum maturity of 15 years. Similar to IPDI, Upper Tier II instruments cannot be issued with a ë*put option*í; they could be issued with ë*call option*í and ë*step up option*í. As in the case of IPDI, c*all option* can be exercised only after the instrument has run for at least ten years and with the prior approval of the Reserve Bank and s*tep-up option* can be exercised only once during the whole life of the instrument, in conjunction with the call option, after the lapse of ten years from the date of issue. Further, the step-up should not be more than 100 bps. Unlike IPDI, loss absorption capacity of Upper Tier II instruments is limited. Interest due on this instrument and principal on redemption can be deferred, but would be cumulative. Interest due and principal on redemption can be deferred, only if, CRAR of the issuing bank is less than regulatory minimum prescribed or the impact of such payment results in bankís CRAR falling below or remaining below the minimum regulatory requirement prescribed. However, banks are allowed to pay with the prior approval of the Reserve Bank, when the payment of interest results in net loss/increase in net loss, provided CRAR remains above the regulatory norm. While paying such unpaid interest and principal, banks are also allowed to pay compound interest at a rate not exceeding the coupon rate of the relative Upper Tier II bonds on the outstanding principal and interest. The Upper Tier II instrument is not repaid at maturity without prior approval of the Reserve Bank. The claims of the investors in Upper Tier II instruments are deemed superior to the claims of investors in instruments eligible for inclusion in Tier I capital, but subordinate to the claims of all other creditors. As in the case of short-term subordinated debt, Upper Tier II instruments are also subjected to a progressive discount for capital adequacy purposes during the last five years of their tenor. These instruments are open for FIIs/NRI investment, subject to certain restrictions. While investments by FIIs are allowed within the limits as laid down in the ECB Policy for investment in debt instruments, NRIs investments are subject to the existing policy in force.

Investments by FIIs in Upper Tier II instruments raised in Indian rupee is outside the limit for investment in corporate debt instruments, *i.e.*, US $ 1.5 billion. However, investment by FIIs in these instruments is subject to a separate ceiling of US $ 500 million. The total amount of Upper Tier II instruments issued in foreign currency cannot exceed 25 per cent of the unimpaired Tier I capital. This eligible amount is computed with reference to the amount of Tier I capital as on March 31 of the previous financial year, after deduction of goodwill and other intangible assets but before the deduction of investments. This is in addition to the existing facility for foreign currency borrowings by Authorised Dealers.

none of the banks which participated in the exercise would be breaching the minimum capital adequacy ratio under the new framework, the net impact reflects a wide range.

2.62 Banks were advised in January 2002 to build up investment fluctuation reserve (IFR) which should be at least 5 per cent of their investments in ëheld for tradingí (HFT) and ëavailable for saleí (AFS) categories within five years so that they are in a better position to meet the market risk (Box II.9). Banks were also encouraged to build IFR up to a maximum of 10 per cent of their AFS and HFT investments. It was advised in October 2005 that banks which have maintained capital of at least nine per cent of the risk weighted assets for both credit and market risks and for both HFT and AFS categories as on March 31, 2006 would be permitted to treat the entire balance in the IFR as Tier I capital. For this purpose, banks were allowed to transfer the entire balance in the IFR ëbelow the lineí in the ëprofit and loss appropriation accountí to statutory reserve, general reserve or the profit and loss account. Banks were further advised that in the

Box II.9: Capital Charge for Market Risks

The Basel Committee on Banking Supervision (BCBS) of BIS had issued the ëAmendment to the Capital Accord to Incorporate Market Risksí containing comprehensive guidelines to provide explicit capital charge for market risks. These guidelines seek to address the issues involved in computing capital charges for interest rate related instruments in the trading book, equities in the trading book and foreign exchange risk (including gold and other precious metals) in both trading and banking books. Trading book for the purpose of these guidelines include: (i) securities included under the HFT category; (ii) securities included under the AFS category; (iii) open gold position limits; (iv) open foreign exchange position limits; (v) trading positions in derivatives; and (vi) derivatives entered into for hedging trading book exposures.

The minimum capital requirement is expressed in terms of two separately calculated charges, *viz*., (i) ëspecific riskí charge for each security, which is akin to the conventional capital charge for credit risk, both for short and long positions; and (ii) ëgeneral market riskí charge towards interest rate risk in the portfolio, where long and short positions (which is not allowed in India except in derivatives) in different securities or instruments can be offset.

In India, as an initial step towards prescribing capital charge for market risks, banks were advised to: (i) assign an additional risk weight of 2.5 per cent on the entire investment portfolio; (ii) assign a risk weight of 100 per cent on open position limits on foreign exchange and gold; and (iii) build up investment fluctuation reserve up to a minimum of five per cent of investments in HFT and AFS categories in the investment portfolio.

In the Monetary and Credit Policy Statement for the year 2002-03 announced in April 2002, it was mentioned that it would be appropriate for banks to adopt the BCBS norm on capital charge for market risk. Accordingly, the Reserve Bank issued draft guidelines on computing capital charge for market risks, on the lines of the Basel Committee framework, in May 2003, to select banks seeking their comments. The draft guidelines were reviewed in June 2004 in the light of the comments received and as announced in the Annual Policy Statement for 2004-05, banks were required to maintain capital charge for market risks in a phased manner over a two-year period. Banks were required to maintain capital for market risks on securities included in the HFT category, open gold position limit, open foreign exchange position limit, trading positions in derivatives and derivatives entered into for hedging trading book exposures by March 31, 2005. In addition to above, banks were required to maintain capital for market risk on securities included in the AFS category by March 31, 2006.

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

To begin with, capital charge for market risks is applicable to banks on a global basis. At a later stage, this would be extended to all groups where the controlling entity is a bank. The banksí overall minimum capital requirement will be the sum of: (a) capital requirement for credit risk, as already laid down in prudential norms on capital adequacy, excluding the items comprising trading book, but including counter party credit risk on all OTC derivatives; and (b) capital requirement for market risks in the trading book.

Banks are required to manage the market risk in their books on an ongoing basis and ensure that the capital requirements for market risks are maintained on a continuous basis, *i.e.*, at the close of each business day. Banks are also required to maintain strict risk management systems to monitor and control intra-day exposures to market risks.

The capital charge for interest rate related instruments and equities is applied to current market value of these items in bankís trading book. The current market value is to be determined as per the extant guidelines of the Reserve Bank on valuation of investments. The measurement of capital charge for market risk should include all interest rate derivatives and off-balance sheet instruments in the trading book and derivatives entered into for hedging trading book exposures which would react to changes in the interest rates, such as FRAs and interest rate positions.

event, the provisions created on account of depreciation in the AFS or HFT categories are found to be in excess of the required amount in any year, the excess should be credited to the profit and loss account and an equivalent amount (net of taxes, if any and net of transfer to Statutory Reserves as applicable to such excess provision) should be appropriated to an Investment Reserve Account and the same would be eligible for inclusion under Tier II within the overall ceiling of 1.25 per cent of total risk weighted assets prescribed for general provisions/loss reserves.

2.63 The New Capital Adequacy Framework includes various options for calculating operational risk capital charge in a continuum of increasing sophistication and risk sensitivity, and increasing complexity. The Guidance Note on operational risk issued to banks in October 2005 outlined a set of sound principles for effective management and supervision of operational risk by banks. Although banks may adopt any one of the options for computing capital charge, it is intended that they benchmark their operational risk management systems with the framework provided in the Guidance Note and strive to move towards more sophisticated approaches. The design and architecture for management of operational risk is required to be oriented towards banksí own requirements dictated by the size and complexity of business, risk philosophy, market perception and the expected level of capital. The exact approach would, therefore, differ from bank to bank.

Exposure Norms and Risk Weights

2.64 The Reserve Bank has prescribed regulatory limits on banksí exposure to individual and group borrowers to avoid concentration of credit. It has also advised banks to fix limits on their exposure to specific industries or sectors. The credit exposure limit for a single and a group of borrowers has been stipulated at 15 per cent and 40 per cent, respectively, of capital funds with additional 5 per cent and 10 per cent for infrastructure funding for single and group borrowers, respectively. In addition, banks may in exceptional circumstances, with the approval of their Boards, consider enhancement of the exposure to a borrower up to a further 5 per cent of capital funds. There also exists a cap on foreign currency borrowing and lending as well as on hedging of such foreign currency loans. The capital market and sensitive sector exposure also continues to be capped. In view of the developments in the banking sector, the Reserve Bank took several measures during 2005-06 to refine and strengthen the exposure norms.

2.65 In view of the rapid increase in loans to the real estate sector and the systemic risks posed by such exposure, banks were advised in March 2006 that while appraising loan proposals involving real estate, they should ensure that the borrowers have obtained prior permission from the Government/ local Governments/other statutory authorities for the project, wherever required. In order to ensure that this process does not hamper the loan approval process, banks were advised that while the proposals could be sanctioned in the normal course, the disbursements should be made only after the borrower has obtained the requisite clearances from the Government authorities.

2.66 The risk weight on banksí exposure to the commercial real estate was increased from 100 per cent to 125 per cent in July 2005 and further to 150 per cent in April 2006. Exposure to commercial real estate includes: (a) fund based and non-fund based exposures secured by mortgages on commercial real estates; and (b) investments in mortgage backed securities and other securitised exposures, where the underlying exposures are to the commercial real estate. Keeping in view the market conditions, exposure of banks to entities for setting up Special Economic Zones (SEZs) or for acquisition of units in SEZs which include real estate would be treated as exposure to commercial real estate.

2.67 In view of the increase in growth of advances to the real estate sector in the recent period, banks were advised to put in place a proper risk management system to contain the risks involved. Banks were also advised to put in place a system for ensuring proper checking and documentation of related papers before sanctioning/disbursing of such loans. On June 29, 2005, the Reserve Bank advised banks to have a board mandated policy in respect of their real estate exposure covering exposure limits, collaterals to be considered, margins to be kept, sanctioning authority/level and sector to be financed. Banks were also advised to report their real estate exposure under certain heads and disclose their gross exposure to the real estate sector as well as the details of the break-up in their annual reports.

2.68 With effect from July 26, 2005, the risk weight for credit risk on the capital market exposures was increased from 100 per cent to 125 per cent. The capital market exposure comprises: (a) direct investment by a bank in equity shares, convertible bonds and debentures and units of equity oriented mutual funds; and (b) advances against shares to individuals for investment in equity shares (including IPOs/ESOPs), bonds and debentures, units of equity oriented mutual funds; and (c) secured and unsecured advances to stock brokers and guarantees issued on behalf of stock brokers and market makers. In the Annual Policy Statement for 2006-07 issued in April 2006, it was decided to consider bankís total exposure to venture capital funds a part of its capital market exposure. Accordingly, banks were required to assign a higher risk weight of 150 per cent to such exposures. In August 2006, banks were advised that all exposures to venture capital funds (VCFs) (both registered and unregistered) would be deemed at par with equity, and hence would be reckoned for compliance with the capital market exposure ceilings (ceiling for direct investment in equity and equity linked instruments as well as ceiling for overall capital market exposure), and the limits prescribed for such exposure would also apply to investments in VCFs.

2.69 In view of more companies offering Employee Stock Options (ESOPs) and employee quota in their IPOs, the instruction that banks could provide finance up to Rs.50,000 or six monthsí salary, whichever is less, to assist employees to buy shares of their own companies was reviewed in 2004. Banks were advised that the above referred instructions would not be applicable for extending financial assistance by banks to their own employees for acquisition of share under ESOPs or IPOs. Earlier, banks were advised that they could extend finance to employees for purchasing shares of their own company under ESOPs to the extent of 90 per cent of the purchase price of the shares or Rs.20 lakh, whichever is lower. However, it was noticed that some banks had extended loans to their employees/ Employee Trusts set up by them, for purchasing their own shares on a clean basis. It was, therefore, clarified on December 27, 2005 that banks (excluding RRBs) would not be allowed to extend advances even to their employees/ Employee Trusts set up by them for the purpose of purchasing their (banksí) own shares under ESOPs/ IPOs or from the secondary market. This prohibition is applicable irrespective of whether the advances are unsecured or secured.

Risk Management

2.70 Basel II aims at encouraging the use of modern risk management techniques and ensuring that bankís risk management capabilities are commensurate with the underlying risks of their business. Basel II requires that the design of risk management framework be oriented towards banksí own requirements dictated by the size and complexity of business, risk philosophy, market perception and the expected level of capital. The risk management systems in banks should, however, be adaptable to changes in business, size, market dynamics and introduction of innovative products by banks in future.

2.71 It is imperative for banks to prepare for business disruptions and system failures to ensure continuity of operations. In this regard, detailed guidelines were issued in April 2005 requiring commercial banks to put in place business continuity measures, including a robust information risk management system within a fixed time frame. The guidelines encompassed both technological and non-technology related components for a comprehensive business continuity planning (BCP) process. The unprecedented floods in recent times in a few cities and the resultant reports of electronic delivery channels of some of the banks being affected has further reinforced the need for robust BCP in banks.

Income Recognition, Asset Classification and Provisioning

2.72 The prudential norms relating to income recognition, asset classification and provisioning, introduced during 1992-93 are being continuously monitored and refined to bring them on par with international best standards. In keeping with this, several measures were initiated in 2005-06. In November 2005, the general provisioning requirement for ëstandard assetsí, barring banksí direct advances to agricultural and SME sectors, was increased to 0.40 per cent from 0.25 per cent. In May 2006, the general provisioning requirement for banks (excluding RRBs) on standard advances in respect of specific sectors, *i.e.*, personal loans, loans and advances qualifying as capital market exposures, residential housing loans beyond Rs.20 lakh and commercial real estate loans was increased to 1.0 per cent from 0.40 per cent. Thus, banks are required to make a minimum general provision for standard assets at three different rates for the funded outstanding on a global loan portfolio basis. As hitherto, these provisions would be eligible for inclusion in Tier II capital for capital adequacy purposes up to the permitted extent.

2.73 In terms of the extant guidelines, provisioning for sub-standard assets is required to be made at 10 per cent for secured exposures and 20 per cent for unsecured exposures. The provisioning requirements for doubtful assets are graded, depending on the period for which an asset has remained doubtful. The provisioning, at present, varies in the range of 20 per cent to 100 per cent on the secured portion, while it is 100 per cent on the unsecured portion.

2.74 In a few cases, it was noted that floating provisions were used to set off against the provisions required under the extant prudential guidlines for smoothening profits. Hence, revised prudential norms/guidelines were issued to banks (excluding RRBs) in June 2006 on utilisation, creation, accounting and disclosures of floating provisions, *i.e.*, provisions which are not made in respect of specific non-performing assets (NPAs) or are made in excess of regulatory requirement for provisions for standard assets (Box II.10).

2.75 The Reserve Bank has been continuously working towards aligning the accounting standards for banks with the international best standard practices. Based on the recommendations made by a Working Group (Chairman: Shri N.D. Gupta), detailed guidelines were issued in March 2003 relating to accounting standards. In April 2004, guidelines were issued to ensure banksí compliance with these accounting standards and that there are no qualifications by the auditors in their financial statements for non-compliance with any accounting standard. The Institute of Chartered Accountants of India (ICAI) is formulating the accounting standard on ëFinancial Instruments: Recognition and Measurementí which would be the Indian parallel of International Accounting Standards (IAS) 39. An Internal Group was constituted by the Reserve Bank to review the existing guidelines on classification and valuation of investments by banks and to align them with IAS 39. The Group, taking into account the unique country-specific circumstances, focused on dovetailing the provisions of IAS 39 with the existing prudential guidelines relating to classification and valuation of investments. The report of the Group was placed on the Reserve Bankís website on July 12, 2006 for wider dissemination and comments.

2.76 In partial modification of the guidelines issued in March 2005 relating to compliance with Accounting Standard (AS) 11 (revised 2003), the threshold limits relating to recording the foreign currency transactions at the date of the transaction were revised in April 2006. Banks were advised that: (i) the weekly average closing rate of the preceding week would not be considered approximating the actual rate at the date of the transaction if the difference between (a) the weekly average closing rate of the preceding

Box II.10: Floating Provisions ñ Revised Norms

The broad features of revised guidelines issued in June 2006 in respect of utilisation, accounting and disclosures of floating provisions are set out below:

ï The floating provisions should not be used for making specific provisions in respect of non-performing assets or for making regulatory provisions for standard assets but can be used only for contingencies under extraordinary circumstances, for making specific provisions in impaired accounts with prior permission of the Reserve Bank.

ï The board of directors of the bank may lay down a policy as to what circumstances would be considered extraordinary for making specific provisions in impaired accounts with prior permission of the Reserve Bank.

ï Bankís board of directors should lay down approved policy regarding the level to which the floating provisions can be created.

ï Bank should hold floating provisions for ëadvancesí and ëinvestmentsí separately and the guidelines prescribed will be applicable to floating provisions held for both ëadvancesí and ëinvestmentí portfolios.

ï Floating provisions cannot be reversed by credit to the profit and loss account.

ï Until utilisation for contingencies, as stated above, these provisions can be netted off from gross NPAs to arrive at disclosure of net NPAs or they can be treated as part of Tier II capital within the overall ceiling of 1.25 per cent of total risk-weighted assets.

ï Banks should make comprehensive disclosures on floating provisions in the ënotes on accountsí to the balance sheet on (a) opening balance in the floating provisions account; (b) the quantum of floating provisions made in the accounting year; (c) purpose and amount of drawdown made during the accounting year; and (d) closing balance in the floating provisions account.

ï Specific provisions for advances at rates which are higher than the rates prescribed under existing regulations are not to be treated as floating provisions.

week and (b) the exchange rate prevailing at the date of the transaction, is more than three-and-a-half per cent of (b); and (ii) in respect of non-integral foreign operations, the quarterly average closing rate would not be considered approximating the actual rate at the date of the transaction, if the difference between (a) the quarterly average closing rate and (b) the exchange rate prevailing at the date of the transaction, is more than seven per cent of (b). Banks were, however, encouraged to equip themselves to record the foreign currency transactions of Indian branches as well as integral foreign operations and translate both the income and expense items of non-integral foreign operations at the exchange rate prevailing on the date of the transaction.

2.77 Scheduled commercial banks (excluding RRBs) were advised in May 2006 to disclose in the ëNotes on Accountí to the balance sheet the information providing details of provisions and contingencies shown under the head ëexpenditureí in ëprofit and loss accountí as follows: i) provisions for depreciation on investment; ii) provision towards NPA; iii) provision towards standard asset; iv) provision made towards income tax; and v) other provisions and contingencies (with details).

Guidelines on Securitisation of Standard Assets

2.78 The Reserve Bank had issued draft guidelines on securitisation of standard assets in April 2005. Based on the feedback received from all stakeholders, the final guidelines on securitisation of standard assets were issued on February 1, 2006. The guidelines are applicable to financial institutions, including non-banking financial companies (Box II.11).

Box II.11: Guidelines on Securitisation of Standard Assets

Securitisation is a process by which assets are sold to a bankruptcy remote special purpose vehicle (SPV) in return for an immediate cash payment. The cash flow from the underlying pool of assets is used to service the securities issued by the SPV. Securitisation, thus, follows a two-stage process. In the first stage, there is sale of single asset or pooling and sale of pool of assets to a ëbankruptcy remoteí SPV in return for an immediate cash payment. The second stage involves repackaging and selling the security interests representing claims on incoming cash flows from the asset or pool of assets to third party investors by issuance of tradable debt securities.

The salient features of the guidelines issued by the Reserve Bank on securitisation of assets are set out below:

ï The sale should result in immediate legal separation of the originator from the assets which are sold to the new owner, *viz.*, the SPV.

ï The SPV should meet the specific criteria to enable the originator to treat the assets transferred by it to the SPV as a true sale and apply the prudential guidelines on capital adequacy and other aspects with regard to the securitisation exposures assumed by it. The criteria mainly specifies that: (i) any transaction between the originator and the SPV should be strictly on armís length basis; (ii) any transaction with the SPV should not intentionally provide for absorbing any future losses; (iii) the SPV and the trustee should not resemble in name or imply any connection or relationship with the originator of the assets in its title or name; and (iv) the SPV should be entirely independent of the originator and the SPV should be bankruptcy remote and non-discretionary.

ï A bank should hold capital against the credit risk assumed when it provides credit enhancement, either explicitly or implicitly, to a SPV or its investors. Credit enhancement facilities include all arrangements provided to the SPV that could result in a bank absorbing losses of the SPV or its investors. Such facilities may be provided by both originators and third parties.

ï A liquidity facility is provided to help smoothen the timing differences faced by the SPV between the receipt of cash flows from the underlying assets and the payments to be made to investors. A liquidity facility should meet specific conditions to guard against the possibility of the facility functioning as a form of credit enhancement and/or credit support.

ï A bank performing the role of a service provider for a proprietary or a third-party securitisation transaction has to ensure certain specific conditions and where these conditions are not met, the service provider may be deemed as providing liquidity facility to the SPV or investors and treated accordingly for capital adequacy purpose.

ï As the securities issued by SPVs would be in the nature of non-SLR securities, banksí investment in these securities would attract all prudential norms applicable to non-SLR investments prescribed by the Reserve Bank from time to time.

ï The counterparty for the investor in the securities would not be the SPV but the underlying assets in respect of which the cash flows are expected from the obligors/ borrowers. These should be taken into consideration while reckoning overall exposures to any particular borrower/ borrower group, industry or geographic area for the purpose of managing concentration risks and compliance with extant prudential exposure norms, wherever the obligors in the pool constitute 5 per cent or more of the receivables in the pool or Rs.5 crore, whichever is lower.

ï Banks can sell assets to SPV only on a cash basis and the sale consideration should be received not later than the transfer of the asset to the SPV. Hence, any loss arising on account of sale should be accounted accordingly and reflected in the profit and loss account for the period during which the sale is effected. Any profit/premium arising on account of sale should be amortised over the life of the securities issued or to be issued by the SPV.

2.79 The stakeholders were also advised that the Reserve Bank would take a view on the treatment for the securitisation transactions undertaken in the period prior to February 1, 2006 on a case-by-case basis with the objective of ensuring adherence to the basic principles of prudence.

NPA Management by Banks

2.80 Since the chances/extent of recovery of NPAs reduce over a period of time, the Reserve Bank in recent years took several measures to expedite recovery of NPAs by banks. For this purpose, several channels of recovery have been designed such as Debt Recovery Tribunals, *Lok Adalats* and corporate debt restructuring mechanism and the SARFAESI Act.

2.81 Corporates sometimes find themselves in financial difficulty, despite their best efforts and intentions, because of factors beyond their control and also due to certain internal reasons. With a view to enabling corporates to tide over temporary financial difficulties as well as for the safety of the money lent by the banks and FIs, timely support through restructuring in genuine cases at times is considered necessary. Based on the cross-country experience, a CDRM was evolved, and detailed guidelines were issued in August 2001 for implementation by banks. Subsequently, guidelines on CDRM were revised in February 2003. A Special Group was constituted in September 2004 (Chairperson: Smt. S. Gopinath) to undertake a review of the scheme on CDRM. The Group suggested certain changes/ improvements in the existing scheme for enhancing its scope and making it more efficient. Based on the recommendations by the Special Group and the feedback received, draft guidelines were prepared and issued to all commercial banks/FIs (excluding RRBs) in November 2005 (Box II.12).

2.82 With a view to providing an additional option and developing a healthy secondary market for NPAs, guidelines on sale/purchase of NPAs were issued in July 2005 covering the procedure for purchase/sale of non-performing financial assets (NPFA) by banks, including valuation and pricing aspects; and prudential norms relating to asset classification, provisioning, accounting of recoveries, capital adequacy and exposure norms, and disclosure requirements (Box II.13).

Know Your Customer Guidelines and Anti-Money Laundering Standards

2.83 The Reserve Bank had issued comprehensive guidelines to banks on November 29, 2004 relating to ëknow your customerí (KYC) and ëanti-money launderingí (AML). Banks were later advised to ensure that they were fully compliant with the provisions of the norms before December 31, 2005. On August 23, 2005, revised guidelines were issued regarding opening of accounts with a view to enabling persons belonging to low-income group to easily access

Box II.12: Corporate Debt Restructuring Mechanism (CDRM) ñ Revised Guidelines

The salient features of the revised guidelines on CDRM are as indicated below:

ï To extend the scheme to entities with outstanding exposure of Rs.10 crore or more.

ï To require the 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 ensuring the decision making more equitable.

ï To give discretion to the core group in dealing with wilful defaulters in certain cases other than cases involving frauds or diversion of funds with malafide intentions.

ï To link the restoration of asset classification prevailing on the date of reference to the CDR Cell to implementation of the CDR package within four months from the date of approval of the package.

ï To restrict the regulatory concession in asset classification and provisioning to the first restructuring where the package also has to meet norms relating to turnaround period, minimum sacrifice and funds infusion by promoters.

ï To converge the methodology for computation of economic sacrifice among banks and FIs.

ï To limit the Reserve Bankís role to providing broad guidelines for CDRM.

ï To enhance the disclosures in the balance sheet for providing greater transparency.

ï To share on a *pro-rata* basis an additional finance requirement by both term lenders and working capital lenders.

ï To allow OTS as a part of the CDRM to make the exit option more flexible.

ï To modify the regulatory treatment of non-SLR instruments acquired while funding interest or in lieu of outstanding principal and valuation of such instruments.

Box II.13: Guidelines on Sale/Purchase of NPAs ñ Salient Features

The salient features of the guidelines are as follows:

ï The guidelines are applicable to banks, FIs and NBFCs purchasing/selling non-performing financial assets (NPFA) from/to other banks/FIs/NBFCs (excluding securitisation companies/reconstruction companies).

ï A financial asset, including assets under multiple/ consortium banking arrangements, would be eligible for purchase/sale in terms of these guidelines if it is a non-performing asset/non-performing investment in the books of the selling bank.

ï A bank which is purchasing/selling NPFA should ensure that the purchase/sale is conducted in accordance with a policy approved by the board.

ï While laying down the policy, the board is required to satisfy itself, that the bank has adequate skills to purchase NPFA and deal with them in an efficient manner which will result in value addition to the bank. The board should also ensure that appropriate systems and procedures are in place to effectively address the risks that a purchasing bank would assume while engaging in this activity.

ï The estimated cash flows are normally expected to be realised within a period of three years and not less than 5 per cent of the estimated cash flows should be realised in each half year.

ï A bank may purchase/sell NPFA from/to other banks only on a ëwithout recourseí basis, *i.e.*, the entire credit risk associated with the NPFA should be transferred to the purchasing bank. Selling bank shall ensure that the effect of the sale of the financial assets should be such that the asset is taken off the books of the bank and after the sale there should not be any known liability devolving on the selling bank.

ï Banks should ensure that subsequent to sale of the NPFA 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. Consequently, the specific financial asset should not enjoy the support of credit enhancements/liquidity facilities in any form or manner.

ï A NPFA 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.

ï Banks shall sell NPFA to other banks only on a cash basis. The entire sale consideration should be received upfront and the asset can be taken out of the books of the selling bank only on receipt of the entire sale consideration.

ï A NPFA 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. Banks should not sell such assets back to the bank, which had sold the NPFA.

ï Banks are also permitted to sell/buy homogeneous pool within retail NPFA, on a portfolio basis, provided each of the NPFA of the pool has remained as NPFA for at least 2 years in the books of the selling bank. The pool of assets would be treated as a single asset in the books of the purchasing bank.

ï The NPFA purchased may be classified as ëstandardí 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 financial asset purchased is required to be determined by the record of recovery in the books of the purchasing bank with reference to cash flows estimated while purchasing the asset.

ï The asset classification status of an existing exposure (other than purchased financial asset) 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.

ï Any restructuring/rescheduling of the repayment schedule or the estimated cash flow of the NPFA by the purchasing bank shall render the account as a NPA.

ï When a bank sells its NPFA to other banks, the same will be removed from its books on transfer. If the sale is at a price below the net book value (NBV) (*i.e.*, book value less provisions held), the shortfall should be debited to the profit and loss account of that year. If the sale is for a value higher than the NBV, the excess provision shall not be reversed but will be utilised to meet the shortfall/loss on account of sale of other NPFA.

ï Any recovery in respect of NPA purchased from other banks should first be adjusted against its acquisition cost. Recoveries in excess of the acquisition cost can be recognised as profit.

ï For the purpose of capital adequacy, banks should assign 100 per cent risk weights to the NPFA purchased from other banks. In case the NPFA purchased is an investment, then it would attract capital charge for market risk also. For NBFCs, the relevant instructions on capital adequacy would be applicable.

ï The purchasing bank will reckon exposure on the obligor of the specific financial asset. Hence these banks 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. For NBFCs, the relevant instructions on exposure norms would be applicable.

ï Banks which purchase/sell NPFA from other banks are required to make disclosures in the ënotes on accountsí to their balance sheets relating to details of NPFA purchased/sold.

banking services. These simplified procedures would help persons who intend to keep balances not exceeding Rs.50,000 and whose total credit in all accounts taken together is not expected to exceed Rs.1 lakh in a year.

2.84 In order to provide succour to a large number of people affected by unprecedented floods in Maharashtra, banks were advised to adopt a simplified approach in opening the accounts of such persons, to enable them to deposit the grant received from the Government.

2.85 The Central Government notified the Rules under the Prevention of Money Laundering Act (PMLA), 2002 on July 1, 2005. In terms of the Rules notified, a Financial Intelligence Unit-India (FIU-IND) was set up in the Ministry of Finance, Government of India, to collect, compile, collate and analyse the cash and suspicious transactions reported by banks and financial institutions. In terms of the provisions of the Rules, banks are required to follow certain prescribed procedure with regard to reporting of suspicious and cash transactions to FIU-IND. The Reserve Bank prescribed detailed guidelines on February 15, 2006 for reporting the cash and suspicious transactions. Banks were advised that while ëcash transaction reportí (CTR) for each month should be submitted to FIU-IND by 15th of the succeeding month, the ësuspicious transaction reportí (STR) should be furnished within 7 days of arriving at a conclusion that any transaction or a series of transactions, whether cash or non-cash, is of suspicious nature. Cash transactions of value of Rs.10 lakh and above or a series of integrally connected transactions, aggregate of which in a month exceeds Rs.10 lakh, are to be reported in CTR. However, individual cash transactions below Rs.50,000 have been excluded from the purview of reporting to FIU-IND. Banks were advised to report all other cash transactions where forged or counterfeit currency notes and bank notes were used as genuine and where any forgery of a valuable security had taken place.

2.86 Principal Officers of banks have been instructed to record their reasons for treating any transaction or a series of transactions as suspicious. It has to be ensured that there is no undue delay in arriving at such a conclusion once a suspicious transaction report is received from a branch or any other office. Such a report should be made available to the competent authorities on request. Banks were advised that they may not put any restriction on operations in the accounts where an STR has been made. It has been emphasised that there should not be any ëtipping offí to the customer at any level.

Fuller Capital Account Convertibility and the Banking Sector

2.87 Given the changes that had taken place over the last two decades, there is merit in moving towards Fuller Capital Account Convertibility (FCAC) within a transparent framework. In consultation with the Government of India, the Reserve Bank, therefore, constituted a Committee on Fuller Capital Account Convertibility (Chairman: Shri S.S. Tarapore) in March 2006 for suggesting measures for further liberalisation of the capital account. The Committee submitted its Report on July 31, 2006, which was placed in public domain on September 1, 2006. The Committee recommended a broad timeframe of a five year period in three phases for fuller capital account liberalisation; 2006-07 (Phase I), 2007-08 and 2008-09 (Phase II) and 2009-10 and 2010-11 (Phase III). The Committee observed that under a FCAC regime, the banking system will be exposed to greater market volatility. Hence, it is necessary to address the relevant issues in the banking system, including the need for enhancing the risk management capabilities in the banking system and the regulatory and supervisory aspects to enable the system to become more resilient to shocks and sustain their operations with greater stability. Given the importance that the commercial banks occupy in the Indian financial system, the banking system, according to the Committee, should be the focal point for appropriate policy measures. In this regard, the Committee made several specific recommendations (Box II.14).

2.88 In pursuance of the recommendation of the Committee on FCAC, it was proposed in the Mid-term Review of October 2006 that borrowers eligible for accessing ECBs could avail of an additional US $ 250 million with average maturity of more than 10 years under the approval route, over and above the existing limit of US $ 500 million under the automatic route, during a financial year. While other ECB criteria such as end-use, all-in-cost ceiling, recognised lender and the like would continue to apply, prepayment and call/put options, however, would not be

Box II.14: Report of the Committee on Fuller Capital Account Convertibility

The major recommendations of the Committee pertaining to the banking sector are as follows:

Prudential Regulation

- Regulation of the specific and inter-related risks that arise from international capital flows, notably liquidity risk, interest rate risk, foreign currency risk, credit risk, counter-party risk and country risk be strengthened.
- Financial institutionsí liquidity management and disclosure practices be improved as they are encouraged to diversify funding sources to contain maturity mismatches and improve debt-equity mix.
- Corporate governance in public sector banks be improved with the aim of ensuring operational autonomy and equipping them to compete with other banks as equals.
- Need for the Reserve Bank to issue restricted banking licences to some banking institutions to enable them to exploit their core competencies. The Banking Regulation (BR) Act, 1949, at present, allows issue of only one type of banking licence, *viz*., whole banking licence, which permits all licensed banks to undertake all banking activities.
- Level of computerisation and branch inter-connectivity and computer security be enhanced to meet the standards of well developed financial markets.
- The system should move forward to a differential capital regime. Consideration be given to introducing a higher core capital ratio than at present. The risk weighting system be modified to reflect the actual economic risk undertaken by banks.
- Unrated or high risk sectors to be given much higher risk weights and/or the Reserve Bank may consider prescribing a higher level of minimum capital requirement than the present 9 per cent.
- Systems for ongoing scientific valuation of assets and available collateral be established. Setting off losses against capital funds on an on-going basis be considered without allowing banks to carry it as an intangible asset on its balance sheet.
- Scope for undertaking enhanced activity particularly in new financial services be linked to quality and adequacy of capital, risk management system and personnel.
- Risk management frameworks in banks and supervisory capacity be strengthened.
- Increased transparency and market discipline with quantitative and qualitative disclosures needed on risk exposures and risk management systems in banks.
- Regulation be modified to discourage or eliminate scope for regulatory arbitrage and focusing on activity-centric regulation rather that institution-centric regulation.

Differential Prudential Regime

- Differential treatment of ëcomplexí banks, *viz*., those which (i) are diversified into areas other than conventional banking; (ii) are parts of a large group/ conglomerate; (iii) undertake significant cross-border transactions; (iv) act as market makers; and (v) are counter-parties to complex transactions. Since these banks are exposed to the complexities of various risks, the Reserve Bank may consider prescribing a higher minimum capital ratio for these banks.
- The Reserve Bank to review and revise its policy to allow banks (i) to undertake market making; (ii) to deal with complex instruments such as derivatives; and (iii) to undertake large cross-border borrowing, lending and investment operations.

Supervisory Practices

- Supervisory practices be adapted to include global consolidated supervision of internationally active financial institutions and establishing contact and information exchange with various other supervisors, primarily host country supervisory authorities.
- Supervisory reporting formats, as at present, need to be reviewed and revised in a post-FCAC scenario after studying the supervisory reporting formats operational in leading territories (such as the UK, the US and Continental Europe).
- The concept of relationship managers be introduced in the Reserve Bank where a dedicated desk official would be tracking all developments in the allotted bank on a day-to-day basis.
- Focus on liquidity risk, interest rate risk, currency risk and currency mismatches, asset concentrations and exposure to price sensitive assets ñ to entities and to countries should be at a global level of *i.e.*, at whole bank level as well as bank group level.
- New technology be adapted for putting in place an on-line connectivity with banks enabling a wide system aggregation of various critical parameters on a near real time basis. There is a need to move towards a central point data centre in the Reserve Bank with appropriate analytical tools.
- Significant upgradation of regulatory and supervisory skills in the Reserve Bank is needed which includes building up a supervisory strategic strike force for dealing with issues expeditiously before they become major endemic problems.

permissible for such ECBs up to a period of 10 years. Furthermore, with a view to providing greater flexibility to the corporates in managing their liquidity and interest costs, prepayment of ECB by authorised dealer banks up to US $ 300 million, as against the earlier limit of US $ 200 million, was allowed without prior approval of the Reserve Bank, subject to compliance with the stipulated minimum average maturity period as applicable to the loan.