

5. Supervision and Supervisory Policy Board for Financial Supervision

2.89 The Board for Financial Supervision (BFS) was constituted on November 16, 1994 by the Central Board of Directors of the Reserve Bank under the Reserve Bank (BFS) Regulations, 1994 as a Committee of the Central Board to pay undivided attention to supervision. The Board exercises its supervisory role over the financial system encompassing banks, both commercial and urban co-operative, financial institutions, NBFCs and primary dealers, over which the Reserve Bank has direct supervisory jurisdiction.

2.90 During July 2005 - June 2006, the BFS met 13 times. Besides delineating the course of action to be pursued in respect of institution-specific supervisory concerns, the Board provided guidance on several regulatory and supervisory policy matters. The focus of the Board continued to be on risk management, corporate governance, consolidated supervision and supervision of conglomerates. The Board also continued to monitor the progress in respect of internal controls, quality of assets in banks and housekeeping. The findings of on-site inspection of the Clearing Corporation of India Ltd. (CCIL) and the follow-up actions taken were also reviewed by the Board.

2.91 In the course of its deliberations during the year, the Board provided several important directions for implementation. Good corporate governance in the financial institutions was stressed upon at every stage and it was decided that banks having governance concerns because of dominant shareholding or other reasons, be kept under close monitoring. It was also suggested to the Government to extend the ěfit and proper statusí guidelines prescribed for private sector banks to the public sector banks as well with a view to attaining higher standards of corporate governance. Disclosures was another area which received attention of the Board. The Boardís concern for continuity of a healthy and vibrant financial sector and a robust regulatory and supervisory regime led to the issuance of several important guidelines on credit cards, mergers, disclosures, outsourcing of services and purchase/sale of NPFA by banks.

2.92 The macro approach to financial supervision has helped the Reserve Bank to refine its regulatory as well as monetary policy stance so as to achieve the fine balance between growth

and financial stability. At the same time, external auditors, who are entrusted with the responsibility of statutory audit of annual accounts of banks, are being increasingly used as an extended arm of the supervisory system. They are also required to verify and certify certain other aspects such as adherence by banks to statutory liquidity requirements and prudential norms relating to income recognition, and classification and provisioning of assets. In the backdrop of an ever increasing complexity of transactions undertaken by banks, the need was felt for a thorough review of the guidelines in respect of a concurrent audit and a system of ěon-lineí audit of business transactions of banks. Accordingly, the Board decided to constitute a Working Group in April 2006 to look into the scope and effectiveness of the existing concurrent audit system in commercial banks with a focus on the areas to be included/excluded from the purview of concurrent auditors and frame fresh guidelines, including preparation of a manual on concurrent audit.

2.93 On-site inspection is an important element of the supervisory system of banks. With a view to improving the monitoring of banks and financial institutions, the inspection system is regularly reviewed and refined (Box II.15).

Progress in Implementation of Risk Based Supervision

2.94 Several initiatives have been taken for a gradual roll out of the risk based supervision (RBS) process since the announcement made in the Monetary and Credit Policy of April 2000. Three rounds of pilot run of RBS covering public sector, private sector and foreign banks were conducted during 2003-2006. Steps were taken to fine-tune the RBS process based on the lessons learnt from the pilot studies. A guidance note was prepared to help the inspecting officers during the on-site RBS pilot study. Further, the risk areas were rationalised to avoid duplication/overlapping. The revised templates provide for nine sections to assess five business risks (credit, market, operational, liquidity and group), two control risks (management and compliance), and capital and earnings. The operational and group risks, which were ěnon-keyí risk areas in the earlier model, have now been brought under the ambit of ěbusiness risksí, which have been given a significant weightage in the revised RBS system. The new methodology for risk assessment enables

Box II.15: Inspection Methodology

The supervision of commercial banks and financial institutions is vested in the Reserve Bank in terms of the provisions of the Banking Regulation Act, 1949 and the Reserve Bank of India Act, 1934. This task is carried out by the Department of Banking Supervision (DBS) under the guidance of the BFS.

The basic objective of supervision of banks is to assess the solvency, liquidity and operational health of banks. The on-site inspection of banks referred to as Annual Financial Inspection (AFI) is conducted annually (except in the case of State Bank of India in which case it is done once in two years). For this purpose, the unit of inspection is the Head Office (HO) of the bank. A team of Inspecting Officers from the Reserve Bank led by the Principal Inspecting Officer (PIO) visits the bank and conducts the inspection based on the internationally adopted CAMEL (Capital Adequacy, Asset Quality, Management, Earnings, Liquidity) model, modified as CAMELS (S for Systems and Control) to suit the needs of the Indian banking system. The focus of the AFI in recent years has been on supervisory issues relating to securitisation, business continuity plan, disclosure requirements and compliance with other existing guidelines.

In order to have an overall perspective, units of the bank throughout the country are also taken up for inspection either by the same team inspecting the HO or by additional teams from the Regional Offices (RO) of the Reserve Bank. These units could be treasury operations, specialised branches and

controlling offices in general, where there may be concerns relating mainly to frauds, NPAs and exposure to sensitive sectors. Major findings of these other unit inspections are incorporated in the Report. The timeframe for carrying out the inspection of the corporate HO of the bank is two to three months. The inspection report is generally finalised within four months.

On completion of the inspection, the RO of the Reserve Bank, under whose jurisdiction the HO of the bank is situated, issues the inspection report to the bank for perusal, corrective action and compliance. Further, a detailed discussion on the findings of the inspection and the road ahead is conducted by the Reserve Bank with the CEO/CMD and other senior functionaries of the bank and a monitorable action plan is decided and/or supervisory action is taken, wherever warranted. The findings recorded in the inspection report along with the responses of the CEO/CMD of the bank are placed before the BFS. Based on the findings of the inspection and other inputs, a supervisory rating is assigned to the bank.

Efforts are afoot to move to a risk based supervision (RBS) approach, which envisages the monitoring of banks by allocating supervisory resources and focusing supervisory attention depending on the risk profile of each institution. The process involves continuous monitoring and evaluation of the appropriateness of the risk management system in the supervised institution in relation to its business strategy and exposures, with a view to assessing its riskiness.

the supervisors to separately assess the risk for inherent/control risk areas and domestic/overseas operations in respect of all the business risk areas, thereby providing important inputs for area-specific supervisory action. The revised risk-rating framework is number driven. It provides granularity to the supervisory risk-rating process (*i.e.*, assessing the degrees of risk and whether the risk is in the upper band or lower band) and enabling preparation of specific supervisory programme/action for individual banks. On-site pilot study (third in series) was taken up in four banks in 2005-06 under the revised RBS framework.

Off-site Monitoring and Surveillance

2.95 The Reserve Bank had instituted a state-of-the-art Off-site Monitoring and Surveillance (OSMOS) system for banks in 1995 as part of crisis management framework for Early Warning System (EWS) and as a trigger for on-site inspections of vulnerable institutions. The scope and coverage of off-site surveillance has since been widened to capture various facets of efficiency and risk management of banks.

2.96 While taking up on-site inspection of banks, data from the OSMOS system are used by the inspecting officers for assessing the performance of banks. On-line connectivity has been provided to all Regional Offices to enable them to access the data directly and generate standard reports. Based on the modification in regulatory norms as also the supervisory requirements, the OSMOS system undergoes revision from time to time. In order to identify areas requiring urgent supervisory action and initiate timely action, the time limit for submission of monthly returns was reduced to 15 days and for quarterly returns to 21 days across all categories of banks from June 2005. The Reserve Bank remains continuously in touch with the banks with a view to enhancing data quality. Several measures were initiated during 2005-06 to ensure smooth operation of the OSMOS system. These, *inter alia*, included: (a) modification of the guidance note on off-site returns¹ in the light of the latest revision of the system, relevant regulatory changes and common reporting mistakes observed in various returns; and (b) meetings with individual pre-identified banks to highlight the mistakes committed in the returns,

removing conceptual ambiguities and sensitising them to the importance of off-site returns.

2.97 The efficiency of the reporting mechanism is also being enhanced through more intensive adoption of technology (Box II.16).

Monitoring of Frauds

2.98 With a view to monitoring closely the frauds in the financial sector, a separate Fraud Monitoring Cell (FrMC) was constituted on June 1, 2004 under the overall administrative control of the Department of Banking Supervision of the Reserve Bank. Timely reporting of information on occurrence of frauds greatly helps the supervisor in disseminating the same to other entities without much loss of time, which, in turn, helps in curbing further perpetration of fraud by the fraudsters. Keeping this in view, a Fraud Reporting and Monitoring System (FRMS) was introduced in 2003 to enable banks to report data relating to frauds in electronic form. The FRMS Package was revised in January 2006 to capture granular details of frauds under different categories, viz., housing loans, credit cards, ATM-debit cards and internet banking, so as to discern the emerging trends in frauds and enable the entities to focus their oversight on more vulnerable areas. Number and amount of frauds reported by banks increased significantly during 2005-06. One of the major reasons for such a sharp increase in the frauds was increase in housing loan frauds. Frauds in

the areas of credit/debit cards and ATMs also increased. During 2005-06, commercial banks reported 13,914 cases of frauds involving a sum of Rs.1,381 crore as against 10,450 cases of frauds amounting to Rs.779 crore during 2004-05. These cases were followed up with the banks for necessary remedial action.

2.99 Frauds were perpetrated in the areas of credit, particularly in working capital finance, including bill finance and cheque discounting. The common *modus operandi* adopted by borrowers was clandestine removal of hypothecated stocks, drawing of false/*benami* bills of accommodative nature and submission of fake documents relating to properties offered as collateral securities. However, during the last two to three years, large scale frauds were reported in the area of housing finance and multiple creation of equitable mortgages on the same properties offered to different banks. Analysis of frauds in the area of housing finance revealed the submission of fake/forged title deeds of properties, salary certificates, income tax returns by the borrowers. Laxity in the conduct of due diligence of borrowers/builders, absence of a system of pre-sanction visit to the project site and laxity in post disbursement supervision were some other contributory factors.

2.100 As regards multiple creation of equitable mortgages, banks are handicapped to verify the position of encumbrance as also genuineness of the title to the property since at present there is

Box II.16: On-line Returns Filing System (ORFS)

The Reserve Bank receives data from commercial banks and other external agencies through several returns. While some of the returns are statutory, others have been introduced to obtain specific information. Originally, most of the returns were paper based. Of late, the Reserve Bank has started receiving some of the returns in soft copy form, either through floppies or e-mails. In order to bring uniformity in the mode of receipt of returns from banks, on-line returns filing system (ORFS) is being implemented in two phases.

In the first phase of implementation, likely to be completed by end of 2006, Form A return (statutory) under Section 42 (2) of the Reserve Bank of India Act have been brought under the ORFS, and fifteen other returns have been taken up for inclusion in the system. In the second phase spread over a period of two years, all the returns received by the Reserve Bank are expected to be brought under the ORFS which will also involve rationalisation of the returns. The ORFS is expected to emerge as the single interface for data transmission between the Reserve Bank and banks.

The on-line returns filing system provides a user-friendly interface to banks and straight-through-processing environment to the Reserve Bank. The main features of ORFS are: (i) an end-to-end secured data transmission made possible due to the features of secured web server and MQ-series present in the ORFS; (ii) no need of any additional hardware or software at the bank's end as banks can use the system by just logging into the Reserve Bank secured web server (either through INFINET or internet); (iii) automatic authentication of banks as user-id and password is required for logging into the Reserve Bank's secured web server; (iv) facility to enter data on-line and upload data directly from an XML file in the computer system of the bank; (v) ensured data quality through on-screen validation checks; (vi) facility to edit/print/save data before transmitting it to the Reserve Bank, so that the banks can preserve the printouts and soft files for their record and future use; (vii) centralised receipt of data – the data received at the secured web server is forwarded to the respective user departments; and (viii) automatic acknowledgement of the receipt of data to the originating bank.

no institutional mechanism for banks to verify the existence of charge (equitable mortgage) on a particular property at a centralised place. To overcome this problem, the Reserve Bank brought to the notice of the State Governments and the Central Government the need for maintaining record of creation of a charge by a bank/FI on an immovable property at a centralised place so as to enable the lending institutions to carry out due diligence before accepting a particular immovable property as a security. However, very few State Governments have initiated action in this regard so far.

2.101 Irregularities in the case of initial public offerings (IPO) also surfaced during the year. The irregularities perpetrated at some of the branches of a few banks came to the knowledge of the Reserve Bank through the findings of the SEBI

inspections. The banking system was misused for manipulation of the IPO process and cornering the retail portion of the initial public offerings by a few individuals in connivance with the depository providers. The scam occurred as a result of total disregard to the laid down Reserve Bank's directives, guidelines and instructions on KYC norms/AML standards, opening of accounts, monitoring of large transactions and sanction of IPO finance or/and loans against shares. The Reserve Bank acted effectively once the irregularities surfaced (Box II.17).

2.102 Disclosure of information in the public interest by the employees of an organisation is increasingly gaining acceptance by public bodies for ensuring better governance standards and probity/transparency in the conduct of affairs of

Box II.17: IPO Irregularities and the Involvement of Banks

In order to corner retail allotment of shares in the IPO of various companies, over and above the eligible limits fixed by SEBI for retail investors, certain individuals/entities made multiple applications for shares, actively colluding with depository participants (DPs) and also misusing the banking facilities. The misuse of the IPO process and manipulation of the banking facilities for the purpose was brought to the notice of the Reserve Bank by SEBI on December 16, 2005. The Reserve Bank acted promptly and took up investigations at the Ahmedabad and Mumbai branches of banks named in the SEBI order, *i.e.*, Bharat Overseas Bank Ltd (BhoB) and Vijaya Bank on December 16, 2005. Based on the lead emanating from the revelations at these banks, scrutinies were taken up at other banks as well.

Based on the findings and taking into account the extent of acts of omissions and commissions at the banks, penalties ranging from Rs.5 lakh to Rs.30 lakh have so far been imposed on 10 banks, *viz.*, BHoB, Indian Overseas Bank, Vijaya Bank, HDFC Bank, ICICI Bank, Standard Chartered Bank, Citi Bank, ING Vysya Bank, IDBI Ltd. and Centurian Bank of Punjab. The penalties were imposed in accordance with the powers conferred upon the Reserve Bank *vide* section 47A (1) (b) of the Banking Regulation Act, 1949, keeping in view the extent and seriousness of irregularities observed in different banks and larger objective of maintaining the credibility of the Indian financial sector. In the case of a few banks, involvement of the bank officials was also observed.

The irregularities which came to notice during the investigations taken up by the Reserve Bank were not systemic or widespread in nature. Only 10 banks out of a total of 89 banks and 22 branches out of a branch network of over 71,000 were involved in the irregularities. In all such cases, banks were asked to initiate criminal action, including filing of cases with police/CBI, against the bank officials involved.

Immediately on surfacing of the irregularities relating to the misuse of the IPO process, all scheduled commercial banks were advised to take a review of the financing of IPOs. All banks have confirmed having completed the review. Majority of the banks have reported that no serious irregularities have been observed. Corrective action has been initiated in respect of those banks where a few irregularities were observed.

The manipulation of the IPO process was perpetrated due to weakness in the internal control systems and procedures such as failure of the alert systems or weaknesses in reporting lines and the internal inspection and audit processes in most of the involved banks, which failed to detect the irregularities. The Reserve Bank initiated detailed investigations in these areas and took up the concerns with the banks' top managements for corrective actions. Other banks were also alerted to these deficiencies with advice to plug the loopholes. The importance of the audit and compliance functions, board oversight, staff training and education aspects were reiterated to the banks.

Further, in the misuse of IPO process by certain individuals/entities, it was observed that some banks had credited the proceeds of individual account payee cheques to third party accounts instead of accounts of respective payees on the request of the associates of the DPs. This manipulation would not have taken place without the banks deviating from the procedure for collection of account payee cheques. Accordingly, a directive was issued prohibiting the banks from crediting account payee cheques to account of any person other than the payee named thereon.

As non-adherence to KYC guidelines had, by and large, contributed to the occurrence of the irregularities, the guidelines on KYC and AML standards were revisited and the date for compliance was extended to March 31, 2006. The banks were also advised on February 15, 2006 to ensure that a proper policy framework on KYC and AML measures is formulated and put in place. All scheduled commercial banks have reported compliance in this regard.

public institutions. Large scale corporate frauds the world over necessitated various legislative measures for safeguarding the public interest through enactments such as Whistleblower Protection Act in the US, Public Interest Disclosure Act in the UK and similar Acts in a few other countries.

2.103 In the Indian context, the Government of India had passed a resolution on April 21, 2004 authorising the Central Vigilance Commission (CVC) as the designated agency to receive written complaints or disclosure on any allegation of corruption or misuse of office and recommend appropriate action. The jurisdiction of the CVC in this regard is restricted to the employees of the Central Government or of any Corporation established by it or under any Central Act, Government companies, societies or local authorities owned or controlled by the Central Government. Thus, the public sector banks and the Reserve Bank are also under the purview of the Government of India resolution.

Credit Information on Borrowers

2.104 As announced in the Annual Policy Statement for the year 2004-05, the Credit Information Bureau of India Limited (CIBIL) was advised to work out a mechanism, in consultation with the Reserve Bank, Small Industries Development Bank of India (SIDBI) and Indian Banks Association (IBA), for development of a system of proper credit records to enable the banks to determine appropriate pricing of loans to small and medium enterprises. CIBIL is currently in the process of exploring solutions in association with its technology partner, Dun & Bradstreet Information Services India (P) Ltd. (D&B) either by modifying the existing system of CIBIL to segregate SMEs data or creating a separate system for drawing information from database of both CIBIL and D&B. CIBIL held discussions in this regard with IBA, SIDBI and the Reserve Bank. The proposed SME solution will provide consolidated report comprising SME loan related data, SME vendor payment related data and a consolidated SME score. With a view to strengthening the legal mechanism and facilitating credit information bureaus to collect, process and share credit information on borrowers of banks/FIs, the Credit Information Act was passed in May 2005. Subsequently, the Reserve Bank released the draft rules and regulations under the Act for feedback on April 5, 2006. On the basis of the responses received, the draft rules and regulations

have been revised and would be notified shortly in consultation with the Government of India (see details in Section 11).

Compliance Function in Banks

2.105 In April 2005, the Basel Committee on Banking Supervision (BCBS) published a paper entitled 'Compliance and the Compliance Function in Banks', prescribing certain principles aimed at strengthening compliance structure in banks. The BCBS defined compliance risk as 'the risk of legal or regulatory sanctions, material financial loss, or loss to reputation a bank may suffer as a result of its failure to comply with laws, regulations, rules, related self-regulatory organisation standards, and codes of conduct applicable to its banking activities (together, compliance laws, rules and standards)'. Consequently, a Working Group consisting of a few compliance officers of banks was set up to review the existing organisational structure and compliance machinery in banks, weaknesses in the existing system, international standards and best practices and to make recommendations with a view to putting in place a robust compliance system in banks.

6. Financial Markets

2.106 Well developed financial markets enable the central bank to effectively conduct monetary policy and help in improving the allocative efficiency of resources. Interest rates on benchmark Government securities facilitate appropriate pricing of other financial assets. It has, therefore, been the endeavour of the Reserve Bank to promote development of all the segments of financial market under its regulatory provision. This is sought to be achieved by easing restrictions on transactions, reducing transaction costs, increasing the width and depth of the market and introducing trading and settlement systems in line with international best practices. During 2005-06, a number of steps were taken to strengthen the institutional framework for financial markets in order to improve the price discovery process and, at the same time, ensure the orderly functioning of various financial market segments. The policy initiatives during 2005-06 were, in particular, guided by provisions of the Fiscal Responsibility and Budget Management (FRBM) Act, which, *inter alia*, prohibits the Reserve Bank from participating in the primary issuances of Government securities with effect from April 1, 2006. This has completed the transition to a fully market based issuance of Government securities,

a process that was initiated in the early 1990s with the introduction of auctions. The implementation of the FRBM Act also necessitated a review of Reserve Bank's market operations, including introduction of new instruments and refining existing instruments in the context of the evolving scenario. Accordingly, a Financial Markets Department (FMD) was set up in July 2005 in the Reserve Bank with a view to (i) enhancing efficiency in operations of the Reserve Bank in the money, the Government securities and the foreign exchange markets; and (ii) moving towards functional separation of debt management from monetary management. Furthermore, the Committee on Fuller Capital Account Convertibility recently made some recommendations for the sound development of financial markets (Box II.18).

Developments in the Money Market

2.107 The money market is the main conduit for transmitting the monetary policy impulses to the real sector of the economy. The broad policy objectives that are being pursued for the development of the money market are ensuring stability in short-term interest rates, minimising default risk and achieving a balanced development of various segments of the market. In pursuance of the recommendations of the Internal Technical Group on Money Market (May, 2005), the Reserve Bank has been encouraging the growth of the collateralised segment, developing the rupee yield curve, improving transparency and better price discovery and providing avenues for better risk management. The process of transforming the call/notice money market into a pure inter-bank market was completed in August 2005. This has been facilitated by the development of the CBLO and the repo market outside the Reserve Bank in which non-bank participants are allowed to even out their short-term mismatches in liquidity. In order to ensure the growth of the money market along sound lines, prudential limits have been placed on borrowings and lendings of banks and primary dealers (PDs) in the call/notice money market.

2.108 Following the Annual Policy Statement for 2005-06, a screen-based negotiated quote-driven system for dealings in the call/notice and the term money market (NDS-CALL) developed by the Clearing Corporation of India Ltd. (CCIL) was launched on September 18, 2006. The introduction of NDS-CALL will help in enhancing transparency, improving price discovery and strengthening market microstructure.

2.109 †A significant development during 2005-06 was the substantial migration of money market activity from the uncollateralised call money segment to the collateralised market repo and CBLO segments. In order to enable market participants to assess the liquidity conditions in an efficient and transparent manner, information on transactions in the collateralised segment of the money market is also being provided on the Reserve Bank's website from April 2006.

2.110 The Reserve Bank has been modulating liquidity conditions keeping in view the evolving circumstances. In order to fine-tune the liquidity management, a Second Liquidity Adjustment Facility (SLAF) was operationalised with effect from November 28, 2005 with features similar to those of the Liquidity Adjustment Facility. An additional LAF was conducted on March 31, 2006 in order to facilitate funds management by banks on account of the year-end closing on March 31, 2006 coinciding with a reporting Friday.

2.111 The minimum maturity period of CDs was reduced from 15 days to 7 days with effect from April 29, 2005 in order to align it with the minimum maturity of CP and fixed deposits with banks. With a view to enhancing transparency and facilitating wider dissemination, information on CP issuance such as issue and maturity date, issue amount, discount/interest rate, unconditional and irrevocable guarantee and credit rating of the guarantor, as reported by the Issuing and Payment Agents (IPAs) on the NDS platform, has been made available on the website of the Reserve Bank with effect from July 1, 2005.

Developments in the Government Securities Market

2.112 As the debt manager to the Government, a deep and liquid market for Government securities is important for the Reserve Bank for reducing the cost of Government debt. In terms of the provisions of the Fiscal Responsibility and Budget Management Act (FRBM), the Reserve Bank is prohibited from subscribing to primary Government paper from April 1, 2006. Keeping this in view, a number of initiatives were taken during 2005-06 to further deepen and widen the Government securities market. These included: permitting short sale in Government securities; introducing the 'When Issued' (WI) market; proposing active consolidation of Government securities; providing greater responsibilities for

Box II.18: Development of Financial Markets ñ Recommendations of the Committee on Fuller Capital Account Convertibility

Countries intending to move towards fuller capital account convertibility (FCAC) need to ensure that different market segments, besides being well developed in terms of physical infrastructure, skill and competency levels are also well integrated. If different markets remain segmented, any policy shock to influence market behaviour would not get transmitted to the various segments, thus, leading to inefficiency of policy outcome. Moreover, segmentation also impedes the development of a term structure of interest rates which facilitates the conduct of monetary policy. The Committee on FCAC made several recommendations to further the development of financial markets along sound lines as detailed below;

(a) Money Market

- i Prudential regulations be strengthened to encourage capital inflows.
- i Necessary coordination be ensured by the lead regulator.
- i More players be allowed to access the repo market.
- i The CBLO and the repo markets be allowed to cover corporate debt instruments.
- i Skills be upgraded to develop the inter-bank term money market.
- i Prudential limits for CP and CD be fixed since any unlimited opening up could have implications for short-term flows.
- i A dedicated cell within the Reserve Bank be set up for closer monitoring of all derivative products.
- i Banks should frame appropriate policy before marketing complex derivatives.
- i The market in interest rate futures be activated and interest rate options be allowed. Initially, options could be introduced as OTC derivatives and subsequently they could be exchange traded.
- i Provision for netting of derivative transactions be made, before opening up the swap market.
- i Internationally aligned accounting standards for derivatives be developed.
- i Fixed Income Money Market and Derivatives Association (FIMMDA) be suitably empowered to act as a self-regulatory organisation to develop market ethics, trading standards and also undertake regulation of participants, besides disseminating information.

(b) Government Securities Market

- i The share of mark-to-market category be progressively increased.
- i Short-selling across settlement cycles with adequate safeguards be permitted.

- i Gilt funds be exempted from the dividend distribution tax and income up to a limit from direct investment in gilts could be exempted from tax to stimulate retail investments in gilts.
- i STRIPS in Government securities should be expeditiously introduced.
- i Non-resident investors, especially longer term investors, could be permitted entry to expand investor base.
- i Repo facility in government securities be widened by allowing all market players without any restrictions.
- i Rapid debt consolidation process be initiated that is tax-neutral.
- i The limit for FII investment in Government securities could be fixed at 6 per cent of total gross issuances by the Centre and States during 2006-07 and gradually raised to 8 per cent of gross issuance between 2007-08 and 2008-09, and to 10 per cent between 2009-10 and 2010-11. The limits could be linked to the gross issuance in the previous year to which the limit relates. The allocation by SEBI of the limits between 100 per cent debt funds and other FIIs should be discontinued.

(c) Forex Market

- i The spot and forward markets should be liberalised and extended to all participants, removing the constraint on past performance/underlying exposures.
- i Separate forex business from lending transactions and introduce an electronic trading platform on which forex transactions for small and medium customers could take place. For very large trades, the Committee proposed a screen-based negotiated dealing system.
- i Reserve Bank's intervention in the forex market be through the anonymous order matching system.
- i Increase in limits for banks on short-term and long-term borrowing/lending overseas to promote more interest parity with international markets.
- i FIIs be provided with the facility of cancelling and rebooking forward contracts and other derivatives booked to hedge rupee exposures.
- i Currency futures be introduced, subject to risks being contained through proper trading mechanism, structure of contracts and regulatory environment.
- i The existing guaranteed settlement platform of CCIL be extended to the forwards market.
- i Banking sector be allowed to hedge currency swaps by buying and selling without any monetary limits.

PDs to support primary issuance; operationalising the NDS-Order Matching system; migrating to a standardised T+1 settlement system; and enabling constituents to sell auctioned stock on the same day.

2.113 As part of its long-term objective of developing the Government securities market, the Reserve Bank introduced the Negotiated Dealing System (NDS) in February 2002. However, the trading facilities on the NDS (both negotiated and

quote driven) were hardly used, largely because they were less user-friendly. In order to provide NDS members with a more advanced and more efficient trading platform, the NDS-OM trading module was introduced effective August 1, 2005 as recommended by the Working Group on Screen Based Trading in Government Securities (Chairman: Dr. R.H. Patil).

2.114 The settlement cycle for Government securities was standardised to T+ 1 effective May 11, 2005 with a view to providing the participants with more processing time at their disposal and thereby enabling better management of both funds and risk. Furthermore, with a view to widening the repo market in Government securities, listed companies and non-scheduled urban co-operative banks were allowed to participate effective May 11, 2005.

2.115 In order to enable the successful bidders to mitigate the price risk, the sale of Government securities allotted to successful bidders in primary issues on the day of allotment was permitted, with and between constituent subsidiary general ledger (CSGL) account holders under delivery *versus* payment (DvP) III, effective May 11, 2005. Until then, the sale contract in respect of securities allotted to successful bidders in primary issues on the day of allotment could be entered into only between entities having subsidiary general ledger (SGL) account and settled under the Reserve Bank's DvP system.

2.116 The Reserve Bank's non-participation in primary auctions except under exceptional circumstances, effective April 1, 2006, as provided in the FRBM Act, has necessitated alternative institutional arrangements to ensure that debt management objectives are met and the Government is able to borrow under all types of market conditions without exacerbating market volatility. With the withdrawal of the Reserve Bank from the primary market, PDs have begun to play a more active and dynamic role. In order to facilitate smooth operations by PDs, several measures were undertaken during the year. First, banks, which fulfill certain minimum eligibility criteria such as minimum net owned funds, minimum CRAR, net NPA position of less than 3 per cent and profit making record for the last three years, were also permitted to undertake PD business. Second, PDs were permitted to diversify their activities in addition to their core business of Government securities, subject to limits. Third, a revised scheme for underwriting commitment and liquidity support to PDs was introduced from April 1, 2006.

2.117 With the objective of enabling participants to manage their interest rate risk more efficiently and also to impart liquidity to the markets, the Internal Technical Group on Government Securities Market (ITGGSM) (July, 2005) recommended permitting short sales in Government securities in a calibrated manner which would enable market participants to express their views on interest rate expectations. Accordingly, effective February 28, 2006, banks and PDs were allowed to undertake outright sale of Central Government dated securities that they do not own, subject to the same being covered by outright purchase from the secondary market within the same trading day. The intra-day short selling has been permitted subject to certain stipulations in terms of stock-wise limits and overall risk limits. Keeping in view the feedback received from the market so far, allowing short-sales across settlement cycles and allowing sale of repoed stock are under active consideration.

2.118 The ITGGSM had also recommended active consolidation of securities in order to impart liquidity to the Government securities market, which would involve replacing illiquid securities with the liquid securities. Various alternatives of active consolidation have been worked out and the consolidation process would be taken up once the methodology is finalised.

2.119 As part of restructuring the debt issuance framework in the light of the FRBM Act, WI transactions have been permitted in Central Government securities from May 2006, in pursuance of the recommendations of the ITGGSM. 'When Issued', a short form of 'when, as and if issued', indicates a conditional transaction in a security authorised for issuance but not as yet actually issued. All WI transactions are on an 'if' basis, to be settled if and when the actual security is issued. 'WI' market facilitates the distribution process for Government securities by stretching the actual distribution period for each issue by allowing the market more time to absorb large issues without disruption. Furthermore, it also enables price discovery process by reducing uncertainties surrounding auctions. Actual trading in the WI market commenced with the auction of Central Government securities during the week August 1-8, 2006. Subsequently, it took place during the auctions of August 14-18, 2006 and September 4-8, 2006. Up to September 30, 2006, total traded volume in the WI segment stood at Rs.440 crore.

Developments in the Foreign Exchange Market

2.120 The Reserve Bank initiated a number of measures during 2005-06 to create a more conducive environment for external transactions while according high priority to customer service. The thrust of reforms in the current account transactions was on removing the restrictions and simplifying the procedures. The approach in the case of capital account has been gradual with sequenced liberalisation of transactions. Measures were also initiated to reduce the transaction cost. AML guidelines were also put in place to maintain the integrity of the market.

2.121 With a view to deepening the foreign exchange market and synchronisation of trading across the money, the Government securities and the foreign exchange markets, the closing time for inter-bank foreign exchange market in India was extended by one hour up to 5.00 p.m. effective May 16, 2005.

2.122 With the progressive liberalisation of foreign exchange related transactions, more entities have been allowed to handle non-trade current account transactions. In continuation of this process, select full-fledged money changers, urban co-operative banks (UCBs) and regional rural banks (RRBs) were permitted to release/remit foreign exchange for a number of non-trade related current account transactions such as private visits, business travel, fee for participation in global conferences/training/international events, film shooting, medical treatment, emigration and emigration consultancy fees. Consequently, scheduled commercial banks holding full-fledged authorised dealers (AD) license were designated as AD Category I and those undertaking non-trade current account transactions as AD Category II.

2.123 AD Category I have been allowed to open foreign currency accounts for the project offices established under the general/specific approval of the Reserve Bank. They have also been permitted to allow intermittent remittances by project offices, without approval of the Reserve Bank, subject to certain conditions. Inter-project transfer of funds, however, require prior approval of the concerned regional office of the Reserve Bank. In the case of disputes between the project office and the project sanctioning authority or other Government/non-Government agencies, the balance held in such account is converted into Indian Rupees and credited to a special account, and dealt with as per the terms of settlement of the dispute.

2.124 AD banks were permitted to remit expenses of branch/office or representative abroad up to 10 per cent for initial and up to five per cent for recurring expenses of the average annual sales/income or turnover during last two accounting years, subject to the existing terms and conditions. Furthermore, AD banks were allowed to remit foreign exchange for acquiring shares under ESOP schemes without any monetary limit, irrespective of the method of operationalisation of the scheme, subject to the following three conditions: (i) the company issuing the shares effectively, directly or indirectly, holds in the Indian company, whose employees/directors are being offered shares, not less than 51 per cent of its equity. (ii) the shares under the ESOP scheme are offered by the issuing company globally on a uniform basis. (iii) an annual return is submitted by the Indian company to the Reserve Bank through the AD banks giving details of remittances/beneficiaries. Further, general permission has been granted to foreign companies to repurchase the shares issued to residents in India under any ESOP scheme, subject to certain conditions.

2.125 With a view to further liberalising the facilities available to exporters/importers and simplifying the procedures, several measures were undertaken during the year. First, ADs were permitted to grant extension of time to realise export proceeds up to US \$ 1 million beyond the prescribed period of six months. Second, the process to open Standby Letters of Credit for import of gold on a loan basis was simplified and the period for fixing the price and repayment of gold loan was rationalised. Third, ADs were allowed to permit airline companies to remit up to US \$ 1 million per aircraft towards security deposits for payment of lease rentals for import of an aircraft/aircraft engine/helicopter on operating lease, subject to certain specific conditions. Fourth, ADs no longer need to follow up submission of evidence of import involving an amount of US \$ 1,00,000 or less, provided they are satisfied about the genuineness of the transaction and the *bona fides* of the remitter. Fifth, residents in India were allowed cancellation and rebooking of all eligible forward contracts and banks were allowed to approve proposals for commodity hedging in exchanges or markets outside India, subject to certain conditions and reporting requirements. Sixth, powers were granted to AD banks to grant GR approval in cases where goods are being exported for re-import after repairs/maintenance/testing/calibration, subject to the condition that the exporter shall produce the

relative bill of entry within one month of re-import of the item exported from India.

2.126 Persons/entities eligible under the FDI route, other than FIIs, have been permitted to invest in the equity capital of asset reconstruction companies (ARCs) registered with the Reserve Bank. FIIs registered with Securities and Exchange Board of India (SEBI) are now allowed to invest in security receipts (SRs) issued by asset reconstruction companies (ARCs) registered with the Reserve Bank up to 49 per cent of each tranche of scheme of SRs, subject to the condition that investment of a single FII in each tranche should not exceed 10 per cent of the issue.

2.127 In order to augment their capital, banks in India were permitted to issue perpetual debt instruments eligible for inclusion as Tier I capital and debt capital instruments as Upper Tier II capital. FIIs registered with SEBI and Non-Resident Indians (NRIs) have now been permitted to subscribe to these instruments, subject to the following conditions: a) investment in perpetual debt instruments should not exceed an aggregate ceiling of 49 per cent of issue size by all FIIs and 10 per cent by an individual FII; b) the investment should not exceed an aggregate ceiling of 24 per cent of each issue by all NRIs and five per cent of each issue by a single NRI; c) investment by FIIs in debt capital instruments (Tier II) shall be within the limits stipulated by SEBI for FII investment in corporate debt; and d) investment by NRIs in debt capital instruments (Tier II) shall be in accordance with the extant policy for investment by NRIs in other debt instruments.

2.128 In view of the increased concerns regarding money laundering activities and to prevent authorised money changers (AMCs) from being misused for such activities, the Reserve Bank issued detailed AML guidelines to enable AMCs to put in place the policy framework and systems for prevention of money laundering while undertaking money exchange transactions. In terms of the guidelines issued, all AMCs are required to formulate suitable policies and procedures for the AML measures which include: (i) customer identification procedure – know your customer norms; (ii) recognition, handling and disclosure of suspicious transactions; (iii) appointment of Money Laundering Reporting Officer (MLRO); (iv) staff training; (v) maintenance of records; and (vi) audit of transactions in accordance with the guidelines issued. The AML policy framework and measures were to be formulated and put in place before March

31, 2006 with the approval of the boards of directors of AMCs.

2.129 The AML guidelines were further modified in view of the difficulties expressed by AMCs in implementing some of the guidelines. These included: (i) photocopies of the identification document need not be kept on record for purchase of foreign exchange of less than US \$ 200 or its equivalent; (ii) the photocopies of the identification document should be maintained for one year and completion of statutory audit for encashment of foreign exchange between US \$ 200 and US \$ 2000 or its equivalent; (iii) the photocopies of the identification document should be maintained for a minimum period of five years for encashment in excess of US \$ 2000 or its equivalent; and (iv) requests for payment in cash by foreign visitors/Non-Resident Indians may be acceded to the extent of US \$ 2000 or its equivalent.

2.130 The policy on external commercial borrowings (ECBs) was reviewed and further liberalised in August 2005 to include non-Government organisations engaged in micro-finance and NBFCs engaged in manufacturing activities. The policy for multi-state co-operative societies was liberalised in January 2006. The prepayment limit of ECB was enhanced to US \$ 200 million from US \$ 100 million in August, 2005.

2.131 Overseas investments by mutual funds registered with SEBI were liberalised by enhancing the existing aggregate ceiling from US \$1 billion to US \$ 2 billion in July 2006. Further, a limited number of qualified mutual funds were permitted in July 2006 to invest cumulatively upto US \$ 1 billion in overseas exchange traded funds as may be permitted by SEBI.

2.132 Foreign Institutional Investors were allowed in July 2006 to offer sovereign securities with AAA rating as collateral to the recognised stock exchanges in India for their transactions in derivatives segment.

7. Customer Service in Banks

2.133 The Reserve Bank has been undertaking measures, on an ongoing basis, for protecting customers' rights, enhancing the quality of customer service and strengthening grievance redressal mechanism in banks. In order to bring all the activities relating to customer service in banks under a single umbrella, the Reserve Bank constituted a separate Customer Service Department (CSD) in July 2006. The functions of

the Customer Service Department include, *inter-alia*, disseminating instructions/information relating to customer service and grievance redressal by banks; administering the Banking Ombudsman (BO) Scheme; acting as a nodal department for the Banking Codes and Standards Board of India (BCSBI), ensuring redressal of complaints received directly by the Reserve Bank on customer service in banks; and liaising between banks, IBA, BCSBI, BO offices and the regulatory departments within the Reserve Bank, on matters relating to customer service and grievance redressal.

2.134 A significant initiative to improve customer service in recent years has been the setting up of an independent body called the Banking Codes and Standards Board of India (BCSBI) on February 18, 2006. A 'Code of Bank's Commitment to Customers' has been evolved through collaborative effort among the BCSBI, the Reserve Bank and the banking industry. Through the Code, banks have committed to have in place a 'tariff schedule' covering all charges. The BCSBI's role is to evaluate, oversee and enforce observance of the Code by banks through the

means of 'covenant' between each member bank and the BCSBI. The BCSBI's objective is to locate and rectify systemic deficiencies by taking collaborative remedial action rather than through penal measures (Box II.19).

2.135 The complaints against banks are handled at two levels in the Reserve Bank. Fifteen Banking Ombudsman Offices handle the complaints maintainable in terms of the provisions of the Banking Ombudsman Scheme. Regulatory departments in the Reserve Bank handle complaints that are not maintainable under the provisions of the Banking Ombudsman Scheme. The complaints have been categorised into deposit accounts, loans and advances, credit cards, activities of direct selling agents, harassment in recovery of loans and general/others.

2.136 The Banking Ombudsman Scheme was first notified by the Reserve Bank on June 14, 1995 under Section 35A of the Banking Regulation Act, 1949 to provide for a system of redressal of grievances against banks. The scheme sought to establish a system of expeditious and inexpensive resolution of customer complaints. The scheme was

Box II.19: Banking Codes and Standards Board of India

The Reserve Bank of India together with 11 other banks in India set up the Banking Codes and Standards Board of India (BCSBI) in February 2006 to monitor and ensure that banking codes and standards voluntarily adopted by banks are adhered to, in letter and spirit, while providing services to individual customers. These industry wide norms have been codified in the form of a Code of Bank's Commitment to Customers (Code), which has been evolved in consultation with the banking industry and released by the Reserve Bank on July 1, 2006.

The Code is a landmark in the development of banking in India as, for the first time, the individual customer has been provided with a Charter of Rights which he can enforce against his bank. The Code sets out minimum standards of banking practices for banks to follow and emphasises transparency in banks' dealings with its customers. To achieve the avowed transparency, it provides for documentation of banks' fees and service charges in the form of a Tariff Schedule and requires banks to set out a cheque collection policy, compensation policy and a security repossession policy. The Code lays great emphasis on providing full information to the customer before a product or service is sold to him. For post sale conduct, the Code insists on banks giving one month's notice to customer before making any change in their tariff schedule or any change in terms and conditions, governing the product, which may adversely affect the customer.

The cardinal principle that runs across all the provisions of Code is that banks should not rely on implicit consent from

customers and all product and services should be sold to the customer only after obtaining his explicit consent in writing. As a logical corollary of this principle, the Code prohibits banks from providing unsolicited credit in any form, including credit cards. The Code addresses the issue of Right to Privacy of customers and also provides for automatic compensation to be paid, in accordance with the bank's compensation policy, for any financial loss incurred by an individual customer due to undue delays, failure in executing mandates or erroneous debits.

The provisions of the Code are applicable to third party products sold through bank branches and the banks are under obligation to ensure that their direct sales agents also comply with the provisions of the Code. BCSBI's purview is restricted to scheduled commercial banks and 69 banks have intimated their willingness to become members. BCSBI is in the process of entering into a covenant with 55 of these major banks.

BCSBI combines the best of statutory regulation and self-regulation. It is a collaborative effort between banks and the Reserve Bank not only in its origin but also in purpose. While banks becoming member of the BCSBI agree to observe the Code, the Reserve Bank derives supervisory comfort from banks being members of the BCSBI as it would look into systemic issues that impinge on customer service and financial inclusion. The spirit of collaboration is further reinforced by the general consultative approach adopted by the BCSBI in formulating the Code and in its implementation.

revised twice, first in 2002 and then in 2006. At present, the scheme is being executed by BO appointed by the Reserve Bank at 15 centres covering the entire country. The BO scheme covers all commercial banks and scheduled primary co-operative banks.

2.137 The revised scheme came into effect from January 1, 2006. It incorporated new grounds of complaints such as credit card issues, failure in providing the promised facilities, non-adherence to the Fair Practices Code and levying of excessive charges without prior notice. It relaxed the mandatory requirement of filing of complaint to facilitate registering of complaints on-line or through e-mail. Further, the complainants can also appeal against the award of BO. The scheme provided for appointment of only serving senior officers of the Reserve Bank as BO and the secretariat of BO would consist of only Reserve Bank officers. However, banks are required to appoint nodal officers in their Zonal Offices/Regional Offices for the Scheme. Also, the cost of the scheme is borne entirely by the Reserve Bank. Furthermore, in order to enable the BO to concentrate on the complaints, rather than on arbitration of inter-bank disputes, the arbitration option rested with the BO was removed. The revised scheme has witnessed an unprecedented surge in the inflow of complaints mainly due to the inclusion of credit card related issues within

the ambit of the scheme, the wide publicity given and the facility of on-line complaint filing.

2.138 In July 2006, banks were advised to place service charges and fees on the homepage of their websites at a prominent place to facilitate easy access to the bank customers (Box II.20). A complaint form, along with the name of the nodal officer for complaint redressal, could also be provided on the homepage itself to facilitate complaint submission by the customers. The complaint form is required to indicate that the first point for redressal of complaints is the bank itself and that complainants may approach the BO only if the complaint is not resolved at the bank level within a month.

Credit Card Operations

2.139 Credit cards have made the concept of everywhere and any-time banking a reality. The Reserve Bank, over the past few years, has taken a number of measures aimed at encouraging the growth of credit card operations in a safe, secure and efficient manner. It has also been the endeavour of the Reserve Bank to ensure that the rules, regulations, standards and practices of the card issuing banks are in alignment with the best international practices. As announced in the Annual Policy Statement for 2004-05, the Reserve Bank constituted a Working Group on Regulatory

Box II.20: Service Charges by Banks

Prior to September 1999, the IBA used to work out a schedule of benchmark service charges for the services rendered by member banks. These were not mandatory in nature, but were being adopted by all banks. The practice of fixing rates for services of banks was consistent with a regime of administered interest rates but not consistent with the principle of competition. Hence, the IBA was directed by the Reserve Bank in September 1999 to desist from working out a schedule of benchmark service charges for the services rendered by member banks. It was decided that individual banks may be permitted to fix services charges for various types of services rendered by them, with the approval of their own boards of directors. However, banks were advised simultaneously that while fixing the service charges for various types of services provided by them, they should ensure that the charges are reasonable and not out of line with the average cost of providing these services.

The Reserve Bank continues to receive representations from the public about the unreasonable and non-transparent service charges being levied by banks suggesting that the existing institutional mechanism in this regard is not adequate. In order to ensure transparency in banking services, the above guidelines were reviewed. Accordingly,

banks were advised in May 2006 to display and update, on their websites, the details of various service charges in the format prescribed by the Reserve Bank. The formats could be modified depending on products offered but all service charges as indicated in the format should be covered. Banks were also required to display the charges relating to certain essential services to their offices/branches. This may also be displayed in the local language. Further, banks were also required to furnish to the Reserve Bank by May 31, 2006, the details of service charges applicable to enable placing of them on the Reserve Bank's website.

Banking Codes and Standards Board of India (BCSBI) has been set up as an independent watchdog to ensure that banks deliver services in accordance with the codes and standards to which they have agreed. In pursuance of the announcement made in the Annual Policy Statement for the year 2006-07, a Working Group was constituted on May 18, 2006 (Chairman: Shri N. Sadasivan). The Group has been entrusted to formulate a scheme for ensuring reasonableness of bank charges and to incorporate the same in the Fair Practices Code, the compliance of which would be monitored by the BCSBI. The Group has since submitted its Report. The recommendations of the Group are being examined.

Mechanism for Cards (Chairman: Shri R. Gandhi) on October 26, 2004. Based on the recommendations of the Working Group and

feedback received from card issuing banks and the public, guidelines on credit card operations of banks were issued in November 2005 (Box II.21).

Box II.21: Credit Card Operations of Banks

Based on the recommendations of the Working Group on Regulatory Mechanism for Cards, a master circular/guidelines on credit card operations were issued to banks/NBFCs on November 21, 2005. The salient features of the guidelines are set out below:

- i Each bank/NBFC must have a well documented policy for credit card operations incorporating the Fair Practices Code for credit card released by the IBA in March 2005.
- i Banks/NBFCs should independently assess the credit risk while issuing cards to persons, especially to students and others with no independent financial means, and assess the credit limit for a credit card customer on the basis of self-declaration/credit information.
- i The card issuing banks/NBFCs would be solely responsible for fulfillment of all KYC requirements.
- i While issuing cards, the terms and conditions for issue and usage of a credit card should be mentioned in clear and simple language.
- i Card issuers should ensure that there is no delay in dispatching bills and the customer has sufficient number of days (at least one fortnight) for making payment before the interest starts getting charged.
- i Card issuers should quote annualised percentage rates (APR) on card products (separately for retail purchase and for cash advance, if different) giving the method of calculation of APR with a couple of examples for better comprehension.
- i The bank/NBFC should not levy any charge that was not explicitly indicated to the credit card holder at the time of issue of the card and getting his/her consent except for charges such as service taxes, which may subsequently be levied by the Government or any other statutory authority.
- i The terms and conditions for payment of credit card dues, including the minimum payment due, should be stipulated so as to ensure that there is no negative amortisation.
- i Changes in charges (other than interest) may be made only with prospective effect giving notice of at least one month.
- i In case, a customer protests any bill, the bank/NBFC should provide explanation and, if necessary, documentary evidence to the customer within a maximum period of sixty days with a spirit to amicably redress the grievances.
- i To obviate frequent complaints of delayed billing, the credit card issuing bank/NBFC may consider providing bills and statements of accounts on-line with suitable security built therefore.
- i Banks/NBFCs have to be extremely careful about the appointment of service providers while outsourcing, ensuring that they do not compromise on quality of customer service and the bank/NBFC's ability to manage credit, liquidity and operational risks, and the Code of Conduct for direct sales agents (DSAs) as formulated by the IBA. Banks/NBFCs should have a system of random checks and mystery shopping to ensure that their agents have been properly briefed and trained.
- i Card issuing bank/NBFC would be responsible for all acts of omission or commission of their agents (DSAs/direct marketing agents (DMAs) and recovery agents) with respect to customer's rights, including personal privacy, clarity relating to rights and obligations, preservation of customer records, maintaining confidentiality of customer information and fair practices in debt collection.
- i In case, an unsolicited card is issued and activated without the consent of the recipient and the latter is billed for the same, the card issuing bank/NBFC shall not only reverse the charges forthwith, but shall also pay a penalty without demur to the recipient amounting to twice the value of the charges reversed.
- i Card issuing bank/NBFC should maintain a 'Do Not Call Register' (DNCR) containing the phone numbers (both cell phones and land phones) of customers as well as non-customers (non-constituents) who have informed the bank/NBFC.
- i Card issuing bank/NBFC should not reveal any information relating to customers obtained at the time of opening the account or issuing the credit card to any other person or organisation without obtaining their specific consent.
- i Before reporting default status of a credit card holder to CIBIL or any other credit information company authorised by the Reserve Bank, banks/NBFCs may ensure that they adhere to a procedure, duly approved by their boards, including issuing of sufficient notice to such card holder about the intention to report him/her as defaulter to the Credit Information Company.
- i In the matter of recovery of dues, banks/NBFCs may ensure that they, as also their agents, adhere to the extant instructions on Fair Practice Code for lenders as advised by the Reserve Bank as also the IBAs Code for collection of dues and repossession of security.
- i Banks/NBFCs/their agents should not resort to intimidation or harassment of any kind, either verbal or physical, against any person in their debt collection efforts.
- i Card issuing bank/NBFC should constitute a grievance redressal machinery within the bank/NBFC and give wide publicity about it through electronic and print media.
- i If a complainant does not get satisfactory response from the bank/NBFC within a maximum period of thirty days from the date of his lodging the complaint, he will have the option to approach the office of the concerned BO for redressal of his grievance/s.
- i The Standing Committee on Customer Service in each bank/NBFC may review, on a monthly basis, the credit card operations, including reports of defaulters to the CIBIL and credit card related complaints. It may take measures to improve the services and ensure the orderly growth of the credit card operations.

Box II.22: Branch Authorisation Policy

For opening of branches, banks are required to approach the Reserve Bank with the proposal. While submitting the proposal, banks are advised to follow certain procedures to comply with the requirements of Section 23 of the Banking Regulation Act, 1949. All specific proposals relating to opening, closing and shifting of all categories of branches, including off-site ATMs, are required to be included in their annual plan submitted to the Reserve Bank. No separate permission is required for an on-site ATM that is opened within a branch. After a branch has been opened, banks need to report immediately the complete address and the date of opening of the branch to the Regional Office concerned of the Reserve Bank. The authorisation granted is valid for one year from the date of issue of the consolidated letter of authorisation/permission issued to banks. In case a bank is not able to open a particular branch due to any genuine reason, it can approach the Regional Office of the Reserve Bank for extension of time not exceeding three months.

The branch authorisation policy framework takes into account several elements before granting approval to the opening of new branches by banks. First, while considering applications for opening of branches, weightage is given to the nature and scope of banking facilities provided by banks to common persons, particularly in underbanked areas, actual credit flow to the priority sector, pricing of products and overall efforts for promoting financial inclusion, including introduction of appropriate new products and the enhanced use of technology for delivery of banking services. Second, such an assessment includes policy on minimum balance requirements and whether depositors have access to minimum banking or no frills banking services, commitment to the basic banking activity and quality of customer service as evidenced, *inter alia*, by the number of complaints received and the redressal mechanism in place in the bank for the purpose. Third, the need to induce enhanced competition in the banking sector at various locations is also taken into account. Regulatory comfort is also relevant in this context. This encompasses: (i) compliance with principles of regulation; (ii) the activities of the banking

group and the nature of relationship of the bank with its subsidiaries, affiliates and associates; and (iii) quality of corporate governance, proper risk management systems and internal control mechanisms.

The existing system of granting authorisation for opening individual branches from time to time has been replaced by a system of giving aggregated approvals, on an annual basis, through a consultative and interactive process. Banks' branch expansion strategies and plans over the medium-term are discussed by the Reserve Bank with individual banks. The medium-term framework and the specific proposals to the extent possible cover the opening/closing/shifting of all categories of branches/offices, including the ATMs. The revised branch authorisation policy has granted reasonable flexibility and freedom to banks in matters relating to shifting, conversion of branches and upgradation of extension counters.

The branch authorisation policy for Indian banks is also applicable to foreign banks, subject to the following conditions. First, foreign banks are required to bring an assigned capital of US\$ 25 million upfront at the time of opening the first branch in India. Second, existing foreign banks having only one branch have to comply with the above requirement before their request for opening of second branch is considered. Third, foreign banks are required to submit their branch expansion plan on an annual basis. In addition to the parameters laid down for Indian banks, the following additional parameters are considered for foreign banks: (i) track record of compliance and functioning in the global markets of the foreign bank and its group (reports from home country supervisors are sought, wherever necessary); (ii) even distribution of home countries of foreign banks having presence in India; (iii) treatment extended to Indian banks in the home country of the applicant foreign bank; (iv) bilateral and diplomatic relations between India and the home country; and (v) India's commitments at WTO. ATMs are not included in the number of branches for such computation.

Branch Authorisation Policy

2.140 In terms of the existing provisions, banks are not allowed, without the prior approval of the Reserve Bank, to open a new place of business in India or change the location of the place of business, other than within the same city, town or village. While the current policy for authorisation of overseas branches of Indian banks would continue, the branch authorisation policy was liberalised and rationalised in September 2005 in order to give reasonable freedom to banks and rationalise the policy for opening of new branches in India. A comprehensive framework for branch authorisation policy consistent with the medium-term corporate strategy of banks and public

interest was put in place effective September 8, 2005 (Box III.22).

8. Financial Inclusion

2.141 The Mid-term Review of Annual Policy Statement for the year 2005-06 while recognising the concerns with regard to the banking practices that tend to exclude rather than attract vast sections of population, urged banks to review their existing practices with a view to aligning them with the objective of financial inclusion. In many banks, the requirement of a minimum balance and charges levied, although accompanied by a number of free facilities, deter a sizeable section of population from opening/maintaining bank accounts.

2.142 With a view to achieving the objective of greater financial inclusion, all banks were advised in November 2005 to make available a basic banking ño-frillsí account either with ñnilí or very low minimum balances as well as charges that would make such accounts accessible to vast sections of population. The nature and number of transactions in such accounts could be restricted, but made known to the customer in advance in a transparent manner. All banks were also advised to give wide publicity to the facility of such a ño-frillsí account, including on their websites, indicating the facilities and charges in a transparent manner. All public and private sector banks have advised the Reserve Bank of having introduced the basic banking ño-frillsí account. Further, except for those foreign banks that do not have significant retail presence, all other foreign banks have advised the Reserve Bank of having introduced the facility of ño-frillsí account. With a view to encourage financial inclusion, the Mid-term Review of the Annual Policy for 2006-07 proposed to simplify the KYC procedure for opening small accounts. It was indicated that for such accounts, banks need to seek only a photograph of the account holder and self-certification of address. Outstanding balances in these accounts at any time would be limited to Rs.50,000 and the total transactions limited to Rs.2,00,000 in one year. As and when the balances or total transactions exceed these limits, banks would be required to convert them into normal accounts and follow the normal procedure of KYC. It was also indicated that the Reserve Bank would issue certain clarifications in respect of conduct of the KYC procedure for normal accounts so as to make it more customer-friendly.

2.143 With the objective of ensuring greater financial inclusion and increasing the outreach of the banking sector, it was decided in January 2006, to allow banks to use the services of NGOs/SHGs, MFIs and CSOs as intermediaries in providing financial and banking services through the use of business facilitator and business correspondent models. The guidelines issued in January 2006 mainly related to: i) eligible entities and scope of activities under business facilitator and correspondent models; ii) payment of commission/fees and other terms and conditions for these entities; iii) redressal of grievances; and iv) compliance with the ñKYCí norms.

2.144 Banks were advised that under the business facilitator model, they could use

intermediaries such as NGOs, farmersí clubs, co-operatives, community based organisations, IT enabled rural outlets of corporate entities, post offices, insurance agents, well functioning *panchayats*, village knowledge centers, agri-clinics/agri-business centres, *krishi vigyan kendras* and *Khadi* and Village Industries Commission (KVIC)/*Khadi* and Village Industries Commission Board (KVIB) units, for providing financial services, depending on the comfort level of the bank. Banks were also advised that under the business correspondent model, NGOs/MFIs set up under the Societies/Trusts Acts; societies registered under the Mutually Aided Co-operative Societies Acts or the Co-operative Societies Acts of States; companies mentioned under Section 25 of the Companies Act, 1956; registered NBFCs not accepting public deposits and post offices may act as ñbusiness correspondentsí. Banks were advised subsequently that the selection/use of NBFCs as business correspondents may be deferred.

2.145 The Reserve Bank advised banks that they may pay reasonable commission/fee to the business facilitators/correspondents, the rate and quantum of which may be reviewed periodically. As the engagement of intermediaries as business facilitators/correspondents involves significant reputational, legal and operational risks, banks were advised that due consideration should be given by them to such risks. Banks were also advised that they should endeavour to adopt technology-based solutions for managing the risks, besides increasing the outreach in a cost effective manner.

2.146 Banks were advised to constitute grievance redressal machinery within the bank for redressing complaints about services rendered by business facilitators and correspondents and give wide publicity about it through electronic and print media. The name and contact number of the designated grievance redressal officer of the bank were required to be made known and widely publicised. Banks were also required to place on their websites the grievance redressal procedure and the timeframe for responding to the complaints. If a complainant does not get satisfactory response from the bank within the stipulated time from the date of lodging the complaint, the complainant has the option of approaching the Banking Ombudsman concerned for the redressal of grievances.

2.147 Banks were further advised that compliance with ñKYCí norms will continue to be

their responsibility. Since the objective is to extend savings and loan facilities to the underprivileged and unbanked population, banks were advised to adopt a flexible approach within the parameters of guidelines issued on eKYC from time to time.

2.148 In order to ensure that the banking facilities percolate to the vast sections of the population, banks were advised in December 2005 to make available all printed material used by retail customers, including account opening forms, pay-in-slips, passbooks *etc.*, in trilingual form, *i.e.*, English, Hindi and the concerned regional language.

2.149 With a view to providing hassle-free credit to banks customers in rural areas, the guidelines on general credit card (GCC) were issued on December 27, 2005 (Box II.23).

2.150 In order to prepare a monitorable action plan for achieving greater financial inclusion and providing of financial services in the North Eastern Region (NER), the Reserve Bank had set up a Committee (Chairperson: Smt. Usha Thorat) in January 2006 to: (i) review the action taken so far for extending banking coverage and increasing the flow of credit in the NER; (ii) identifying bottlenecks in the extension of financial services; (iii) suggest measures to overcome the impediments in financial inclusion and enable greater flow of credit, draw up state-wise action plan appropriate to local conditions in each of the States; and (iv) consider matters relevant

to the above and recommend appropriate actions on them.

2.151 The Committee, which submitted its report in July 2006, made several recommendations with a view to achieving greater financial inclusion in the NER. Some of the major recommendations made by the Committee include: (i) banks should draw up plans for each branch for providing no frills account to at least 50 households per month in the next 4 years to achieve greater financial inclusion; (ii) banks should undertake extensive recourse to bank/SHG-linkage programme and business correspondent/business facilitator model and IT based solutions including smart cards based and mobile payments for carrying out banking transactions from non-bank locations; (iii) simplified alternatives such as land possession certificate/certificate from the group/local tribal bodies/farmers clubs/Village Development Boards regarding the borrowers' right to cultivate land, be adopted, given that community ownership and non-transferable rights on land often lead to problems in offering land as collateral; (iv) location specific activity-wise action plans be implemented for stepping up flow of credit to agriculture, allied activities and the SME sector; (v) the *ad hoc* incentive package of human resource management be replaced by performance based cash incentive; and (v) the currency management and payments/settlement system in the region be improved.

Box II.23: General Credit Card (GCC) Scheme

Credit cards are now being extensively issued to and used by individuals to make purchases of goods and services on credit and make cash withdrawals. In rural areas, with limited point-of-sale (POS) and limited ATM facilities, while similar product may not be feasible, there has been demand for General Credit Card (GCC) akin to *Kisan Credit Card (KCC)*. Consequently, banks and RRBs were permitted to introduce a GCC scheme at any of their branches for issuing GCC to their constituents in rural and semi-urban areas, based on the assessment of income and cash flow of the household similar to that prevailing under normal credit card.

The objective of the scheme is to provide hassle free credit to banks' customers based on the assessment of cash flow without insistence on security, purpose or end-use of the credit. This is in the nature of overdraft or cash-credit with no end-use stipulations. The credit facility extended under the scheme will be in the nature of revolving credit. The GCC holder will be entitled to draw cash from the specified branch of a bank up to the limit sanctioned. It is not necessary that GCC should be linked to purchase; GCC may

not necessarily be in the form of a card. GCC can be issued in the form of a pass book, if the holder of GCC desires to operate cash withdrawals from bank branch.

Banks would have flexibility in fixing the limit based on the assessment of income and cash flow of the entire household. However, the total credit facility under GCC for an individual should not exceed Rs.25,000 and interest rate on the facility may be charged, as considered appropriate and reasonable. The limit may be periodically reviewed and revised/cancelled depending on track record of the account holder. The eligibility criteria are subject to review. With a view to targeting women as beneficiaries of bank credit, they may be given a preferential treatment under the GCC scheme. Banks may utilise the services of local post offices, schools, primary health centers, local government functionaries, farmers' association/club, well-established community-based agencies and civil society organisations for sourcing of borrowers for issuing GCC.

Fifty per cent of credit outstanding under GCC up to Rs.25,000 will be eligible for being treated as indirect agricultural financing.

Box II.24: Working Group on Improvement of Banking Services in Uttaranchal

The major recommendations/observations of the Group (Chairman: Shri V. S. Das) are as follows:

- i There is a slowdown in investment credit, which has impaired agricultural borrowers' credit absorption capacity and eventually affected the growth of crop loans as well. Banks should integrate the investment and production credit needs of the farmers and increase their investment credit.
- i In view of a large number of small and fragmented land holdings, banks need to adopt cluster financing and subsequently sub-clusters could be developed around the main cluster.
- i In view of engagement of women in farm activities, suitable mechanism may be worked out to enable them to avail credit from the banking system.
- i In order to financially include 100 per cent of the unprivileged population, each bank branch may cover a minimum of 25 new households per month over a period of three years, with a basic banking ñno frills' account and limited overdraft facility through GCC/KCC either directly or through SHGs.
- i Banks need to have CREDIT PLUS approach in their financial inclusion schemes by extending insurance, marketing and consultancy services.
- i Considering the time, distance and cost for customers to reach a bank branch, especially in remote areas, banks need to use business facilitator and business correspondent models for increasing their banking outreach to underserved/unbanked persons by using the services of local persons like school teachers, postmen, primary health workers, as also of NGOs/MFIs/ CSOs.
- i Having regard to the trusted relationship that the people have with post offices and postmen, banks could gainfully appoint post offices as their business correspondents on the lines of Maharashtra model for achieving the ultimate target of 100 per cent financial inclusion.
- i With a view to providing financial literacy and awareness of banking facilities to the people living in far-flung rural and hilly areas, an awareness campaign through media, newspapers, road shows, street plays, audio visuals during major festivals, needs to be launched. SLBC convenor banks may take a lead with the help of other major PSBs and the State Government.
- i Village *panchayats* may be groomed to (i) act as banking services facilitation centre at each village to act as a link between the bank servicing the region and the residents of the village; and (ii) promote banking services and resolve savings and credit needs of the residents of the village.
- i For greater outreach of banking services in remote areas, financial information network and operations (FINO) model, a technology backbone company for providing facilities akin to banking to the grass root financial entities serving people who do not have access to banking facilities, could be adopted. FINO has already offered their assistance in five districts of the State on a pilot basis.
- i To give more autonomy to the boards of RRBs, the requirement of obtaining prior approval from the sponsor banks in staff requirement matters may be dispensed with. Each RRB should evolve its own operational policies, including staff matters. Pending recruitment of staff, the problem of staff shortage may be addressed by deputation of staff from concerned sponsor banks.
- i Banks having larger share of foreign exchange business in the State may make arrangements for providing foreign exchange facilities at all district headquarters and other strategic locations.

2.152 Pursuant to the meeting held between the Governor of the Reserve Bank and the Chief Minister of Uttaranchal, a Working Group (Chairman: Shri V. S. Das) was constituted on May 22, 2006, to examine the problems/issues relating to banking services in Uttaranchal and prepare an action plan for implementation for the purpose (Box II.24).

2.153 The banking sector plays an important role in the economic development of a country by mobilising savings and allocating them efficiently. However, banking penetration in India has been low. There are also wide variations of banking penetration across the States. With a view to undertaking a detailed study on banking penetration in India and recommending measures to achieve higher banking penetration in the

country, a Working Group (Chairman: Shri Janak Raj) has been constituted. The Group is expected to submit the Report by December 2006.

9. Payment and Settlement Systems

2.154 The smooth functioning of the payment and settlement system is a pre-requisite for financial stability. The Reserve Bank, therefore, has taken several measures from time to time to develop the payment and settlement system in the country along sound lines. The initiatives taken during the year include: (i) enhancing usage of the RTGS system; (ii) providing incentives and guidelines for reducing transaction costs for electronic payment system; (iii) improving legal infrastructure for the payment system; (iv) introducing nationwide payment system for

retail payment; (v) improving international remittance services; and (vi) facilitating newer channels of payment and settlement (for details refer to section 7 of Chapter III).

2.155 The Board for Regulation and Supervision of Payment and Settlement Systems (BPSS), set up in March 2005 as a committee of the Central Board of the Reserve Bank, is the apex body for giving policy direction in the area of payment and settlement systems. The BPSS, which held six meetings since its constitution, gave important policy directions/decisions. These include: (i) setting target for usage of the RTGS system; (ii) publishing frequently asked questions (FAQ) on payment systems; (iii) publishing the charges levied by banks for electronic payment systems; (iv) setting up an umbrella organisation for all retail payment systems in the country; (v) finalising the Payment and Settlement Systems Bill; and (vi) preparing the Electronic Funds Transfer Regulations under the Reserve Bank of India, Act.

2.156 The use of Electronic Clearing Service (ECS), both debit and credit, is on the increase. However, it is the debit clearing which is growing at a faster pace. The reach of ECS has increased and it is now available at 58 centres. In November 2005, banks were advised to develop appropriate delivery channels of electronic payment services using the payment systems developed by the Reserve Bank such as RTGS, ECS, Electronic Fund Transfer (EFT) and National Electronic Fund Transfer (NEFT) with no further delay. Banks, which fulfill the eligibility criteria for participation in RTGS, were invited to participate in the NEFT. In order to start a robust state-of-the-art nationwide ECS covering more branches and locations with centralised data submission system, SCBs (including co-operative banks) were advised to furnish certain information indicating their level of preparedness for the project as on June 27, 2006. To take the effort further, all SCBs were directed on July 4, 2006 to initiate steps for incorporating an appropriate mandate management routine for handling ECS (Debit) transactions. Earlier in terms of the guidelines issued on October 17, 2005, banks were advised to provide details to the customers in their Pass Book/Account Statement regarding the credits affected through ECS. Banks were also advised to furnish information on pricing of services for products based on structured financial messaging solution (SFMS)/RTGS/SEFT/EFT/ECS infrastructure. With

effect from June 14, 2005, processing charges for all electronic transactions under EFT, SEFT and ECS facility amounting to Rs.2 crore and above, were waived up to the period ended March 31, 2007. This is in addition to the existing waiver on transactions involving less than Rs.2 crore.

2.157 The operationalisation of the NEFT in November 2005 was a major step in the direction of setting up and operating a national level payment system. The NEFT is a secured network, which uses the SFMS messaging format with public key infrastructure (PKI) enabled digital signatures retail electronic payment system having a nation-wide network. All the SEFT clearing banks were advised to migrate to NEFT system by December 15, 2005. With the implementation of NEFT, the SEFT system was discontinued from February 2006.

2.158 The Reserve Bank has also advised banks to adopt the centralised funds management system (CFMS), which enables banks to transfer funds across its accounts with various offices of the Reserve Bank. At present, the system is available at six centres, viz., Mumbai, Delhi, Chennai, Kolkata, Hyderabad and Bangalore. Two more centres are likely to be included in the system soon.

2.159 The Reserve Bank has also decided to implement the National Settlement System (NSS) to facilitate better liquidity management by banks. The concept paper on NSS explaining settlement of clearing across the country at one location was prepared. Feedback received from banks is being processed and the implementation of the facility will be taken up shortly. To start with, the clearing settlements arrived at the four metros would be settled through the NSS. In the second phase, settlement of clearing in other large cities would also be carried out through the NSS.

2.160 For further improving the efficiency of the paper-based system, a plan has been drawn up for computerisation of clearing operations at centres where there are more than 30 banks (apart from the 59 centres where magnetic ink character recognition (MICR) cheque processing centres have already been set up). A few centres have already computerised the clearing house operations using the magnetic media based clearing system (MMBCS). Under this system, the member banks present their claims in the form of an electronic file, which gets processed on the

computer. This enables arriving of settlement figures within a quarter of an hour as compared with three or four hours under the manual system.

2.161 A set of Minimum Standards of Operational Efficiency for MICR cheque processing centres has been framed in order to ensure smooth operations of the MICR cheque processing centres. The standards mainly relate to encoding of instruments, time schedule, operational procedures, speed and accuracy of on-line reject repair (OLRR), checking of settlement reports for supervisory signals, enabling banks to download reports/data on-line, reconciliation and business continuity plan. The MICR cheque processing centres have to submit self assessment report certifying adherence to the minimum standards for operational efficiency to the Reserve Bank.

2.162 The implementation of Cheque Truncation System (CTS) is another effort for bringing in efficiency of paper-based system. To be introduced on a pilot project basis in the national capital region of Delhi by end-December 2006, the CTS would be rolled out in the rest of the country in phases. Under CTS, paper instruments do not travel beyond the presenting bank. It is up to banks to take a business decision on the point of truncating the cheque - at the branch level or service branch or gateway level. The CTS enables banks to handle the payment instruments in an easier way. Customers also enjoy the benefit of encashing their cheques faster. Apart from reduction in transaction costs for banks as well as customers, the full implementation of CTS would make it possible to achieve T+1 clearing cycle (even T+0) as CTS is straight-through-processing and automated payment processing enabled. Moreover, with CTS, banks also have the additional advantage of much reduced reconciliation problems and incidents of clearing frauds. In order to ensure that banks are ready with the desired infrastructure well in time, detailed guidelines were issued to banks on the hardware/communication requirements.

2.163 As indicated in the Payment System Vision - 2005-08, the IBA constituted a Working Group to look into the setting up of a separate entity for taking over of the operations of retail payment systems. On recommendations of the Working Group, a company registered under Section 25 of the Companies Act is being set up.

2.164 The Clearing Corporation of India Limited (CCIL) set up by banks is the central counter party

(CCP) for clearing of transactions in Government securities and foreign exchange. The CCIL operates the G-Sec clearing while the settlement for both the securities and funds takes place in the Reserve Bank. CCIL acts as the CCP for all the transactions and guarantees both the securities and funds legs of the transaction. DvP-III mode of settlement has been adopted, whereby both the securities leg and the fund leg are settled on a net basis. CCIL guarantees settlement of trades on the settlement date by acting as a central counter party to every trade through the process of novation. Another large value segment operated by the CCIL is the forex clearing. Every eligible foreign exchange contract entered into between members, gets novated and is replaced by two new contracts - between CCIL and each of the two parties, respectively. The rupee leg is settled through the members' current account with the Reserve Bank and the USD leg through CCIL's account with the designated settlement bank at New York. The settlement through CCIL has reduced the gross dollar requirement by more than 90 per cent.

2.165 SCBs were advised to expedite the process of allotting Indian Financial System Code (IFSC) to the branches in March 2006. It was also decided that IFSC of the branch be printed just above the MICR band on the cheques preferably above the serial number of the cheque. In July 2006, it was decided that prior approval of the Reserve Bank would not be required for offering internet banking services, subject to fulfilment of certain conditions.

Remittances Services

2.166 The cross border remittances are mainly from migrant workers to their families in their home country. However, the remittances can be expensive relative to the often low income of migrant workers and to the rather small amounts sent. A Task Force was constituted by the Committee on Payment and Settlement System (CPSS) of the Bank for International Settlements (BIS) to develop principles for international remittance services. Based on the recommendations of the Task Force, the CPSS published a Consultative Report on General Principles for International Remittance Services in March 2006. The General Principles are aimed at the public policy objectives of achieving safe and efficient international remittance services (Box II.25).

Box II.25: Consultative Report on General Principles for International Remittance Services

The main principles laid down in the Consultative Report are set out below:

General Principle 1: The market for remittance services should be transparent and should have adequate consumer protection.

General Principle 2: Improvements in payment system infrastructure, that have the potential to increase the efficiency of remittance services, should be encouraged.

General Principle 3: Remittance services should be supported by a sound, predictable, non-discriminatory and proportionate legal and regulatory framework in relevant jurisdictions.

General Principle 4: Competitive market conditions, including appropriate access to domestic payments

infrastructure, should be fostered in the remittance industry.

General Principle 5: Remittance services should be supported by appropriate governance and risk management practices.

Remittance service providers should participate actively in the implementation of the General Principles. Public authorities should evaluate what action is required to be taken to achieve the public policy objectives through implementation of the General Principles.

Reference :

Bank for International Settlements (2006): *Consultative Report on General Principles for International Remittance Services*, March.

2.167 An internal study revealed that a major portion of the remittances received (54 per cent) was utilised for family maintenance. On an average, about 20 per cent of the funds received were deposited in the bank accounts and 13 per cent were invested in land/property/equity shares. A cross-section analysis of the relationship between the size of remittances and the frequency of sending remittances revealed an inverse relationship between the two, which is in line with the empirical findings of studies in other developing countries. The Study found that there is a preference for time-efficient modes such as electronic wires/swift by the overseas Indians, even though they turn out to be costlier as compared with drafts and cheques.

2.168 The Working Group on the Cost of Non-Resident Indian (NRI) Remittances submitted its Report to the Reserve Bank in August 2006. Some of the major recommendations made by the Group include: (a) banks in India should review their existing scale of charges both at the foreign and the domestic centres and resort to latest technology for handling large volume of transactions; (b) banks should improve their infrastructure by extending the scope of existing electronic transfer facilities such as the RTGS or setting up centralised remittance receiving centres and widening the scope of exchange houses; (c) Indian banks should explore tie-ups with more correspondent banks which would bring down the cost for the NRIs at the foreign centres; (d) the cap on number of branches of Indian banks with drawal arrangements with exchange houses may be reviewed; and (e) NRIs may be advised to route

their remittances through a branch of an Indian bank or a foreign bank having a branch in India. NRIs should be advised, as far as possible, to convert foreign currencies into Indian Rupees at the Indian end to get the benefit of a better exchange rate.

10. Technological and Other Developments

2.169 The financial sector has been a large user of information technology (IT). Banks, in particular, have been increasingly using IT in their day to day operations. Over the years, banks have (a) extended the reach of core banking solutions (CBS) to more branches so as to facilitate éanywhere banking; (b) introduced technology based products and services such as mobile banking; and (c) expanded the internet banking facilities. Banks have been increasingly using the NEFT for ensuring wider reach for electronic funds movement.

2.170 With enhanced level of IT usage by banks, the Reserve Bank is gradually moving away from micro-management of IT related matters of banks. Instead, the Reserve Bank has begun to frame guidelines and standards which relate to common inter-bank requirements. During the year, the Financial Sector Technology (FST) Vision Document, 2005-08 was released to all banks in July 2005. The document outlines the approach to be followed by the Reserve Bank as far as IT implementation for the immediate future is concerned. The Vision Document has helped banks to formulate their IT policies in a manner which are in line with the direction given by the Reserve Bank. At the same time, it also facilitated banksí overall movement in

a unified manner towards common inter-operable standards for IT systems and inter-bank messaging. In order to follow-up the implementation of the tenets of the FST Vision Document, a Conference of IT Chiefs of all categories of banks was organised by the Reserve Bank in January 2006.

Technology Based Services provided by the Reserve Bank to Banks

2.171 The Reserve Bank continued to function as a business facilitator for developing new products and services by banks. Some of the systems developed by the Reserve Bank for use by banks were NDS, RTGS, CFMS and SFMS over the INFINET.

2.172 Improvements in the software architecture of NDS have resulted in better throughput and reduced processing time for member banks of the system. A major enhancement made during the year was the migration towards front-end validation by the member instead of validation being performed by the host. The system functioned smoothly during the year. The process of converting the system into a screen based trading system was completed. The first set of modules was made operational at the CCIL from August 2005.

2.173 The RTGS system has stabilised well and the use of the facility for transfer of funds, especially for large value and for systemically important purposes, has been on the rise. The system has a mesh topology and the number of members using the system has gone up to 110 with nearly 25,000 bank branches offering RTGS based fund transfers to their customers.

2.174 During the year, the transmission of clearing data, both for cheque clearing and for electronic clearing services, was done in many centres through the secured website. In addition, collation of inputs from currency chests as part of the integrated currency chest operations and management system (ICCOMS) was done using the secured website. The secured internet website was extended to cover the centralised data base management system (CDBMS) and for commercial banks to access clearing data for STP based posting. The software system developed for the BO in September 2005 also uses the secured website as the means of information transmission. This system facilitates monitoring of complaints not only by the offices of the BO situated at various locations but also by the Reserve Bank and the Ministry of Finance.

Banks and IT based Delivery Channels

2.175 Over the past few years, the banking sector has witnessed a large increase in the use of IT based delivery channels and internet banking activity. Some of the new facilities provided include: (i) funds transfer options to cover third party customer accounts within the same bank; (ii) funds transfer across banks; (iii) utility bill payments and other regular periodical payment facilities; and (iv) integration with e-commerce transactions such as for booking of tickets for rail and air.

2.176 Banks were advised in July 2006 not to associate themselves with internet based electronic purse schemes, which are in the nature of acceptance of deposits withdrawable on demand.

2.177 Mobile banking is another activity, which is gaining ground. Many customer-friendly facilities from short messaging service (SMS) alerts to action based on mobile instructions are being incorporated, which could have far reaching implications for the financial sector. The delivery channels such as internet and mobile banking, however, also raise some concerns about the security (Box II.26).

Developments in the INFINET

2.178 The Indian Financial Network (INFINET) continued to be the most preferred communication channel for transmission of electronic information by banks for the systemic inter-bank payment systems of the Reserve Bank. INFINET is being used by banks for inter-office communication as well. INFINET uses the SFMS, which is a message processing system similar to the Society for Worldwide Financial Telecommunication (SWIFT) messaging system. SFMS is PKI enabled so as to provide for security of highest levels for secure and safe inter-bank financial message transfers, apart from conforming to the laws of the land such as the Information Technology Act, 2000. SFMS based message transfers can conform to the requirements of straight through processing (STP) so as to ensure quick, safe and secure processing with little or no interference by humans. The INFINET is a wide area terrestrial and satellite [using very small aperture terminals (VSATs)] based blended network. The terrestrial links are provided by means of leased optical fibre channels with adequate bandwidth. The network operated and managed by the Institute for Development and Research in Banking Technology (IDRBT), is poised to be used for connectivity options available

Box II.26: Security in Delivery Channels

Banking in India has witnessed a large scale transformation in the last few years. Some of the new technology-based delivery channels implemented by banks for their customers include internet banking, mobile banking and card based funds transactions. In all these products, the underlying medium of information transportation is generally a commonly available, inexpensive and public oriented vehicle such as internet or mobile telephony.

Given the need for optimal levels of security for financial transactions, the enhanced security of technology-based transactions assumes significance. The Reserve Bank had issued guidelines for internet banking in 2001, which continue to be the baseline set of requirements for banks to follow when they offer internet banking services to their clients. However, technological developments combined with the increase in unethical attempts to break into systems have warranted a continuous review of the security implemented in such systems.

A set of preventive, detective and control measures are necessary for enhanced customer confidence in internet banking. Apart from base level security features such as user IDs (identification) and passwords, other security facilitators such as firewalls, proxy servers and customer held identification devices could also be used. Authentication is another basic requirement which is implemented by the use

of public key infrastructure (PKI) based encryption, biometric and/or other devices. Trust, which is achieved by reputed and independent third parties confirming the authenticity/genuineness of transactions/messages is being achieved in the Indian case by the use of digital signatures which are issued by certification/registration authorities under the Information Technology Act, 2000. Non-repudiation, which prevents denial or repudiation by the sender and receiver of electronic messages, privacy and availability are of utmost importance for building customer confidence.

Other requirements such as confidentiality, virus detection and prevention, disaster recovery management and business continuity plans need to be taken care of in internet banking offerings, in addition to regular periodical tests of the sites access facilities provided, audit of the personnel associated with the process and other similar critical aspects such as an overview of the types of service access.

Some of the recent initiatives undertaken to address potential security risks for mobile banking and home content access are: (i) smart phone access based on SIM authentication; (ii) (RF)ID (Radio-Frequency Identification) based authentication, based on SIM stored user name/password; (iii) PC based access with user name/password; and (iv) PC based access through mobile phone presence.

in the form of virtual private networks (VPNs) over public network. Banks in India have been encouraged to use their own networks for inter-branch communications. With internet base delivery channels becoming easily available, the concept of VPNs is gaining ground amongst banks

in India as well. A few banks have set up their own corporate networks using VPNs. Another notable feature during the year was the migration of SWIFT to IP based network, with extensive usage of VPNs. This has instilled greater level of confidence amongst the banks (Box II.27).

Box II.27: Virtual Private Networks

Network based communication and computation have come of age. From a period characterised by users having their own networks, today, the internet has become the most preferred mode of electronic communication. The migration towards centralised processing systems, the large scale proliferation of the internet and low costs have resulted in increased usage of public networks. This has been achieved with enhanced security, wherever required.

A Virtual Private Network (VPN) is a network made up of public communication links and using the internet as the medium for transporting electronic information. A VPN is a private network within a public network to connect remote sites or users together. It facilitates transmission of messages amongst the members of the VPN in an encapsulated manner so that unauthorised access to these messages is not possible. VPNs use enhanced security features to ensure that authorised users only have access to the network and that data travelling over the network cannot be intercepted. Thus, the key differentiator in a VPN is the security on such networks. Security on VPNs is achieved by the use of cryptographic tunnelling protocols to provide the necessary

confidentiality, sender authentication and message integrity to achieve the privacy intended. When properly chosen, implemented and used, such techniques can provide secure communications over unsecured networks. Such security requirements are ensured from a service provider by means of a defined service level agreement (SLA) between the customer and the service provider.

Some of the advantages of resorting to a VPN include a larger geographical coverage, enhanced security, reduced costs, quick transmission time for message transfers and a relatively simpler network topology.

A well-designed and implemented VPN incorporates the key essential features of security, reliability, scalability and optimal network management. A VPN involves two parts: (i) the protected or 'inside' network, which provides physical and administrative security to protect the transmission; and (ii) a less trustworthy, 'outside' network or segment, which is generally the internet. Generally, a firewall sits between a remote user's workstation or client and the host network or server. An example of a financial VPN is the SWIFT, which has migrated to the secure electronic messages using VPNs.

11. Legal Reforms in the Banking Sector

2.179 An efficient financial system requires a regulatory framework with well-defined objectives, adequate and clear legal framework and transparent supervisory procedure. A comprehensive legislation is also a pre-requisite for the regulatory authority to discharge its responsibilities effectively. Keeping this in view, the Reserve Bank has been making constant efforts to upgrade and strengthen the legal framework in tune with the changing environment. The Central Government, on the recommendation of the Reserve Bank, has initiated a number of measures in this respect over the past few years.

Recent Acts Enacted by the Parliament

2.180 In order to facilitate the task of monetary management and provide operational flexibility, a greater empowerment of the Reserve Bank in the wielding of policy instruments was considered necessary. Keeping this in view, the Reserve Bank

of India Act, 1934 was amended by the Parliament. This amendment, *inter-alia*, has empowered the Reserve Bank to determine the CRR without any ceiling or floor rate (Box II.28).

2.181 The Credit Information Companies (Regulation) Act, 2005 has been enacted for regulation of Credit Information Companies and facilitating efficient distribution of credit and for matters connected therewith or incidental thereto. After coming into force of the Act, the existing obligation, on the part of credit institutions such as banks and FIs, to maintain secrecy with respect to affairs of their constituents would not be a legal constraint for them. The Act provides for establishment, supervision and regulation of a credit information company that can undertake the functions of collecting, processing and collating information on trade, credit and financial standing of the borrowers of credit institutions which are members of the credit information company. It could provide credit information to

Box II.28: The Reserve Bank of India (Amendment) Act, 2006 ñ Salient Features

The Reserve Bank of India (Amendment) Act, 2006, gives enabling powers to the Reserve Bank with regard to instruments for monetary management. The amendment mainly provides flexibility to the Reserve Bank in prescribing reserve requirements for scheduled banks and also gives comprehensive powers to regulate the money and the government securities market.

(i) *Cash Reserve Ratio*

Under the amended statute, the Reserve Bank, in order to secure monetary stability in the country, can determine the CRR for scheduled banks without any ceiling or floor rate. With the amendment of the Act, the Reserve Bank also cannot pay interest on any portion of CRR balances of banks once the Act comes into force. Prior to the amendment, the Reserve Bank did not pay interest on CRR balances on the statutory minimum level of 3 per cent of banks' demand and time liabilities. Also, no interest was paid on excess CRR balances maintained by the banks beyond the prescribed level.

(ii) *Reverse Repo and Repo*

The amended Act enables the Reserve Bank to undertake repo and reverse repo operations as also lending and borrowing of securities, including foreign securities.

The amendments have implications for the business undertaken by the Reserve Bank on its own account. Further, the insertion in clause (12A) defines repo/reverse repo as essentially collateralised borrowing/lending transactions in either cash or securities that are structured as sale purchase transactions, with the securities passing from seller to buyer in the ready leg and back to seller in the forward leg. Until the amendment, the accounting treatment of repo reflected the legal interpretation of repo as sale/purchase transactions. The amended provisions define repo/reverse repo as two legs

of the same transactions and not two discrete/independent transactions.

(iii) *Money and Government Securities Market*

The new Chapter (III-D) of the amended Act empowers the Reserve Bank to determine the policy relating to interest rates or interest rate products and regulate the agencies dealing in securities, money market instruments, foreign exchange, derivatives, or other instruments of like nature, give directions, and also call for information and cause inspection of entities that are otherwise not under the regulatory purview of the Reserve Bank. As such, the Reserve Bank's permission would be required for exchange-traded derivative products if the underlying is foreign exchange, interest rate, credit or a combination of these. Policy guidelines on interest rate futures and issues relating to repo in corporate bonds would also be under the Reserve Bank's purview. Prior to the amendment, the Reserve Bank regulated the transactions in money markets and other instruments under the powers delegated to it by the Central Government.

(iv) *Derivatives*

The insertion of a new clause in the Act would allow the Reserve Bank to deal in derivatives which may have interest rate, securities (including foreign securities), indices of rates or prices, foreign exchange rate, credit rating or index and/or the price of gold or silver coins, gold or silver bullion or any other financial instrument as its underlying value variables.

The amendments give legal sanctity to over-the-counter (OTC) derivatives if at least one of the parties to the transaction is the Reserve Bank or any agency falling under its regulatory purview. Prior to the amendment only exchange-traded derivatives were valid. Other contracts could be settled under the Contract Act, 1872.

its specified users. The Rules and Regulations for the purposes of carrying out the provisions of the Act are pending consideration of the Government.

2.182 The Government Securities Act, 2006 proposes to consolidate and amend the law relating to issue and management of Government securities by the Reserve Bank. The Act provides for: (i) empowering the Reserve Bank to prescribe the form for transferring Government securities; (ii) holding of Government promissory notes by trusts; (iii) simplifying the procedure for recognising title to Government securities up to Rs. one lakh with enabling power to the Central Government to enhance the said limit up to Rs. one crore; (iv) allowing micro films, facsimile copies of documents, magnetic tapes and computer printouts to be admissible as evidence; and (v) suspension of the holders of subsidiary general ledger account from trading with the facility of that account in the event of misuse of the said facility. Other salient features of the Act include: (i) enabling creation of pledge, hypothecation or lien in respect of Government securities; and (ii) empowering the Reserve Bank to call for information, conduct inspection and issue directions as well as make regulations, with the previous approval of the Central Government, for carrying out the purposes of the Act. The Act is yet to be brought into force.

2.183 The Banking Companies (Acquisition and Transfer of Undertakings) and Financial Institutions Laws (Amendment) Act, 2005 mainly seeks to amend the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 and the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980. The Bill, *inter alia*, provides for: (i) electing one to three shareholder directors on the boards of the nationalised banks on the basis of issued capital of the bank instead of one to six directors under the existing provisions so as to provide for a more equitable representation on the Board based on the percentage of ownership; (ii) modifying the provisions relating to nomination of directors by the Reserve Bank on the boards of nationalised banks; (iii) conferring power upon the Reserve Bank to appoint one or more additional directors; (iv) empowering the shareholders of nationalised banks to discuss, adopt and approve the Directors' report, the profit and loss account and balance sheet of the bank at the annual general meeting; (v) enabling the banks to transfer the unclaimed dividends for more than seven years

to Investor Education and Protection Fund established under section 205 C of the Companies Act, 1956. The Act also provides for: (i) enabling nationalised banks to issue preference shares in accordance with guidelines framed by the Reserve Bank and to raise capital by preferential allotment or private placement or public issue with the approval of the Reserve Bank and the Central Government; (ii) restricting the voting rights of preference shareholders to resolutions directly affecting their rights and up to a maximum of one per cent of the total voting rights of all the shareholders holding preference share capital only; (iii) *ëfit* and *properistatus* for the elected directors; and (iv) supersession of Board by the Central Government on the recommendation of the Reserve Bank and appointment of an administrator and a Committee to assist the administrator. The Act came into force with effect from October 16, 2006.

Bills introduced in the Parliament

2.184 The Banking Regulation (Amendment) Bill, 2005, introduced in the Lok Sabha on May 13, 2005, seeks to amend some of the provisions of the Banking Regulation Act, 1949 with a view to strengthening the regulatory powers of the Reserve Bank. The Bill includes provisions for: (i) removing the restriction on voting rights and introducing the requirement of prior approval of the Reserve Bank for acquisition of shares or voting rights above the specified limit (empowering the Reserve Bank to satisfy itself that the applicant is a *ëfit* and *proper person* to acquire shares or voting rights and to impose such further conditions that the Bank may deem fit to impose); (ii) removing the lower limit (floor) of SLR and empowering the Reserve Bank to specify the SLR subject to a maximum of forty per cent of the total demand and time liabilities; (iii) amending the definition of approved securities in Section 5(a) of the Act to empower the Reserve Bank to specify from time to time any security, in addition to securities issued by the Central or the State Government, as *ëapproved securities*; (iv) amending Section 12 of the Act to enable banking companies to issue preference shares, subject to regulatory guidelines framed by the Reserve Bank; (v) empowering the Reserve Bank to direct a banking company to disclose in its financial statement or furnish separately such statements and information relating to the business of any associate enterprise, as the Reserve Bank considers necessary and also to cause an

inspection to be made of any associate enterprise; (vi) empowering the Reserve Bank† to supersede the board of directors of a banking company and appoint an administrator; (vii) amending Section 56 of the Act to remove the provision which allowed facilitating primary credit societies to carry on the business of banking without obtaining a license from the Reserve Bank; and (viii) empowering the Reserve Bank to order special audit of a co-operative bank in public interest or in the interest of the co-operative bank or its depositors.

2.185 The Securities Contracts (Regulation) Amendment Bill, 2005 seeks to amend the Securities Contract (Regulation) (SCR) Act, 1956 so as to provide a legal framework for trading in securitised debt including mortgage backed debt. The Bill proposes, *inter alia*, (i) to include securitisation certificate or instrument under the definition of 'securities' and to insert for the said purpose, a new sub-clause in clause (h) of section 2 of the SCR Act, 1956; and (ii) to provide for obtaining approval from SEBI for issue of securitisation certificate or instrument and procedure thereof, and to insert for the purpose, a new section 17 A in the SCR Act, 1956.

2.186 The Central Government has introduced the State Bank of India (Subsidiary Banks Laws)

Amendment Bill, 2006 in the Lok Sabha to amend the laws governing subsidiary banks (of the State Bank of India) to enhance the capital of the subsidiary banks. This will enable the subsidiary banks to raise resources from the market and to provide flexibility in the management of these banks.

2.187 The Payments and Settlements Bill, 2006 was introduced in the Lok Sabha on July 25, 2006. The Bill seeks to designate the Reserve Bank as the authority to regulate payment and settlement systems. The Bill contains provisions for: (i) compulsory requirement of an authorisation by the Reserve Bank to operate payment systems; (ii) empowering the Reserve Bank to regulate and supervise the payment systems by determining standards, calling for information, returns and documents; (iii) conferring power on the Reserve Bank to audit and inspect by entering the premises where payment systems are being operated; (iv) empowering the Reserve Bank to issue directions; (v) providing for settlement and netting to be final and irrevocable at the determination of the amount of money, securities or foreign exchange payable by participants; and (vi) overriding other laws. The Bill has since been referred to the Standing Committee on Finance.