Chapter II

Policy Developments in Commercial Banking

Introduction

2.1 The banking industry the world over has undergone a profound transformation since the early 1990s. The changed operating environment for the banking sector, underpinned by globalisation, deregulation and advances in information technology, has resulted in intense competitive pressures. Banks have responded to this challenge by diversifying through organic growth of existing businesses as well as through acquisitions. This has exposed the banking sector to newer risks and posed serious regulatory challenges. Regulatory and supervisory policies are, therefore, being continuously refined to meet the emerging challenges. The focus of regulatory initiatives has been on strengthening the financial institutions by aligning the prudential norms with the international standards, identifying systemic risks and adopting appropriate risk mitigating policies. While continuously striving to strengthen the prudential framework, regulators in recent years have also focussed on improving bank governance and information disclosures that enhance market discipline. In most cases, the regulatory initiatives have been guided by international best practices, adapted suitably to the domestic conditions. The major challenge facing the banking system and the supervisory authorities continues to be the maintenance of financial stability. This has become increasingly evident in the recent financial market turmoil following the unfolding of the US sub-prime mortgage crisis.

2.2 In the context of the rapidly evolving financial landscape, the Reserve Bank has also been suitably reorienting its regulatory and supervisory framework. It has also been the endeavour of the Reserve Bank to improve credit delivery and customer service by banks. The Reserve Bank has simultaneously focussed on financial inclusion and extension of banking services to the unbanked areas of the economy. Various initiatives by the Reserve Bank from time to time have imparted strength, resilience and dynamism to the financial system.

2.3 During 2006-07, renewed emphasis was placed on further strengthening of the prudential and exposure norms. In conformity with the commitment to ensure a smooth transition to Basel II, a number of measures were initiated. Apart from the release in April 2007 of the final guidelines for implementation of the New Capital Adequacy Framework (Basel II) by banks, some of the major initiatives included issuing guidelines on stress testing by banks, and enhancement of disclosure norms to strengthen Pillar 3 (Market Discipline) of the new framework. In order to maintain asset quality in the face of rapid credit growth, risk weights and provisioning requirements for lending to sensitive sectors were enhanced. Other major initiatives taken during the year included modification in the existing guidelines on banks' exposure to the capital market, issuance of comprehensive guidelines on derivatives, revised framework for managing the attendant risks in outsourcing, issuance of prudential norms on creation and utilisation of floating provisions, and modifications in the guidelines on sale/purchase of NPAs. In order to improve credit delivery, the guidelines on the priority sector were revised. The Reserve Bank also initiated several measures to provide basic banking services, especially in the less developed regions.

2.4 This chapter provides an account of various policy measures undertaken by the Reserve Bank in the Indian commercial banking sector during 2006-07 (July-June) and 2007-08 (up to October 2007). The stance of monetary policy as it evolved during 2006-07 and 2007-08 (up to October 2007), together with monetary policy measures, is presented in Section 2, followed by a review of the measures initiated in the area of credit delivery in Section 3. Section 4 details the various measures initiated to promote financial inclusion. Initiatives taken in the areas of prudential regulation and supervision are set out in Section 5 and Section 6, respectively. Section 7 sets out the policy developments in the area of financial markets, *i.e.*, the money market, the Government securities market and the foreign exchange market. This is followed by an account of measures initiated in the area of customer service by banks in Section 8. Policy measures relating to the payment and settlement systems

and technological developments are outlined in Section 9 and Section 10, respectively. Section 11 details the measures undertaken to strengthen the legal infrastructure.

2. Monetary Policy

2.5 The conduct of monetary policy during 2006-07 was set against the backdrop of evolving changes in the institutional framework as also by the sudden shifts in both global and domestic conditions, particularly towards the latter part of the year, which posed threats to price and financial stability. Accordingly, even while the Annual Policy Statement for 2006-07 and its subsequent quarterly reviews (in July, October 2006 and January 2007) were the principal means of communicating the policy assessment, policy measures for the year 2006-07 as in the recent period, were undertaken outside the policy review cycle in response to the evolving situation. Another important development in 2006-07 in the context of institutional architecture was the reconstitution of Technical Advisory Committee on Monetary Policy (TACMP) in January 2007. The role of TACMP is advisory in nature, and it provides guidance in the process of formulating monetary policy from time to time. As such, the responsibility, accountability and time path for decision making by the Reserve Bank are not formally constrained by the deliberations of the TACMP.

2.6 With the sharp acceleration of growth in 2006-07 accompanied by inflation rising on the back of food as well as some manufactured products' prices, the major policy challenge facing the Reserve Bank during the year was that of managing the transition to a higher growth path while containing inflationary pressures. Aggregate demand/pressures generated by quickening growth warranted a higher priority than before to price stability and the anchoring of inflation expectations, since they were being amplified by supply constraints. Furthermore, in the context of the high uncertainty surrounding the evolving domestic and global developments, the Third Quarter Review of January 2007 alluded to the burdens, complexities and constraints on the conduct of monetary policy at that juncture. Excess liquidity flowing out of mature economies and the enduring strength of foreign exchange inflows have complicated the conduct of monetary policy through the consequent expansion of liquidity potentially reducing the efficacy of monetary policy tightening. Furthermore, monetary policy in India has to contend with continuing fiscal dominance, lags in supply response to demand pressures as also the burden of protecting inadequately prepared segments of the economy from volatility in financial markets often related to sudden shifts in capital flows. The conduct of monetary policy is also affected by several complexities – globalisation, fuzziness in reading underlying macroeconomic and financial developments, particularly in detecting and measuring inflation and inflation expectations; high and persisting global macro-imbalances; elevated crude oil and asset prices; and sizeable movements in major international currencies with pass-through to domestic inflation being muted. The operation of monetary policy in India is also constrained by uncertainties in the transmission of policy signals due to the existence of administered interest rates, incentives for some elements of capital flows provided by public policy setting, and the predominantly public sector ownership of the banking system which plays a critical role in other public policy considerations.

2.7 Even though domestic factors continued to be the most significant influence in fashioning the monetary policy stance, global factors varied in importance as the year went by. The Reserve Bank took note of the resilience of global growth as well as a number of downside risks that loomed over the global economy which had implications for the medium-term prospects of countries like India. In the first half of 2007, a number of these risks appear to have materialised. It is in the context of these extraordinary developments that monetary policy for 2007-08 accord priority to orderly and sound markets and institutions to emphasise the need for ensuring the availability of appropriate liquidity in the system through flexible use of policy instruments at its disposal so that all legitimate requirements of credit are met, consistent with the objective of price and financial stability (Box II.1).

Annual Policy Statement for 2006-07

2.8 The Annual Policy Statement for the year 2006-07, which was issued in April 2006, was framed against stronger than expected performance of the Indian economy in the previous year with inflation contained well within the projected range and inflation expectations anchored and stability in financial markets and

Box II.1: Stance of Monetary Policy during April 2006 to October 2007

Annual Policy Statement for 2006-07 (April 2006)

- To ensure a monetary and interest rate environment that enables continuation of the growth momentum consistent with price stability while being in readiness to act in a timely and prompt manner on any signs of evolving circumstances impinging on inflation expectations.
- To focus on credit quality and financial market conditions to support export and investment demand in the economy for maintaining macroeconomic, in particular, financial stability.
- To respond swiftly to evolving global developments.

First Quarter Review for 2006-07 (July 2006)

- To ensure a monetary and interest rate environment that enables continuation of the growth momentum while emphasising price stability with a view to anchoring inflation expectations.
- To reinforce the focus on credit quality and financial market conditions to support export and investment demand in the economy for maintaining macroeconomic and, in particular, financial stability.
- To consider measures as appropriate to the evolving global and domestic circumstances impinging on inflation expectations and the growth momentum.

Mid-term Review for 2006-07 (October 2006)

- To ensure a monetary and interest rate environment that supports export and investment demand in the economy so as to enable continuation of the growth momentum while reinforcing price stability with a view to anchoring inflation expectations.
- To maintain the emphasis on macroeconomic and, in particular, financial stability.
- To consider promptly all possible measures as appropriate to the evolving global and domestic situation.

Third Quarter Review for 2006-07 (January 2007)/ Annual Policy Statement for 2007-08 (April 2007)/ First Quarter Review for 2007-08 (July 2007)

- To reinforce the emphasis on price stability and well-anchored inflation expectations while ensuring a monetary and interest rate environment that supports export and investment demand in the economy so as to enable continuation of the growth momentum.
- To re-emphasise credit quality and orderly conditions in financial markets for securing macroeconomic and, in particular, financial stability while simultaneously pursuing greater credit penetration and financial inclusion.
- To respond swiftly with all possible measures as appropriate to the evolving global and domestic situation impinging on inflation expectations, [financial stability (in July 2007 Statement)] and the growth momentum.

Mid-Term Review for 2007-08 (October 2007)

- To reinforce the emphasis on price stability and well-anchored inflation expectations while ensuring a monetary and interest rate environment that supports export and investment demand in the economy so as to enable continuation of the growth momentum.
- To re-emphasise credit quality and orderly conditions in financial markets for securing macroeconomic and, in particular, financial stability while simultaneously pursuing greater credit penetration and financial inclusion.
- To respond swiftly with all possible measures as appropriate to the evolving global and domestic situation impinging on inflation expectations, financial stability and the growth momentum.
- To be in readiness to take recourse to all possible options for maintaining stability and the growth momentum in the economy in view of the unusual heightened global uncertainties, and the unconventional policy responses to the developments in financial markets.

external sector payments developments having evolved in concert with the strength of the macroeconomic fundamentals. It noted, however, that while domestic factors continued to be significant, the global factors were gaining greater importance in determining the monetary policy response. While global growth had exhibited considerable resilience in the face of high and volatile oil prices, geo-political tensions supply shocks and the housing boom had started to flatten out in several countries across the world. In the international financial markets, investors' appetite for risk had driven down risk premia on a wide variety of risky assets, suggesting a disconnect between medium-term risks and perceptions thereof with implications for financial stability worldwide.

2.9 The Annual Policy Statement placed GDP growth in the range of 7.5-8.0 per cent during 2006-07 while resolving to contain the year-on-year inflation rate of 2006-07 in the range of 5.0-5.5 per cent. The expansion in M3 was projected at around 15.0 per cent with growth in aggregate deposits at around Rs.3,30,000 crore and non-food bank credit growth at around 20 per cent. Against this backdrop, it was noted that a key factor was the assessment of the risks in as

accurate a manner as was feasible and to be in readiness to act as warranted to meet the challenges posed by the evolving situation, given the unfolding of the risks. While domestic macroeconomic and financial conditions supported prospects of sustained growth momentum with stability in India, it was recognised that the balance of risks was tilted towards the global factors and that it was necessary to assign more weight to global factors than before while formulating the policy stance. In accordance with this assessment and consistent with the stance set out for the year (refer Box II.1), the Annual Policy Statement left the key policy instruments, *i.e.*, the Bank Rate, the repo/reverse repo rates under the LAF and the cash reserve ratio unchanged while committing to continue with its policy of active demand management of liquidity to ensure that appropriate liquidity was maintained in the system and all legitimate requirements of credit were met, consistent with the objective of price and financial stability. On June 8, 2006 the LAF reverse repo/repo rates were increased by 25 basis points each to ensure that inflationary expectations were anchored for supporting economic growth and financial stability.

First Quarter Review for 2006-07

2.10 The First Quarter Review, which was issued in July 2006, took note of the optimistic near-term outlook for the Indian economy while underscoring the need to remain on guard against risks to inflation from the incomplete pass-through of international crude as well as from food prices. It also noted that since the announcement of the Annual Policy Statement, financial markets were repricing risks in an environment of uncertainty and monetary policy had been tightened further in some advanced economies as well as in some emerging economies. The overall macroeconomic and geo-political global environment appeared to be indicative of marked downside risks. In the First Quarter Review of 2006-07, as a pre-emptive action, the reverse repo rate under the LAF was increased further by 25 basis points while keeping the repo rate unchanged.

Mid-term Review for 2006-07

2.11 The Mid-term Review of the Annual Policy Statement for 2006-07, which was issued in October 2006, was formulated against the background of high GDP growth and high rate of consumer inflation coupled with escalating capital flows, rising asset prices, volatile financial markets and tightening infrastructural bottlenecks which underscored the need to reckon with dangers of overheating and the implications for the timing and direction of monetary policy setting. Demand pressures were visible in the build up of money supply, reserve money as also in the demand for bank credit which was growing at above 30 per cent for the third year in succession. The expanding merchandise trade deficit and the current account deficit despite buoyant export growth and some moderation in the growth of non-oil imports was another area of concern. The Review noted that as monetary policy operates with lags that can be long and variable, the setting of monetary policy required to be forward looking with the full impact of current policy actions coming into play 12 to 18 months later. Against this backdrop, the fixed repo rate under the LAF was increased by 25 basis points from 7.0 per cent to 7.25 per cent.

2.12 Following the Mid-term Review, it was decided on December 8, 2006 to increase the CRR of the SCBs, regional rural banks (RRBs), scheduled state co-operative banks and scheduled primary (urban) co-operative banking system by one-half of one percentage point of their net demand and time liabilities (NDTL) in two stages, to 5.25 per cent and 5.50 per cent, effective from the fortnights beginning December 23, 2006 and January 6, 2007, respectively, with a view to draining excess liquidity and pre-empting upward pressures on inflation expectations.

Third Quarter Review for 2006-07

2.13 The Third Quarter Review, which was issued in January 2007, expressed renewed concerns about the rapid expansion of bank credit and the surge in capital inflows, and pointed out that the enduring strength of foreign exchange inflows complicated the conduct of monetary policy tightening by expanding liquidity, especially in some specific sectors. Hence, provisioning requirements on standard assets were enhanced and risk weights were increased with regard to exposure to sectors such as real estate, capital markets, consumer loans and systemically important non-banking financial companies (NBFC-SI) with a renewed focus on credit quality. Furthermore, with a view to fortifying liquidity management and ensuring orderly conditions in

the financial markets, the ceiling on interest rates relating to Non-Resident Indian (NRI) deposits was reduced. The fixed repo rate under the LAF was also increased by 25 basis points from 7.25 per cent to 7.50 per cent.

2.14 Following the issue of the Third Quarter Review in January 2007, some notable developments prompted a swift reinforcement of the monetary policy stance and, over the remaining part of the year, management of liquidity received priority in the policy hierarchy. Financial markets experienced some volatility in the fourth quarter of 2006-07 alongside sizeable swings in liquidity and a hardening of interest rates across the spectrum. With the pace of growth accelerating further as reflected in the buoyancy in industrial output and non-food bank credit, concerns about the accentuation of excess demand pressures seemed to be considerably heightened, particularly with the tightening of the supply constraints. Headline inflation surged to a two-year peak by end-January 2007, with potential upside risks to inflation expectations warranting an immediate policy response. Aggregate deposit growth rose to 11-year high as banks aggressively mobilised funds to support over-extended credit portfolios. The liquidity adjustment facility (LAF), which had been in an injection mode persistently during January 7 to February 7, 2007 switched into absorption mode in the following week (February 8-13) with additional liquidity absorbed under the MSS. Reflecting the large reversal of liquidity, the call money rate which was ruling 25-85 basis points above the repo rate, eased below the middle of the LAF corridor, indicating easing of liquidity conditions. The Reserve Bank used all policy instruments, including the cash reserve ratio (CRR), to ensure the appropriate modulation of liquidity in response to the evolving situation. To drain excess liquidity, pre-empt the stoking of demand pressures and contain inflation expectations, it was considered necessary on February 13, 2007 to increase the CRR in two stages by 25 basis points each (Table II.1). A ceiling of Rs.3,000 crore was stipulated on daily reverse repo under the LAF with effect from March 5, 2007 and a more flexible use of MSS was made with the help of Treasury bills and dated securities with prior announcement.

Table II.1: Recent Changes in Policy Rates and Cash Reserve Ratio

(Per cent)

Effective From	Reverse Repo Rate	Repo Rate	Cash Reserve Ratio
1	2	3	4
March 31, 2004	4.50	6.00	4.50
September 18, 2004	4.50	6.00	4.75 (+0.25)
October 2, 2004	4.50	6.00	5.00 (+0.25)
October 27, 2004	4.75 (+0.25)	6.00	5.00
April 29, 2005	5.00 (+0.25)	6.00	5.00
October 26, 2005	5.25 (+0.25)	6.25 (+0.25)	5.00
January 24, 2006	5.50 (+0.25)	6.50 (+0.25)	5.00
June 9, 2006	5.75 (+0.25)	6.75 (+0.25)	5.00
July 25, 2006	6.00 (+0.25)	7.00 (+0.25)	5.00
October 31, 2006	6.00	7.25 (+0.25)	5.00
December 23, 2006	6.00	7.25	5.25 (+0.25)
January 6, 2007	6.00	7.25	5.50 (+0.25)
January 31, 2007	6.00	7.50 (+0.25)	5.50
February 17, 2007	6.00	7.50	5.75 (+0.25)
March 3, 2007	6.00	7.50	6.00 (+0.25)
March 31, 2007	6.00	7.75 (+0.25)	6.00
April 14, 2007	6.00	7.75	6.25 (+0.25)
April 28, 2007	6.00	7.75	6.50 (+0.25)
August 4, 2007	6.00	7.75	7.00 (+0.50)
November 10, 2007	6.00	7.75	7.50 (+0.50)

Note : 1. With effect from October 29, 2004, the nomenclature of repo and reverse repo was changed in keeping with international usage. Now, reverse repo indicates absorption of liquidity and repo signifies injection of liquidity. Prior to October 29, 2004, repo indicated absorption of liquidity, while reverse repo meant injection of liquidity. The nomenclature in this Report is based on the new usage of terms even for the period prior to October 29, 2004.

2. Figures in parentheses indicate change in policy rates.

Annual Policy Statement for 2007-08

2.15 The Annual Policy Statement for 2007-08, which was issued in April 2007, pointed out that the stance of monetary policy in 2007-08 would be conditioned by the patterns in which the global and, more particularly, the domestic environment unfolds. The likely evolution of macroeconomic and financial conditions indicated an environment supportive of sustaining the current growth momentum in India.

2.16 The Annual Policy Statement for 2007-08 envisaged that in view of the lagged and cumulative effects of monetary policy on aggregate demand and assuming that supply management would be conducive, the capital flows would be managed actively and in the absence of shocks emanating in the domestic or global economy, the policy endeavour would be to contain inflation close to 5.0 per cent 2007-08. The Statement added that the Reserve Bank's self-imposed medium-term ceiling on inflation at 5.0 per cent had a salutary effect on inflation expectations and the socially tolerable rate of inflation had come down. In recognition of India's evolving integration with the global economy and societal preferences in this regard, it resolved to condition policy and perceptions for inflation in the range of 4.0-4.5 per cent as conducive for maintaining self-accelerating growth over the medium-term. Real GDP growth in 2007-08 was placed at around 8.5 per cent. Monetary expansion was projected in 2007-08 at around 17.0-17.5 per cent with the growth in aggregate deposits at around Rs.4,90,000 crore and a graduated deceleration of non-food credit to 24.0-25.0 per cent from the average of 29.8 per cent over 2004-07. Against this backdrop, it reiterated that the policy preference for the period ahead was strongly in favour of reinforcing the emphasis on price stability and anchoring inflation expectations and that the Reserve Bank would ensure that appropriate liquidity was maintained in the system so that all legitimate requirements of credit were met, particularly for productive purposes, consistent with the objective of price and financial stability. Towards this end, the Reserve Bank would continue with its policy of active demand management of liquidity through open market operations (OMO), including the MSS, LAF and CRR, and use all the policy instruments at its disposal flexibly, as and when the situation warrants.

First Quarter Review for 2007-08

2.17 The First Quarter Review of the Annual Policy Statement for 2007-08, which was issued in July 2007, was formulated in an environment of encouraging response of banks to the sustained policy emphasis and actions for ensuring credit quality and overall financial stability. Rebalancing of banks' balance sheets was underway, captured by movements in key banking aggregates. Beginning the last quarter of 2006-07, a dip in non-food credit growth from the persistent high rates that prevailed during 2004-07 had turned into a steady deceleration, in broad alignment with the indicative trajectory set out in the Annual Policy Statement of April 2007. While the slowdown reflected, in part, the usual seasonal decline in bank credit that occurred at that time of the year, there had also been some deceleration in bank lending to sectors such as real estate, housing, computer software, trade and transport operators in response to rising lending rates, shifts in banks' portfolios in favour of investments in gilts and prudential considerations. On the other hand, there were indications of a pick-up in credit demand from agriculture and industry, in particular, infrastructure. Banks had aggressively mobilised time deposits (including certificates of deposit) with aggregate deposit growth in the first quarter of 2007-08 outstripping the 11-year high recorded in 2006-07. Accordingly, the incremental non-food credit deposit ratio (year-on-year) had come down appreciably from the average level of 115 per cent prevailing in the preceding two years.

2.18 The First Quarter Review noted that while global growth had shown some signs of moderation in the first quarter of 2007, there had been a gain in momentum in the subsequent months, leading to an upward revision in consensus forecasts. Demand pressures appeared to be holding up economic activity in the mature economies, stronger than expected. While headline inflation had remained generally steady, inflationary pressures remained and seemed to be more persistent than before, along with elevated levels of commodity and asset prices. In the global financial markets, volatility was experienced in the first quarter of 2007, triggered by concerns about the US sub-prime mortgage market and potential economy-wide effects. With greater risk aversion going forward, credit quality deteriorating and the widening of credit spreads, the Review underlined that the potential fragility

of hedge funds could pose significant risks to financial market stability and to the prospects for financing and growth in the EMEs. In view of the above developments, the CRR was increased by 50 basis points to 7.0 per cent with effect from the fortnight beginning August 4, 2007. It was also decided to withdraw the ceiling of Rs.3,000 crore on daily reverse repo under the LAF with effect from August 6, 2007. The Reserve Bank, however, retained the discretion to re-impose a ceiling as appropriate and also to conduct repo/reverse repo auctions at a fixed rate or at variable rates as circumstances warranted as also the right to accept or reject tender(s) under the LAF. The Second LAF, which was introduced on November 28, 2005 and was conducted between 3.00 p.m. and 3.45 p.m. on a daily basis, was also withdrawn with effect from August 6, 2007.

Mid-term Review for 2007-08

2.19 The Mid-term Review of the Annual Policy Statement 2007-08, which was issued in October 2007, indicated that GDP growth originating in agriculture and allied activities had risen above trend in the first quarter of 2007-08 and was poised to maintain this performance over the rest of the year on the back of a favourable south-west monsoon and improvement in sown acreage. Based on the recent developments, the Review observed some slackening of momentum in the industrial and services sectors. Moreover, global uncertainties might have some moderating influence on the performance of manufacturing as well as services. Overall, these sectors are expected to sustain the momentum of growth. Accordingly, real GDP growth in 2007-08 was placed at 8.5 per cent for policy purposes, as set out in the Annual Policy Statement of April 2007 and reiterated in the First Quarter Review, assuming no further escalation in international crude prices and barring domestic or external shocks. The Review, however, expressed concern about rising and volatile international crude prices and observed that the high levels of food prices posed risks to the inflation outlook. In view of the persisting high levels of the price of the Indian crude basket, some pass-through to domestic petroleum product prices appeared reasonable. The policy resolve going forward, according to the Review, should be to consolidate the success in lowering inflation on an enduring basis so that an environment of stability prevails to nurture and protect the transition to higher growth. Accordingly, in view of the lagged and cumulative effects of monetary policy on aggregate demand and assuming that supply management would be conducive, capital flows would be managed actively and in the absence of shocks emanating in the domestic or global economy, the policy endeavour would be to contain inflation close to 5.0 per cent in 2007-08. Furthermore, in recognition of India's evolving integration with the global economy and societal preferences in this regard, the resolve, going forward, would be to condition expectations in the range of 4.0-4.5 per cent so that an inflation rate of around 3.0 per cent becomes a medium-term objective consistent with India's broader integration into the global economy.

2.20 At the time of Mid-term Review, money supply had expanded well above the indicative trajectory of 17.0 -17.5 per cent set in the Annual Policy Statement of April 2007. Fiscal spending and foreign exchange market interventions had mainly driven this acceleration as reflected in sizeable reserve money growth. Deposit growth had also run ahead of the projection of Rs.4,90,000 crore for 2007-08 as a whole. Non-food credit (inclusive of non-SLR investments) had decelerated and was close to the projection of 24.0-25.0 per cent given in the Annual Policy Statement. However, moderating the expansionary effects of net capital inflows was warranted so that money supply was not persistently out of alignment with the indicative projections set out in the Annual Policy Statement. On a review of the prevailing macroeconomic condition, the CRR was increased by 50 basis points to 7.5 per cent with effect from the fortnight beginning November 10, 2007 (Box II.2).

Statutory Pre-emptions

2.21 A significant development during 2006-07 was the legislative amendments in the Reserve Bank of India Act, 1934 and the Banking Regulation Act, 1949, which have enhanced the Reserve Bank's operational flexibility and maneuverability in its monetary management operations. The Reserve Bank, since the early 1990s, has made conscious efforts to move away from direct instruments of monetary control to indirect instruments. Accordingly, the statutory pre-emptions by way of cash reserve ratio and statutory liquidity ratio (SLR) were significantly

Box II.2: Major Policy Announcements in the Mid-term Review of Annual Policy Statement for the Year 2007-08

Monetary Measures

- Bank Rate kept unchanged at 6.0 per cent.
- Repo Rate and Reverse Repo Rate under the LAF kept unchanged at 7.75 per cent and 6.0 per cent, respectively.
- CRR increased by 50 basis points to 7.5 per cent from the fortnight beginning November 10, 2007.

Financial Markets

- Non-competitive bidding scheme in the auctions of State Development Loans (SDLs) to be operationalised by March 31, 2008.
- Repos in corporate bonds to be permitted once corporate bond markets develop and suitable settlement system is put in place.
- Covering of 'Short-sale' and 'When Issued' transactions permitted outside the NDS-OM system.
- Reinstatement of eligible limits under the past performance route for hedging facility provided.
- Oil companies permitted to hedge their foreign exchange exposures to the extent of 50 per cent of their inventory volume as at the end of the previous quarter.
- Importers and exporters allowed to write covered call and put options in both foreign currency/ rupee and cross currency and receive premia.
- ADs permitted to run cross currency options books, as also to offer American options.

Credit Delivery Mechanism

- Internal Working Group to be constituted to examine the recommendations of the Committee on Agricultural Indebtedness (Chairman: Dr. R. Radhakrishna).
- A working group to be constituted to study the recommendations of Sengupta Committee report relevant to the financial system.
- A working group to be constituted for preparing a road-map for migration to core banking solutions by RRBs.
- RRBs and state/central co-operative banks to disclose the level of CRAR as on March 31, 2008 in their balance sheets. A road-map to be evolved for achieving the desired level of CRAR.
- High Level Committee to be constituted to review the Lead Bank Scheme.
- A concept paper to be prepared on financial literacy-cum-counselling centres proposed.

Prudential Measures

- Final guidelines on *Credit Default Swaps* to be issued by end-November 2007.
- Banks to follow prescribed norms while engaging recovery agents and abusive practices followed by banks' recovery agents would invite serious supervisory disapproval.
- A working group to be constituted to draw up a suitable framework for cross-border supervision and supervisory cooperation with overseas regulators.
- The process of consolidated supervision system to be integrated with the financial conglomerate monitoring mechanism for bank-led conglomerates.

Institutional Developments

- Banks urged to ensure that adequate disaster recovery systems are put in palce.
- An action plan to be drawn up for implementation of National Electronic Clearing Service (NECS).
- A working group to be constituted for providing IT support by the Reserve Bank to UCBs.
- The Committee on Financial Sector Assessment (CFSA) to complete the assessment by March 2008.

reduced over the years. The CRR was brought down from a peak of 15 per cent in 1994-95 to 4.5 per cent by June 2003, before the onset of withdrawal of monetary accommodation beginning September 2004.

2.22 The CRR was hiked by a cumulative of 100 basis points during 2006-07 in four equal phases of 25 basis points each. During 2007-08 so far, the CRR has been raised further by another 150 basis points (25 basis points each effective the fortnights beginning April 14 and 28, 2007, 50 basis points effective the fortnight beginning August 4, 2007), and 50 basis points effective the fortnights beginning November 10, 2007 to 7.5 per cent of banks' NDTL (refer Table II.1).

2.23 Section 42 of the Reserve Bank of India Act, 1934 was amended in June 2006 with a view to enhancing the Reserve Bank's operational flexibility and providing it with greater maneuverability in monetary management. The Amendment Act, 2006 gives discretion to the Reserve Bank to decide the percentage of scheduled banks' demand and time liabilities to be maintained as CRR, without any ceiling (20 per cent earlier) or floor (3 per cent earlier). As per the amendment, the Reserve Bank is also not required to make interest payment on CRR balances as it attenuates the effectiveness of the CRR as an instrument of monetary policy. Consequent to the amendment, the Reserve Bank announced the removal of the floor of 3 per cent

and ceiling of 20 per cent on CRR. Furthermore, it also announced that no interest would be payable on CRR balances from the fortnight beginning June 24, 2006. The Extraordinary Gazette notification dated January 9, 2007 of the Government of India, however, notified January 9, 2007 as the date on which all the provisions, except Section 3, of the Reserve Bank of India (Amendment) Act, 2006 would come into force. Section 3 of the Reserve Bank of India (Amendment) Act, 2006 provided for the removal of the ceiling and floor on the CRR to be prescribed by the Reserve Bank as also the provisions for interest payment on eligible CRR balances. Pending the notifications of the relevant provisions, the floor and ceiling on CRR were restored and the Reserve Bank decided to pay interest on eligible CRR balances but consistent with the monetary policy stance and measures at relevant periods of time. The Reserve Bank also exempted those banks from payment of penal interest which had breached the statutory minimum CRR level of 3.0 per cent during the period from June 22, 2006 to March 2, 2007. The Government of India in the Extraordinary Gazette notification dated March 9, 2007 notified Section 3 of the Reserve Bank of India (Amendment) Act, 2006 and fixed April 1, 2007 as the date on which the related provisions would come into force. As such, the floor and ceiling on the CRR to be prescribed by the Reserve Bank now no longer exist. In view of the then prevailing monetary conditions, the Reserve Bank decided to maintain *status quo* on the CRR maintenance, including the CRR rate and the extant exemptions. The Reserve Bank also indicated that no interest would be payable on CRR balances of banks with effect from the fortnight beginning March 31, 2007.

2.24 Monetary control is also exercised through the prescription of a statutory liquidity ratio (SLR), which is a variant of the secondary reserve requirement in several countries. It is maintained in the form of specified assets such as cash, gold and 'approved' and unencumbered securities – the latter being explicitly prescribed – as a proportion to NDTL of banks. The SLR is also important for prudential purposes, *i.e.*, to assure the soundness of the banking system. The pre-emption under the SLR, which was increased to about 38.5 per cent of NDTL in the beginning of the 1990s, was brought to its statutory minimum of 25 per cent by October 1997. Banks, however, continue to hold Government securities in excess of the statutory minimum SLR, reflecting risk perception and portfolio choice, although the extent of excess holdings has declined in recent years. Commercial banks' holdings of Government securities, as a proportion of their NDTL, declined further during the year, reaching 28.0 per cent of their NDTL at end-March 2007 from 31.3 per cent at end-March 2006. During 2007-08 so far (up to October 12, 2007), banks' holding of SLR securities as a percentage of NDTL, however, increased marginally to 30.0 per cent. Consequent upon the promulgation of the Banking Regulation (Amendment) Ordinance, 2007 on January 23, 2007, Section 24 of the Banking Regulation Act, 1949 was amended, which, *inter alia*, removed the floor rate of 25 per cent for SLR to be prescribed by the Reserve Bank and empowered it to determine the SLR-eligible assets, thereby giving it more flexibility in its monetary management operations. The Ordinance was subsequently repealed and replaced by the Banking Regulation (Amendment) Act 2007 which received the assent of the President on March 26, 2007 and is deemed to have come into force from January 23, 2007.

Interest Rate Structure

2.25 Deregulation and rationalisation of the interest rate structure has been a key component of the financial sector reform process initiated since the early 1990s. This has not only helped in improving the competitiveness and resource allocation process in the financial system but has also facilitated the monetary transmission mechanism. All interest rates, barring select rates such as savings deposits, non-resident India (NRI) deposits, small loans up to Rs. 2 lakh and export credit, have been deregulated.

Bank Rate and Repo/Reverse Repo Rate

2.26 The Bank Rate has served well as a signaling rate for the medium-term stance of monetary policy. Keeping in view the assessment of the economy including the outlook for inflation, the Bank Rate during the year was retained at the existing level of 6.0 per cent; the rate was last revised in April 2003.

2.27 Reforms in the monetary policy operating framework, which were initiated in the late 1980s, culminated into the introduction of

Liquidity Adjustment Facility (LAF) in 2000 (Annex VI). Under the LAF, the Reserve Bank sets its policy rates, *i.e.*, repo and reverse repo rates and carries out repo/reverse repo operations, thereby providing a corridor for overnight money market rates. In view of exogenous influences impacting liquidity at the shorter end, *viz.*, volatile Government cash balances and unpredictable foreign exchange flows, the LAF avoids targeting a particular level of overnight money market rate. Although repo auctions can be conducted at variable or fixed rates on overnight or longer-term, given market preference and the need to transmit interest rate signals quickly, the LAF has settled into a fixed rate overnight auction mode since April 2004. The Second LAF (SLAF), which was introduced from November 28, 2005 to enable market participants to fine-tune their liquidity management during the day, was withdrawn with effect from August 6, 2007. LAF operations continue to be supplemented by access to the Reserve Bank's standing facilities linked to the repo rate: export credit refinance to banks and standing liquidity facility to the primary dealers. The repo and reverse repo rates were revised in the light of the evolving macroeconomic and monetary conditions (refer Table II.1).

Deposit Rates

2.28 Progressive deregulation of interest rates in those segments that have remained regulated has been engaging the attention of the Reserve Bank. Wide consultations have also been held with various stakeholders on the issue. While some interest rates continue to be regulated, it has been the endeavour of the Reserve Bank to modify them in line with the changing scenario. The interest rate on savings bank deposits is regulated by the Reserve Bank and is currently prescribed at 3.5 per cent per annum; the rate was last revised on March 1, 2003.

2.29 Depending on the monetary and macroeconomic developments, the ceilings on interest rates on non-resident external rupee deposits (NRE) and foreign currency non-resident (Bank) [FCNR(B)] deposits are linked to the LIBOR/SWAP rates and are reviewed regularly from time to time. The interest rate ceiling on NRE deposits for one to three year maturity was reduced by 50 basis points each on January 31, 2007 and on April 24, 2007 to LIBOR/SWAP rates for US dollar of corresponding maturities. The interest rate ceiling on FCNR(B) deposits was reduced by 25 basis points to LIBOR/SWAP rates minus 25 basis points for the respective currency/ maturities on January 31, 2007 and further by 50 basis points to LIBOR/SWAP rates minus 75 basis points for the respective currency/maturities on April 24, 2007 (Table II.2).

Table II.2: Interest Rate Prescriptions for NRE/ FCNR(B) Deposits and Foreign Currency Export Credit

Type	Effective From	Ceiling Interest Rate
1	2	3
NRE deposit	November 1, 2004	LIBOR/EURIBOR/ SWAP rates plus 50 basis points.
	November 17, 2005	LIBOR/EURIBOR/ SWAP rates plus 75 basis points.
	April 18, 2006	LIBOR/EURIBOR/ SWAP rates plus 100 basis points.
	January 31, 2007	LIBOR/EURIBOR/ SWAP rates plus 50 basis points.
	April 24, 2007	LIBOR/EURIBOR/ SWAP rates
FCNR (B) deposit	April 29, 2002	LIBOR/EURIBOR/ SWAP rates minus 25 basis points.
	March 28, 2006	LIBOR/EURIBOR/ SWAP rates.
	January 31, 2007	LIBOR/EURIBOR/ SWAP rates minus 25 basis points.
	April 24, 2007	LIBOR/EURIBOR/ SWAP rates minus 75 basis points.
Export Credit in Foreign Currency	April 29, 2002	LIBOR/EURIBOR rates plus 75 basis points
	April 18, 2006	LIBOR/EURIBOR/ rates plus 100 basis points

@ : Interest rates on NRE/FCNR(B) deposits are effective from close of business in India.

Lending Rates

2.30 On July 12, 2007, the Government announced a package of measures to provide relief for a temporary period in terms of interest rate subvention of 2 percentage points per annum on rupee export credit availed of by exporters in nine categories of exports, *viz.*, textiles (including handlooms), readymade garments, leather products, handicrafts, engineering products, processed agricultural products, marine products, sports goods and toys and to all exporters from SME sectors defined as micro-enterprises, small enterprises and medium enterprises. Accordingly, it was decided that banks would charge interest rate not exceeding benchmark prime lending rate (BPLR) minus 4.5 per cent on pre-shipment credit up to 180 days and post-shipment credit up to 90 days on the outstanding amount for the period April 1, 2007 to December 31, 2007 to all SME sectors and the nine sectors as indicated above.

2.31 On October 6, 2007, the Government of India partially modified the interest rate subvention to exporters to extend the scheme by three months up to March 31, 2008 and increased the coverage of the scheme to include jute and carpets, processed cashew, coffee, tea, solvent extracted de-oiled cake, plastics and linoleum.

3. Credit Delivery

2.32 It has been the endeavour of the Reserve Bank to improve credit delivery and make available basic banking services to a large section of society without procedural hassles. Furthermore, the financing requirements of the economy have also undergone a structural change with the transformation of the economy into a high growth path in the recent past. The Reserve Bank has, therefore, been creating a conducive environment for provision of adequate and timely bank finance at reasonable rates to different sectors of the economy. Some of the initiatives taken in the recent past to improve credit delivery include (i) augmentation of credit flow to the agriculture and other priority sectors as also to distressed farmers and areas stricken by natural calamities; (ii) simplification of systems and procedures; (iii) permitting the use of banking facilitators/correspondents; (vi) information technology to address the last mile problem; and (v) providing greater operational flexibility to regional rural banks (RRBs).

2.33 During the year, some new initiatives were undertaken to improve the credit delivery mechanism. The guidelines on lending to the priority sector were revised to improve credit delivery to those sectors of the society/economy that impact large segment of the population, the weaker section and to the sectors which are employment-intensive such as agriculture and tiny and small enterprises. In order to review the efficacy of the existing legislative framework governing money lending and its enforcement machinery in different States and to make recommendations to the State Governments for improving the legal and enforcement framework in the interest of rural households, a Technical Group (Chairman: Shri S. C. Gupta) was set up. The Group submitted its Report in July 2007, which has been placed in public domain for comments from the general public. These apart, several other measures were initiated with a view to improving credit delivery such as financial inclusion and improvement in 'customer services' which are detailed in the subsequent sections of this Chapter. Measures pertaining to institutional reform, covering revival of regional rural banks and the co-operative structure and development of alternative avenues of credit dispensation such as micro-finance institutions, are discussed in Chapters 3 and 4 respectively.

Priority Sector Lending

2.34 The scope and extent of priority sector lending has undergone a significant change in the post-reform period with several new areas and sectors being brought under its purview. While there had been demands to include new areas, such as infrastructure, within the ambit of priority sector, there is apprehension that it will dilute the definition of the priority sector with the focus on the needy sectors of the economy and weaker sections of society getting completely lost. Against this background, an internal Working Group was set up in the Reserve Bank (Chairman: Shri C. S. Murthy) to examine the need for continuance of priority sector lending prescriptions, review the existing policy on priority sector lending, including the segments constituting the priority sector, targets and sub-targets, and to recommend changes, if any, required in this regard. Based on the draft Technical Paper submitted by the internal Working Group, and the feedback received thereon, the guidelines on lending to the priority sector were revised. The sectors of the

society/economy that impact large segments of the population, the weaker sections and the sectors which are employment-intensive, such as agriculture and micro and small enterprises, have been retained as priority sector in the revised guidelines, which came into effect from April 30, 2007. Agriculture, small enterprise, micro credit, retail trade, education loans and housing loans up to Rs. 20 lakh are the broad categories included in the priority sector (Box II.3).

Credit to Agriculture and Allied Activities

2.35 The agriculture and allied sector directly impacts output, wages, employment and consumption patterns of a vast multitude of the population. Though the share of agriculture in the GDP declined from a little over 36 per cent in the 1980s to 18.5 per cent in 2006-07, the number of people dependent on agriculture for their food and livelihood have remained largely unchanged. A number of steps have, therefore, been taken by the Reserve Bank and the Government of India to facilitate credit flow to the agriculture sector. Towards this end, the Union Finance Minister had announced some measures on June 18, 2004 for doubling the flow of credit to the agriculture sector within a period of three years. The actual disbursement of credit by banks had exceeded the targets during all the three years up to 2006-07. Carrying forward this measure, the Union Finance Minister has fixed a target of Rs.2,25,000 crore for disbursements by banks for 2007-08.

Simplification of the Procedures and Processes for obtaining Agricultural Loans

2.36 A Working Group to Examine Procedures and Processes for obtaining Agricultural Loans (Chairman: Shri C. P. Swarnkar) was constituted by the Reserve Bank in December 2006, to suggest measures to further simplify the procedures and thereby reduce the cost and time for obtaining agricultural loans, especially for small and marginal farmers. The Group submitted its Report in April 2007. Based on the recommendations of the Group, all scheduled

Box II.3: Revised Guidelines on Priority Sector Lending

Based on the draft Technical Paper submitted by the internal Working Group (Chairman: Shri C. S. Murthy) and the feedback received thereon from the governments, banks, financial institutions, non-banking financial companies, associations of industries, media, public and Indian Banks' Association, the guidelines on lending to priority sector were revised on April 30, 2007. The guiding principle of the revised guidelines on lending to the priority sector has been to ensure adequate flow of bank credit to those sectors of society/economy that impact large segments of the population, the weaker sections and to the sectors which are employment-intensive, such as agriculture and tiny and small enterprises. The broad categories of advances under the priority sector now include agriculture, small enterprises sector, retail trade, microcredit, education and housing, subject to certain limits.

The major changes made in the guidelines are set out below:

(i) In order to overcome the crowding out effect against small loans, particularly to agriculture, big-ticket loans/ advances have been kept out of the direct agriculture segment (loans/advances in excess of Rs. 1 crore granted to corporates, will get only one-third weightage for being counted under direct agriculture).

(ii) With a view to encouraging direct and retail lending by banks, intermediation has been generally discouraged by keeping loans for on-lending, barring a few categories, out of the priority sector fold and by phasing out investment in bonds of financial institutions from the priority sector.

(iii) Some of the banks had a 'nil' or negligible net bank credit (NBC) and were engaging mostly in non-funded business (derivatives). This distortion has been sought to be corrected by linking their targets to the credit equivalent of their off balance-sheet business.

(iv) The overall priority sector lending targets at 40 per cent and 32 per cent for the domestic and foreign banks respectively, as also other sub-targets, have been retained unchanged. However, these are now calculated as a percentage of adjusted net bank credit (ANBC) or credit equivalent amount of off-balance sheet exposures (OBE), whichever is higher, instead of NBC. ANBC includes NBC plus investments made by banks in non-SLR bonds held in HTM category In order to address the problem faced by banks in pursuing a moving target the reference ANBC or credit equivalent of OBE for the purpose of the targets has been stipulated as ANBC or credit equivalent of OBE as on 31st March 31 of the preceding year.

(v) Certain concessions granted earlier for the purpose of priority sector (*i.e.,* exclusion of FCNR(B)/NRNR deposits from NBC) have lost their relevance in an environment of substantially large foreign exchange reserves. Such concessions have, therefore, been withdrawn. The outstanding FCNR (B) and NRNR deposits balances would no longer be deducted for computation of ANBC for priority sector lending purposes.

(vi) The revised guidelines also take into account the revised definition of small and micro enterprises as included in the Micro, Small and Medium Enterprises Development (MSMED) Act, 2006 (refer Box II.5).

commercial banks (including RRBs) were advised to dispense with the requirement of 'no dues' certificate (NDC) for small loans up to Rs.50,000 for small and marginal farmers, share-croppers and instead obtain a self-declaration from the borrower. Further, in order to overcome the problem of producing identification/status documents by the landless labourers, share-croppers and oral lessees, banks were advised to accept certificates provided by local administration/*panchayati raj* institutions regarding the cultivation of crops in the case of loans to landless labourers, share-croppers and oral lessees. Other recommendations of the Group are being examined by the Reserve Bank.

Measures to Assist Distressed Farmers

2.37 Consequent upon the announcement made by the Reserve Bank in its Annual Policy Statement for the year 2006-07, a Working Group (Chairman: Dr. S. S. Johl) was set up to suggest measures for assisting distressed farmers, including provision of financial counseling services and introduction of a specific credit guarantee scheme (under the DICGC Act) for such farmers. The Group submitted its Report in November 2006. In the light of the recommendation of the Group and in order to assist distressed farmers whose accounts had earlier been rescheduled/converted on account of natural calamities, as also farmers who had defaulted on their loans due to circumstances beyond their control, banks were advised in the Mid-term Review of Annual Policy, released on October 31, 2006 to frame, with the approval of their boards, transparent one-time settlement (OTS) policies for such farmers. It is also proposed to introduce a credit guarantee scheme for distressed farmers (Box II.4).

Micro, Small and Medium Enterprises Development (MSMED) Act, 2006

2.38 The Micro, Small and Medium Enterprises Development (MSMED) Act, 2006 was notified on October 2, 2006. With the inclusion of the services sector in the definition of micro, small and medium enterprises and extension of the scope to medium enterprises, the enactment of the MSMED Act, 2006 has brought about a paradigm shift from small scale industry to micro, small and medium enterprises. The MSMED Act, 2006 has defined micro, small and medium enterprises engaged in manufacturing or production and providing or rendering of services (Box II.5).

2.39 Consequent upon the announcement made in the Annual Policy Statement for the year 2007-08, all State Level Banker's Committee (SLBC) Convenor banks were advised on May 8, 2007 to review their institutional arrangements for delivering credit to the SME sector, especially in 388 clusters identified by the United Nations Industrial Development Organisation (UNIDO) spread over 21 States in various parts of the country.

Box II.4: Relief Measures for Distressed Farmers – Credit Guarantee Scheme

- The Working Group to suggest measures to assist distressed farmers (Chairman: Shri S S Johl), had, *inter alia*, suggested the operation of a credit guarantee scheme for distressed small borrowers (agricultural and others) by Deposit Insurance and Credit Guarantee Corporation. The features of the scheme, as recommended by the Group, are as follows:
- All the commercial banks, including RRBs and rural co-operative banks (state and central co-operative banks) have to compulsorily participate in the scheme.
- The scheme will cover only the borrowers affected by 'systemic distress'. Systemic distress, for the purposes of the scheme, will cover extensive loss of crops/assets caused due to natural calamities and pests/locusts on an epidemic scale.
- The scheme will cover those borrowers with aggregate sanctioned limits up to Rs.1 lakh granted after the introduction of the scheme, and whose loans are required to be restructured/rescheduled for the second successive time on account of systemic distress. The earlier restructuring/reschedulement should have been done in terms of Reserve Bank's/NABARD's guidelines.
- Consumption loans will not be covered under the scheme except to the extent included in the Kisan Credit Card (KCC) limit.
- The scheme shall guarantee up to 60 per cent of the amount outstanding in the guaranteed account/s, as on the date of occurrence of the natural calamity, necessitating restructuring/reschedulement for the second successive time. The balance loss should be borne by the bank/s concerned.
- Based on the recommendations of the Group, an Agricultural Loans (Distressed formers) Guarantee Scheme, 2007 has been drafted and forwarded to Government of India. The Scheme is being revised based on Government's Comments.

Box II.5: Salient Provisions of the Micro, Small and Medium Enterprises Development (MSMED) Act, 2006

The MSMED Act, 2006 classifies enterprises broadly into(i) manufacturing enterprises; and (ii) service enterprises. These broad categories are further classified into micro enterprises, small enterprises and medium enterprises, depending upon the level of investment in plant and machinery and equipment as the case may be.

(i) Manufacturing Enterprises

(a) Micro (manufacturing) Enterprises: Enterprises engaged in the manufacture/production, processing or preservation of goods and whose investment in plant and machinery[1] does not exceed Rs. 25 lakh.

(b) Small (manufacturing) Enterprises: Enterprises engaged in the manufacture/production, processing or preservation of goods and whose investment in plant and machinery is more than Rs. 25 lakh but does not exceed Rs. 5 crore.

(c) Medium (manufacturing) Enterprises: Enterprises engaged in the manufacture/production, processing or preservation of goods and whose investment in plant and machinery is more than Rs. 5 crore but does not exceed Rs. 10 crore.

(ii) Service Enterprises

(a) Micro (service) Enterprises: Enterprises engaged in providing/rendering of services and whose investment in equipment[2] does not exceed Rs. 10 lakh.

(b) Small (service) Enterprises: Enterprises engaged in providing/rendering of services and whose investment in equipment is more than Rs. 10 lakh but does not exceed Rs. 2 crore.

(c) Medium (Service Enterprises): Enterprises engaged in providing/rendering of services and whose investment in equipment is more than Rs. 2 crore but does not exceed Rs. 5 crore.

(iii) The small and micro (service) enterprises include small road and water transport operators, small business, professional and self-employed persons, and all other service enterprises. Although medium enterprises are included in the SME sector, credit to medium enterprises is not included under the priority sector.

(iv) Delayed Payment to Micro and Small Enterprises

The existing provisions of the Interest on Delayed Payment Act, 1998 to small scale and ancillary industrial undertakings have been strengthened under the MSMED Act as follows:

(a) The buyer to make payment on or before the date agreed upon between him and the supplier in writing or, where there is no agreement in this behalf, before the appointed day. The agreement between seller and buyer shall not exceed 45 days.

(b) If the buyer fails to make payment of the amount to the supplier, he shall be liable to pay compound interest with monthly rests to the supplier on the amount from the appointed day or, from the date agreed upon, at three times of the Bank Rate notified by the Reserve Bank.

(c) For any goods supplied or services rendered by the supplier, the buyer shall be liable to pay the amount with interest thereon as indicated at (b) above.

(d) In the case of dispute with regard to any amount due, a reference shall be made to the Micro and Small Enterprises Facilitation Council, constituted by the respective State Government.

(v) National Board for Micro, Small and Medium Enterprises (MSME)

The Act also provides for constitution of a National Board for Micro, Small and Medium Enterprises under the chairmanship of the Union Minister for MSME, with wide representation of stakeholders, to (i) examine the factors affecting the promotion and development of micro, small and medium enterprises; and (ii) review the policies and programmes of the Central Government in regard to facilitating the promotion and development and enhancing the competitiveness of such enterprises and the impact thereof on such enterprises, and make recommendations on matter relating thereto.

The Act also provides for the constitution of an Advisory Committee under the chairmanship of Secretary (MSME), Government of India to examine matters referred to it by the National Board and give recommendations thereto, and also provide advice to the Central Government and the State Governments on matters relating to micro, small and medium enterprises.

(vi) Memorandum of Micro, Small and Medium Enterprises

The Act has also laid down the procedure for filing of memoranda by persons intending to establish micro or small enterprises or medium enterprise engaged in manufacture or production of goods or engaged in providing or rendering of services.

2.40 Public sector banks were advised to operationalise at least one specialised SSI branch in every district and centre having a cluster of SSI units. At the end of March 2007, 636 specialised SSI bank branches were operationalised by the banks as against 629 as at the end-March, 2006.

[1] Investment in plant and machinery refers to original cost, excluding land and building and the items specified by the Ministry of Small Scale Industries vide its notification No. S.O. 1722(E) dated October 5, 2006.

[2] Investment in equipment refers to original cost, excluding land and building and furniture, fittings and other items not directly related to the service rendered or as may be notified under the MSMED Act, 2006

Credit to Small and Medium Enterprise (SME) Sector

2.41 The definition of small scale industry and small business enterprises for purposes of inclusion in the priority sector has been aligned with the definition adopted in the MSMED Act, 2006. Further, in order to improve credit delivery to SMEs, banks were urged to review their institutional arrangements for delivering credit to the SME sector, especially in identified clusters in various parts of the country, and to take measures to strengthen the expertise in and systems at branches located in or near such identified clusters with a view to providing adequate and timely credit.

2.42 Consistent with the notification on October 2, 2006 of the MSMED Act, 2006, the definition of micro, small and medium enterprises engaged in manufacturing or production and providing or rendering of services for the purpose of priority sector lending has been modified, and guidelines were issued to banks in April 2007 and July 2007.

2.43 In order to ensure that credit is available to all segments of small enterprise, banks were advised in July 2007 to ensure that (a) 40 per cent of the total advances to small enterprises sector should go to micro (manufacturing) enterprises having investment in plant and machinery up to Rs.5 lakh and micro (service) enterprises having investment in equipment up to Rs.2 lakh; (b) 20 per cent of the total advances to small enterprises sector should go to micro (manufacturing) enterprises with investment in plant and machinery above Rs.5 lakh but up to Rs.25 lakh, and micro (service) enterprises with investment in equipment above Rs.2 lakh but up to Rs.10 lakh. Thus, 60 per cent of small enterprises advances should go to the micro enterprises.

Foreign Banks' Deposits with Small Industries Development Bank of India

2.44 Foreign banks are at present required to make good the shortfall in achievement of the stipulated targets/sub-targets by depositing, for a period of three years, an amount equivalent to the shortfall with the Small Industries Development Bank of India (SIDBI). As per the revised priority sector guidelines issued in April 2007, foreign banks having shortfall in the stipulated priority sector lending target/sub-targets would be required to contribute to Small Enterprises Development Fund (SEDF) to be set up by SIDBI, or for such other purpose as may be stipulated by the Reserve Bank from time to time. The corpus of SEDF would be decided by the Reserve Bank on a year-to-year basis. The tenor of the deposits shall be for a period of three years or as decided by the Reserve Bank from time to time.

Internal Working Group on Special Relief Measures by Banks in Areas Affected by Natural Calamities

2.45 During calamities in the recent past such as *tsunami*, heavy rains, floods and earthquakes, a number of instances of operational problems relating to functioning of ATMs, opening of accounts of small customers, operations of accounts in the absence of documents and failure of computer networks came to the notice of the Reserve Bank. Following the announcement made in the Mid-term Review of the Reserve Bank's Annual Policy Statement for the year 2005-06, an internal Working Group (Chairman: Shri G. Srinivasan) was set up in the Reserve Bank to look into various issues in respect of areas affected by natural calamities and to suggest suitable revisions and additions to the existing guidelines to make them comprehensive. The Working Group submitted its final report on June 12, 2006.

2.46 Based on the recommendations of the Group, the Reserve Bank issued some additional guidelines to banks on August 9, 2006, to provide special relief measures in areas affected by natural calamities. The guidelines included: (a) operating from temporary premises in areas where the bank branches are affected by natural calamity; (b) waiving the penalties relating to accessing accounts such as fixed deposits to satisfy customer's immediate requirements; (c) restoring the functioning of ATMs at the earliest and putting in place arrangements for allowing customers to access other ATM networks and mobile ATMs; (d) simplifying the procedure for opening of new accounts for persons affected by natural calamities; (e) restructuring of the existing loans; and (f) enhancing the limit on consumption loans. Further, banks were advised on September 4, 2006 that the instructions on moratorium, additional collateral for restructured loans and asset classification in respect of fresh finance would be applicable to

all affected restructured borrowal accounts, including accounts of industries and trade, besides agriculture.

Package of Relief Measures to the Vidarbha Region in Maharashtra

2.47 In order to mitigate the distress of farmers in the six debt-ridden districts in Vidarbha region of Maharashtra, the Hon'ble Prime Minister had announced a rehabilitation package so as to enable the affected borrowers to become immediately eligible for fresh loans from the banking system. Under the package, the entire interest on loans overdue as on July 1, 2006 was waived in the six debt-ridden districts (Amravati, Wardha, Yavatmal, Akola, Washim and Buldhana) and the principal amounts of the overdue loans were rescheduled over a period of 3-5 years with a one-year moratorium. The package also envisaged that an additional credit flow of Rs.1,275 crore would be ensured in these six districts. The total amount of credit of Rs. 1,275 crore envisaged to be released by banks has been allocated by the SLBC among the banks functioning in these districts. The Government of India has sanctioned Rs.356 crore for reimbursing the banks towards waiver of interest in districts of Vidarbha.

Package for Debt Stressed Districts of Andhra Pradesh, Karnataka and Kerala

2.48 The Government of India had approved a package for mitigating the distress of farmers in 25 debt stressed districts of Andhra Pradesh, Karnataka and Kerala. The package, insofar as it relates to agricultural credit, includes the following elements. One, the entire interest on overdue loans as on July 1, 2006 would be waived in the 25 affected districts and all farmers would have no past interest burden as on that date, so that they would immediately be eligible for fresh loans from the banking system. Two, the overdue loans of the farmers as on July 1, 2006 would be rescheduled over a period of 3-5 years with a one-year moratorium. Three, a credit flow of Rs.13,818 crore, Rs.3,076 crore and Rs. 1,945 crore would be ensured in the affected districts of Andhra Pradesh, Karnakata and Kerala, respectively, during 2006-07.

2.49 The Government of India has sanctioned Rs.718 crore, Rs.105 crore and Rs.180 crore for reimbursing the banks towards waiver of interest in the affected districts of Andhra Pradesh, Karnakata and Kerala, respectively.

Technical Group for Review of Legislations on Money Lending

2.50 The All-India Debt and Investment Survey (NSS Fifty-Ninth Round) had revealed that the share of money lenders in total dues of rural households had increased from 17.5 per cent in 1991 to 29.6 per cent in 2002. Considering that high indebtedness to money lenders could be an important reason for distress of farmers, a Technical Group for Review of Legislations on Money Lending (Chairman: Shri S. C. Gupta) as announced in the Annual Policy Statement for the year 2006-07 was set up to review the efficacy of the existing legislative framework governing money lending and its enforcement machinery in different States and make recommendations to the State Governments for improving the legal and enforcement framework in the interest of rural households. The Group submitted its report on June 15, 2007, which has been placed in the public domain for comments from the stakeholders.

2.51 The Group has, *inter alia,* recommended a model law for the consideration and adoption by the State Governments that do not have a comprehensive legislation in place for governing money lending. The proposed model law reflects the significant elements of similar legislation available internationally and domestically. The Group has also recommended some modifications to the existing legislations to facilitate quick, informal and easy dispute resolution and better enforcement. The model legislation provides for (a) a simple and hassle free procedure for compulsory registration and periodical renewal of registration by moneylenders; (b) adoption of the rule of *Damdupat* restricting the maximum amount of interest chargeable by the moneylender; and (c) periodical resetting of the maximum rate of interest in line with market rates by State Governements in consultation with SLBC. The Group has also explored the possibility of establishing a link between the formal and informal credit providers, whereby a moneylender may serve as an 'accredited loan provider', *i.e.,* an additional credit delivery channel for the formal sector, provided there are safeguards in place (Box II.6).

Box II.6: Technical Group to Review the Legislations on Money Lending

The Technical Group (Chairman: Shri S.C. Gupta) made the following recommendations:

- Moneylenders should be registered compulsorily with the State Governments. Unregistered moneylenders will be penalised. The procedure for registration and renewal should be made simple and hassle free.
- In order to focus the legislation on the regulation of money lending transactions, banks, statutory corporations, co-operatives, financial institutions, NBFCs and the Reserve Bank need to be kept out of the purview of the legislation.
- To provide the State Governments with the flexibility of adjusting the rates of interest in accordance with the market realities, the maximum rates of interest to be charged by moneylenders should be notified by the State Governments from time to time. While determining the maximum rate, the range of interest rates and costs and other expenses being charged should be taken into account. In order to prevent usury, the rule of damdupat has been recommended.
- Alternate dispute resolution mechanisms such as Lok Adalat and Nyaya Panchayat for speedy and economical dispensation of justice have been recommended. Alternatively, State Governments may think of setting up of fast-track Courts/designated Courts to deal with disputes relating to lending transactions by money lenders and accredited loan providers. The choice of the forum can be decided by the State Governments depending upon the local conditions.
- In order to ensure that the enforcement/administration of the legislation is properly monitored, a new section has been proposed which would require State Governments to place an annual report on the administration of the legislation before the State Legislature.
- The State Governments should take adequate steps to publicise the maximum rates of interest notified under the Act, the offences under the Act and the dispute redressal machinery provided thereunder.
- A new chapter in the States' money lending legislations, aimed at establishing a link between the formal and informal credit providers, to be called 'Accredited Loan Providers', has been recommended.
- The Technical Group has recommended a set of conditions in the agreement between the banks/financial institutions and the 'accredited loan providers' as safeguard measures.
- The advances made by institutional creditors to accredited loan providers may be treated as priority sector lending. This would encourage the banks to take up the role of institutional creditors and disburse loans through the linkage with accredited loan providers as an additional business.

4. Financial Inclusion

2.52 Financial inclusion refers to delivery of banking services at an affordable cost to the vast sections of disadvantaged and low-income groups who tend to be excluded from the formal banking channel. Despite widespread expansion of the banking sector during the last three decades, a substantial proportion of the households, especially in rural areas, is at present outside the coverage of the formal banking system. The Reserve Bank's broad approach to financial inclusion aims at 'connecting people' with the banking system and not just credit dispensation; giving people access to the payments system; and portraying financial inclusion as a viable business model and opportunity. Efforts towards 'financial inclusion' include sensitising the banks to the banking and financial needs of the common person and ensuring access to basic banking facilities. In consonance with the above approach, the Reserve Bank has undertaken a number of measures in recent years for attracting the financially excluded population into the formal financial system. The Annual Policy Statement for 2006-07 urged all banks to give effect to the measures announced by the Reserve Bank from time to time on financial inclusion at all their branches.

2.53 Introduction of 'zero balance' or 'no frills' accounts has enabled the common person to open bank account. However, providing banking facilities closer to the customer, especially in remote and unbanked areas, while keeping transaction costs low, remains a challenge. This has to be done with affordable infrastructure and low operational costs with the use of appropriate technology. Pursuant to the announcement made in the Annual Policy Statement for the year 2007-08, banks were urged on May 7, 2007 to scale up their financial inclusion efforts by utilising appropriate technology, while ensuring that the solutions developed are: (i) highly secure; (ii) amenable to audit; and (iii) follow widely accepted open standards to allow inter-operability among the different systems adopted by different banks. Banks have initiated pilot projects utilising smart cards/mobile technology to increase their outreach. Biometric methods for uniquely identifying customers are also being increasingly adopted.

Pilot Project for 100 per cent Financial Inclusion: Status and Further Action

2.54 The convenor banks of the State Level/ Union Territory Level Bankers' Committees (SLBC/UTLBC) in all States/Union Territories were advised on April 28, 2006 to identify at least one district in each State/Union Territory for achieving 100 per cent financial inclusion by providing a 'no-frills' account and issue of general purpose credit card (GCC). They were also advised that on the basis of experience gained, the scope for providing 100 per cent financial inclusion may be extended to cover other areas/districts. The SLBCs/UTLBCs were further advised to allocate villages to the various banks operating in the State for taking the responsibility for ensuring 100 per cent financial inclusion and also to monitor financial inclusion in the meetings of the SLBC/ UTLBC from September 2006 onwards. So far, 160 districts have been identified and 100 per cent financial inclusion has been achieved in the whole of Union Territory of Puducherry and in 28 districts in eight States (Andhra Pradesh, Gujarat, Haryana, Himachal Pradesh, Karnataka, Kerala, Punjab and West Bengal). All districts of Himachal Pradesh have achieved financial inclusion. An evaluation of the progress made in achieving financial inclusion in these districts is being undertaken to draw lessons for further action in this regard.

Services to Depositors and Small Borrowers in Rural and Semi-Urban Areas

2.55 The Annual Policy Statement for the year 2005-06 proposed a survey for assessing customer satisfaction on credit delivery in rural areas by banks. Accordingly, the National Council of Applied Economic Research (NCAER) was entrusted with the job of carrying out a study on the quality of services rendered by branches of commercial banks to their customers (both depositors and small borrowers) in rural and semi-urban areas. The NCAER initiated the study in January 2006 and submitted the Report in October 2007. The study covered 930 bank branches across the country from 30 States/Union Territories, and included 9,300 depositors and 13,950 borrowers. Prompt service delivery at the counter and professional attitude of the bank staff in reaching out to the customers emerged as key determinants for customer satisfaction in rural and semi-urban areas.

Credit Counselling: Setting up of Centres on a Pilot Basis

2.56 The Working Group (Chairman: Prof. S. S. Johl) constituted by the Reserve Bank to suggest measures for assisting distressed farmers had recommended that financial and livelihood counselling are important for increasing the viability of credit. Further, the Working Group constituted to examine the procedures and processes for agricultural loans (Chairman: Shri C. P. Swarnkar) had also recommended that banks should actively consider opening of counselling centres, either individually or with pooled resources, for credit and technical counselling with a view to giving special thrust to credit delivery in the relatively under-developed regions. In the light of the recommendations of these two Groups, as announced in the Annual Policy Statement for the year 2007-08, State Level Bankers' Committee convenor banks were advised to set up, on a pilot basis, a financial literacy-cum-counselling centre in any one district. Based on the experience gained, the concerned lead banks may set up such centres in other districts.

Use of Intermediaries as Agents

2.57 In January 2006, the Reserve Bank permitted banks to utilise the services of non-governmental organisations/self-help groups (NGOs/SHGs), micro-finance institutions (other than NBFCs) and other civil society organisations as intermediaries in providing financial and banking services through the use of business facilitator (BF) and business correspondent (BC) models. The BC model allows banks to do 'cash-in/cash-out' transactions at a location much closer to the rural population, thus, addressing the last mile problem. Banks are also entering into agreements with postal authorities for using the enormous network of post offices as business correspondents, thereby increasing their outreach and leveraging the postman's intimate knowledge of the local population and trust reposed in him.

Working Groups on Improvement of Banking Services in Different States/Union Territories

2.58 The Reserve Bank has been initiating measures to improve the outreach of banks and their services, and promote financial inclusion in less developed States/UTs. During 2005-06, the Reserve Bank had constituted two committees/working groups to examine the

problems/issues relating to banking services in the North-Eastern regions (Chairperson: Smt Usha Thorat) and Uttarakhand (Chairman: Shri V.S. Das). During 2006-07, the Reserve Bank constituted four more working groups to look into the banking services in Bihar, Himachal Pradesh, Lakshadweep Islands and Chattisgarh.

2.59 In order to prepare a monitorable action plan for achieving greater financial inclusion and provision of financial services in the North Eastern region, the Reserve Bank had set up a Committee on Financial Sector Plan for the North Eastern region (Chairperson: Smt. Usha Thorat). The Committee submitted its report in July 2006. The Committee had stressed the need for improving the infrastructure, creating a favourable investment climate, focusing on a few sectors of strategic advantage for development and encouraging a favourable credit culture. The implementation of the recommendations of the Committee is being closely monitored by the Reserve Bank. On request from Government of India to include the State of Sikkim while reviewing the credit flow from banks in the North Eastern region, a Task Force for the State of Sikkim was constituted under the chairmanship of the Regional Director, West Bengal and Sikkim, Reserve Bank, to recommend action plan for the State of Sikkim to the Committee on Financial Sector Plan. The Task force forwarded its report on June 22, 2007 to all the stakeholders for implementation of the recommendations.

2.60 A Working Group (Chairman: Shri V. S. Das) was constituted in May 2006 to examine the problems/issues relating to banking services in Uttarakhand and to prepare an action plan for the purpose. The Group submitted its report on August 14, 2006. The action points arising out of the recommendations have been forwarded to the concerned agencies for implementation.

2.61 A Working Group (Chairman: Shri V. S. Das) was constituted to look into the problems faced by the bankers and borrowers in the State of Bihar. The recommendations of the Group are being implemented by the SLBC, banks and the State Government of Bihar. A Working Group under the chairmanship of the Regional Director for Chhattisgarh and Madhya Pradesh, Reserve Bank was also constituted to draw up an action plan for improving the banking services in the State of Chhattisgarh. The recommendations of the Group are under implementation.

2.62 A Working Group was constituted under the chairmanship of the Regional Director for Kerala and the Union Territory of Lakshadweep, Reserve Bank to undertake a study of banking services in the Union Territory of Lakshadweep Islands. The Group is expected to submit its report shortly.

2.63 Another Working Group was constituted under the chairmanship of the Regional Director for the States of Punjab and Himachal Pradesh and Union Territory of Chandigarh, Reserve Bank to review the role of banks and financial institutions in supporting the initiatives taken by the State Government of Himachal Pradesh for promoting economic development of the State and also recommend measures for enhancing greater outreach/penetration of the banking system in the State. The Group submitted its report on September 26, 2007 and its recommendations are under examination.

2.64 In pursuance of the policy to improve banking facilities in certain less developed States/ regions, a Working Group (Chairman: Shri V.S. Das) was constituted in October 2007 to recommend measures to enhance the outreach of banking services in the State of Jharkhand.

Micro-finance

2.65 Recognising the potential of micro-finance to positively influence the upliftment of the poor, the Reserve Bank has been making efforts to create an environment for its orderly development. The Reserve Bank conducted a joint fact-finding study in May 2006 with a few major banks. The study revealed that some of the micro-finance institutions (MFIs) financed by banks or acting as their intermediaries/partners appeared to be focussing on relatively better banked areas. They were also operating in the same area trying to reach out to the same set of poor resulting in multiple lending. Further, many MFIs supported by banks were not engaging themselves in capacity building and empowerment of the groups to the desired extent. Also, some banks, as principal financiers of MFIs, did not appear to be engaging them for improving their systems, practices and lending policies. An advisory was, therefore, issued to banks in November 2006 communicating these findings and advising them to take corrective action at their end.

2.66 The micro-finance sector has gained momentum in recent years and this has brought into focus the issue of its regulation. A draft Micro-

financial Sector (Development and Regulation) Bill, 2007 is under consideration of the Union Government, which envisages regulation of the micro-finance sector. The Bill was tabled in the Lok Sabha on March 20, 2007.

Loans Extended against Gold and Silver Ornaments: Reduction of Risk Weight

2.67 Loans against gold and silver ornaments are commonly availed of by the poorer sections of society in both rural and urban areas. These loans entail relatively low risk as they are extended with adequate margins and the collateral (gold or silver) is easily marketable, particularly where the size of the loan is small. Such loans being in the nature of retail (personal) loans attracted a risk weight of 125 per cent. In the Annual Policy Statement for the year 2007-08, the risk weight on loans up to Rs.1 lakh against gold and silver ornaments was reduced to 50 per cent from the earlier level of 125 per cent for all categories of banks.

5. Prudential Regulation

2.68 The focus of Reserve Bank's regulatory initiatives during 2006-07 continued to be on adopting international best practices and their gradual harmonisation with the Indian practices with a view to reinforcing financial stability. In conformity with the commitment to ensure a smooth transition to Basel II, a number of measures were initiated. Apart from the release of the final guidelines for implementation of the New Capital Adequacy Framework (Basel II) by banks, some of the major initiatives included issuing of guidelines on stress testing by banks, and enhancement of disclosure norms to strengthen Pillar 3 (Market Discipline) of the new framework. Other major initiatives taken during the year included modification in the existing guidelines on banks' exposure to the capital market; issuance of comprehensive guidelines on derivatives, revised framework for managing the attendant risks in outsourcing; issuance of prudential norms on creation and utilisation of floating provisions; and modification in the guidelines on sale/purchase of NPAs.

Capital Adequacy

Basel II – Implementation of the New Capital Adequacy Framework

2.69 The Basel Committee on Banking Supervision (BCBS) framework on capital adequacy in India was introduced in April 1992, when all scheduled commercial banks (including foreign banks) were required to maintain a capital to risk-weighted asset ratio (CRAR) of 8 per cent in a phased manner. The stipulated minimum CRAR was increased to 9 per cent from end-March 2000. Essentially, under the above system the balance sheet assets, non-funded items and other off-balance sheet exposures are assigned prescribed risk weights and banks have to maintain unimpaired minimum capital funds equivalent to the prescribed ratio on the aggregate of the risk weighted assets and other exposures on an ongoing basis. Taking into account the size, complexity of operations, relevance to the financial sector, need to ensure greater financial inclusion and the need for having an efficient delivery mechanism, the capital adequacy norms applicable to various categories of financial institutions have been maintained at varying levels of stringency. In India, a three-track approach has been adopted with regard to capital adequacy rules. On the first track, commercial banks are required to maintain capital for both credit and market risks as per Basel I framework; the co-operative banks, on the second track, are required to maintain capital for credit risk as per Basel I framework and through surrogates for market risk; and the regional rural banks, on the third track, have a minimum capital requirement which is, however, not on par with the Basel I framework.

2.70 On the lines of 'Amendment to the Capital Accord to Incorporate Market Risks' issued by the BCBS in 1996, banks in India were advised in June 2004 to maintain capital charge for market risks. The BCBS released the 'International Convergence of Capital Measurement and Capital Standards: A Revised Framework' on June 26, 2004. Based on the Revised Framework, the draft guidelines for implementation by banks in India were initially placed in the public domain on February 15, 2005 inviting feedback/comments from a wide spectrum of banks and other stakeholders. Comprehensive version of the framework was issued in July 2006. The final guidelines on the revised capital adequacy framework (Basel II) were issued to banks in India on April 27, 2007 after considering the feedback received.

2.71 The Basel II norms address three types of risks, *viz.*, credit risk, market risk and operational risk for minimum capital requirements and has a

three pillar structure with minimum capital requirements as the first pillar, supervisory review process as the second pillar and market discipline as the third pillar. In terms of the provisions of the final guidelines on the revised framework, all commercial banks in India (excluding local area banks and regional rural banks) migrating to Basel II are required to adopt Standardised Approach (SA) for credit risk and Basic Indicator Approach (BIA) for operational risk, while continuing to apply the Standardised Duration Approach (SDA) for computing capital requirement for market risks. While foreign banks operating in India and Indian banks having operational presence outside India are expected to migrate to the Revised Framework with effect from March 31, 2008, all other commercial banks (excluding local area banks and regional rural banks) are encouraged to migrate to these approaches under Basel II in any case not later than March 31, 2009. Banks are required to obtain prior approval of the Reserve Bank in case they intend to migrate to the advanced approaches for computing risk weights. The pre-requisites and procedure for approaching the Reserve Bank for seeking such approval would be issued in due course.

2.72 Banks are required to maintain a minimum capital to risk-weighted assets ratio (CRAR) of 9 per cent on an ongoing basis. However, taking into account the relevant risk factor and internal capital adequacy assessments of each bank, the Reserve Bank may prescribe a higher level of minimum capital to risk-weighted asset ratio to ensure that the capital held by a bank is commensurate with its overall risk profile. Banks are encouraged to maintain, at both solo and consolidated level, a minimum Tier I ratio of at least 6 per cent. Banks below this level must achieve this ratio on or before March 31, 2010.

2.73 With a view to ensuring smooth transition to the Revised Framework and providing opportunity to banks to streamline their systems and strategies, banks were advised to have a parallel run of the Revised Framework (Box II.7).

Enhancement of Banks' Capital Raising Options

2.74 Under the Basel II framework, Indian banks are expected to have larger capital requirements as they would need to earmark capital for operational risk, apart for credit and market risks. For smooth transition to Basel II and with a view to providing additional options for raising capital funds, banks were allowed in January 2006 to augment their capital funds by issuing innovative perpetual debt instruments

Box II.7: Migration to New Capital Adequacy Framework: Parallel Run Process

With a view to ensuring smooth transition to the Revised Framework and providing opportunity to streamline their systems and strategies, banks in India were advised to have a parallel run of the Revised Framework, which they have been conducting since 2006-07. The boards of the banks were required to review the results of the parallel run on a quarterly basis. The parallel run consists of the following:

(i) Banks are required to apply the prudential guidelines on capital adequacy – both current guidelines and the guidelines on the Revised Framework – on an on-going basis and compute their CRAR under both the guidelines.

(ii) An analysis of the bank's CRAR under both the guidelines is required to be reported to the Board at quarterly intervals. While reporting the above analysis to the Board, banks should also furnish a comprehensive assessment of their compliance with the other requirements relevant under the Revised Framework, which include the following, at the minimum:

(a) Board approved policy on utilisation of the credit risk mitigation techniques, and collateral management;

(b) Board approved policy on disclosures;

(c) Board approved policy on internal capital adequacy assessment process (ICAAP) along with the capital requirement as per ICAAP;

(d) Adequacy of bank's management information system (MIS) to meet the requirements under the New Capital Adequacy Framework, the initiatives taken for bridging gaps, if any, and the progress made in this regard;

(e) Impact of the various elements/portfolios on the bank's CRAR under the revised framework;

(f) Mechanism in place for validating the CRAR position computed as per the New Capital Adequacy Framework and the assessments/findings/ recommendations of these validation exercises;

(g) Action taken with respect to any advice/guidance/ direction given by the Board in the past on the above aspects.

A copy of the quarterly report to the Board is required to be submitted to the Reserve Bank.

The minimum capital maintained by banks on implementation of Basel II norms is subject to a prudential floor computed with reference to the requirement as per Basel I framework for credit and market risks. The floor has been fixed at 100 per cent, 90 per cent and 80 per cent for the position as at end-March for the first three years of implementation of the Revised Framework.

(IPDI) eligible for inclusion as Tier I capital and debt capital instruments eligible for inclusion as Upper Tier II capital (Upper Tier II instruments). Initially banks were allowed to issue these instruments in Indian Rupees and were required to obtain prior approval of the Reserve Bank, on a case-by-case basis, for issue in foreign currency. Further, the total amount raised by issue of these instruments by banks was reckoned as liability for the calculation of net demand and time liabilities for the purpose of reserve requirements.

2.75 The guidelines were reviewed and the following relaxations were introduced in July 2006:

(i) The total amount raised by a bank through IPDIs is not to be reckoned as liability for calculation of net demand and time liabilities for the purpose of reserve requirements and, as such, not to attract CRR/SLR requirements.

(ii) The total amount raised by a bank through IPDIs is not to exceed 15 per cent of total Tier I capital, and the eligible amount is required to be computed with reference to the amount of Tier I capital as on March 31 of the previous financial year, after deduction of goodwill and other intangible assets but before the deduction of investments.

(iii) Investment by FIIs in IPDI raised in Indian Rupees is outside the external commercial borrowing (ECB) limit for rupee denominated corporate debt fixed for investment by FIIs in corporate debt instruments.

(iv) Banks can augment their capital funds through the issue of IPDI/Upper Tier II instruments in foreign currency without seeking the prior approval of the Reserve Bank, subject to the compliance with certain requirements. One, IPDI/ Upper Tier II instruments issued in foreign currency should comply with all terms and conditions applicable to the guidelines issued on January 25, 2006, unless specifically modified in July 2006 guidelines. Two, in the case of IPDI, not more than 49 per cent of the eligible amount could be issued in foreign currency. In the case of Upper Tier II instruments, the total amount issued in foreign currency should not exceed 25 per cent of the unimpaired Tier I capital and to be computed with reference to the amount of Tier I capital as on March 31 of the previous financial year, after deduction of goodwill and other intangible assets but before the deduction of investments. The amount raised by issue of these instruments in foreign currency would be in addition to the existing limit for foreign currency borrowings by authorised dealers. Three, investment by FIIs in Upper Tier II Instruments raised in Indian Rupees shall be outside the limit for investment in corporate debt instruments, *i.e.*, US$ 1.5 billion. However, investment by FIIs in these instruments would be subject to a separate ceiling of US$ 500 million.

2.76 With a view to providing a wider choice of instruments to Indian banks for raising Tier I and Upper Tier II capital, banks were allowed in October 2007 to issue preference shares in Indian Rupees, subject to extant legal provisions through issuance of perpetual non-cumulative preference shares (PNCPS) as Tier I capital. The perpetual cumulative preference shares (PCPS), redeemable non-cumulative preference shares (RNCPS) and redeemable cumulative preference shares (RCPS) were allowed as Upper Tier II capital. The perpetual non-cumulative preference shares will be treated on par with equity, and hence, the coupon payable on these instruments will be treated as dividend (an appropriation of profit and loss account). The Upper Tier II preference shares will be treated as liabilities and the coupon payable thereon will be treated as interest (charged to profit and loss account). The total amount raised by the bank by issue of PNCPS shall not be reckoned as liability for calculation of net demand and time liabilities for the purpose of reserve requirements and, as such, will not attract CRR/SLR requirements. The total amount raised by a bank through the issue of Upper Tier II instruments shall be reckoned as liability for the calculation of net demand and time liabilities for the purpose of reserve requirements and, as such, will attract CRR/SLR requirements.

Guidelines on Stress Testing

2.77 A well designed and implemented stress testing framework would supplement banks' risk management systems and help in making these systems more robust. The stress testing involves identifying possible events and future economic conditions that could unfavourably impact bank's credit exposures, and making an assessment of the ability of banks to withstand the loss arising out of such events. Internationally, stress testing

has become an integral part of banks' risk management systems and is used to evaluate the potential vulnerability to some unlikely, but plausible events or movements in financial variables. There are broadly two categories of stress tests used in banks, *viz.*, sensitivity tests and scenario tests. These may be used either separately or in conjunction with each other.

2.78 Sensitivity tests are normally used to assess the impact of change in one variable (for instance, a high magnitude parallel shift in the yield curve, a significant movement in the foreign exchange rates, a large movement in the equity index) on the bank's financial position. Scenario tests include simultaneous movement in a number of variables (for instance, equity prices, oil prices, foreign exchange rates, interest rates, liquidity, *etc.*) based on a single event experienced in the past *(i.e.,* historical scenario – for instance, natural disasters, stock market crash, depletion of a country's foreign exchange reserves), or a plausible market event that has not yet happened (*i.e.,* hypothetical scenario - for instance, collapse of communication systems across the entire region/country, sudden or prolonged severe economic downturn), and the assessment of their impact on the bank's financial position.

2.79 Stress tests are also carried out on the asset portfolio incorporating various scenarios, such as economic downturns, industrial downturns, market risk events and sudden shifts in liquidity conditions. Furthermore, exposures to sensitive sectors and high risk category of assets would have to be subjected to more frequent stress tests based on realistic assumptions for asset price movements. Stress tests enable banks to assess the risk more accurately, thereby facilitating planning for appropriate capital requirements.

2.80 Banks in India are beginning to use statistical models to measure and manage risks. Stress tests are, therefore, relevant for them. Further, the supervisory review process under Pillar 2 of Basel II framework is intended not only to ensure that banks have adequate capital to support all the risks in their business, but also to encourage banks to develop and use better risk management techniques in monitoring and managing their risks. The need for banks in India to adopt 'stress tests' as a risk management tool was emphasised in the Annual Policy Statement for 2006-07. Accordingly, guidelines on stress testing were issued by the Reserve Bank on June 26, 2007. In terms of provisions of the guidelines, banks are required to put in place appropriate stress test policies and the relevant stress test framework for the various risk factors by September 30, 2007.

2.81 Banks have been advised to undertake the stress tests on a trial basis and use the results of these trial tests as a feedback to further refine the framework. It has also been decided to allow some time to banks to refine the stress testing frameworks. Banks are required to ensure that their formal stress testing frameworks, which are in accordance with the guidelines, are operational from March 31, 2008. Guidelines on stress testing, as relevant for the Basel II framework, would be issued separately.

Enhanced Bank Disclosures

2.82 A set of disclosure requirements has been prescribed by the Reserve Bank to encourage market discipline. In view of the Pillar 3 disclosure framework of the BCBS, the disclosure requirements designed for Indian banks are being streamlined in the light of the industry developments and the experience from the ongoing monitoring in this area.

2.83 In order to ensure that the drawdown by banks of their statutory reserves is done prudently and is not in violation of any of the regulatory prescriptions, banks were advised in September 2006 (i) to take prior approval from the Reserve Bank before any appropriation is made from the statutory reserve or any other reserves; (ii) all expenses including provisions and write-offs recognised in a period, whether mandatory or prudential, should be reflected in the profit and loss account for the period as an 'above the line' item (*i.e.*, before arriving at the net profit); (iii) wherever drawdown from reserves takes place with prior approval of the Reserve Bank, it should be effected only 'below the line' (*i.e.*, after arriving at the profit/ loss for the year); and (iv) to ensure that suitable disclosures are made of such drawdown of reserves in the 'notes on accounts' to the balance sheet.

2.84 Scheduled commercial banks (SCBs), excluding RRBs, were required to adopt the three business segments, *viz.*, 'treasury', 'other banking business' and 'residual' as the uniform business segments and 'domestic' and 'international' as the uniform geographic segments for the purpose of segment reporting under AS-17 in terms of circular dated March 29, 2003. As the segment of 'other

banking business' was very broad, in order to lend sufficient transparency to the balance sheet, it was decided to divide this segment into three categories, *viz.*, corporate/wholesale banking, retail banking and other banking operations. Revised draft guidelines were placed on the Reserve Bank's website on December 19, 2006, for feedback from all the stakeholders. Based on the feedback, final guidelines were issued on April 18, 2007. Accordingly, banks will adopt the following business segments for public reporting purposes, from March 31, 2008: (a) treasury, (b) corporate/ wholesale banking, (c) retail banking, and (d) other banking operations. The segment of 'retail banking' would include exposures which fulfil the four criteria of orientation, product, granularity and low value of individual exposures for retail exposures as laid down in the BCBS document entitled 'International Convergence of Capital Measurement and Capital Standards: A Revised Framework'. Individual housing loans will also form part of the retail banking segment for the purpose of reporting under AS-17. The segment of wholesale banking would include all advances to trusts, partnership firms, companies and statutory bodies, which are not included under 'retail banking'. The segment 'others banking business' would include all other banking operations not covered under 'treasury', 'wholesale banking' and 'retail banking' segments. It will also include all other residual operations such as para-banking transactions/activities. Banks will also be required to report any additional segments, which fulfill the criteria laid down under AS-17. The disclosure requirement will come into force from the reporting period ending March 31, 2008.

Exposure Norms and Risk Weights

2.85 The Reserve Bank has prescribed regulatory limits on banks' exposure to individual and group borrowers to avoid concentration of credit, and has advised banks to fix limits on their exposure to specific industries or sectors (real estate) to ensure better risk management. In addition, banks are also required to observe certain statutory and regulatory limits in respect of their exposures to the capital market. In pursuance to the announcement made in the Mid-term Review of Annual Policy Statement for the year 2005-06, prudential capital market exposure norms prescribed for banks were rationalised in terms of base and coverage.

2.86 Aggregate exposure (both fund and non-fund based) of banks to the capital market in all forms under direct and indirect exposures was revised in terms of the guidelines issued on December 15, 2006, which came into effect from April 1, 2007. The aggregate exposure of a bank/ consolidated bank to the capital market in all forms (both fund based and non-fund based) cannot exceed 40 per cent of its net worth as on March 31 of the previous year. In terms of the revised guidelines, net worth consists of (i) paid-up capital plus free reserves including share premium but excluding revaluation reserves; (ii) investment fluctuation reserve (IFR); and (iii) credit balance in profit and loss account *less* the debit balance, accumulated losses and intangible assets. General or specific provisions are included in the computation of net worth. The guidelines also laid down norms for computation of exposure norms for loans and advances against shares; bank financing to individuals against shares to joint holders or third party beneficiaries; margins on advances against shares/issue of guarantees; investments in venture capital funds (VCFs); intra-day exposures; enhancement in limits; and transitional provisions.

2.87 Considering the higher risks inherent in banks' exposure to VCFs, the Reserve Bank, on August 23, 2006, revised the prudential framework governing banks' exposure to VCFs. Under the revised framework, all exposures to VCFs (both registered and unregistered) are deemed on par with 'equity' and hence, are reckoned for compliance with the capital market exposure ceilings (ceiling for direct investment in equity and equity linked instruments as well as ceiling for overall capital market exposure) and the limits prescribed for such exposure are also applied to investments in VCFs. While the investment in quoted equity shares/bonds/units of VCFs in the bank's portfolio are required to be held under 'available for sale' (AFS) category and valued as per the valuation norms applicable for AFS portfolio.

2.88 Investments in unquoted shares/bonds/ units of VCFs made after issuance of these guidelines are required to be classified under 'held to maturity' (HTM) category for an initial period of three years and valued at cost during this period. After three years, the unquoted units/shares/ bonds have to be transferred to AFS category.

2.89 While significance of venture capital activities and need for banks' involvement in financing venture capital funds is well recognised, there is also a need to address the relatively higher risks inherent in such exposures. Therefore, the

risk weight for exposure to VCFs was increased to 150 per cent (specific risk charge in the case of investments held in AFS portfolio raised to 13.5 per cent).

2.90 The supervisory review process (SRP) undertaken with respect to select banks having significant exposure to sensitive sectors revealed that real estate exposure increased across banks, mainly on account of individual housing loans (Box II.8). In recognition of the risk facing banks due to their exposures to the real estate sector, provisioning requirements and risk weights on real estate exposures were tightened. In July 2005, the Reserve Bank increased the risk weight on exposures to commercial real estate from 100 per cent to 125 per cent. Given the continued rapid expansion in credit to this sensitive sector, the risk weight was raised further to 150 per cent in April 2006.

2.91 The risk weights on housing loans extended by banks to individuals against mortgage of housing properties and investments in mortgage backed securities (MBS) of housing finance companies (HFCs), recognised and supervised by National Housing Bank (NHB) were increased to 75 per cent for capital adequacy purposes in December 2004 (Box II.9). As mentioned in the Annual Policy Statement for the year 2007-08, banks on May 3, 2007 were advised to tighten their credit administration in the area of housing loans. Banks were also advised to reduce the risk weight in respect of housing loans up to Rs.20 lakh to individuals against the mortgage of residential housing properties from 75 per cent to 50 per cent. Similarly, the risk weight for banks' investment in mortgage backed securities which are backed by housing loans, would now qualify for 50 per cent risk weight. The risk weight on mortgage backed securities issued by the housing

Box II.8: Supervisory Review Process

The Mid-term Review of the Annual Policy Statement for the year 2005-06 had stated that a supervisory review process (SRP) would be initiated with select banks having significant exposure to some sectors, viz., real estate, highly leveraged NBFCs, venture capital funds and capital markets, in order to ensure that effective risk mitigants and sound internal control systems are in place. In the first round, a framework was developed for monitoring the systemically important individual banks.

The second round of SRP has been directed to analyse the exposure to sensitive sectors, in particular to the real estate sector, of select banks. Ten banks were identified as outliers based on the real estate and capital market exposure in excess of 200 per cent and 25 per cent, respectively, of their net worth. The second round of SRP was conducted in two phases. Under Phase I, detailed information on exposure to sensitive sectors, including real estate sector as per the revised definition, was sourced from the banks, followed by discussions with their senior officials. Phase II of the SRP was based on on-site focused examinations to assess the risk exposures of identified individual outlier banks with reference to their actual control environment, procedures, and compliance with internal and regulatory norms. The on-site scrutiny focused on large lending towards real estate and other sensitive sectors, companies involved, branch-wise large individual exposures, and other related matters.

The initial analysis revealed that real estate exposure increased across all the banks and individual housing loans constituted the bulk of real estate loan portfolio of all the banks. These banks had real estate exposure of more than 200 per cent of their net worth. Growth in individual housing loans largely accounted for the spurt in real estate exposure. Commercial real estate exposure has also risen in varying degrees across all the banks. Although exposure to the capital market showed an increasing trend, none of the banks, however, breached the regulatory limits. Exposure to highly leveraged NBFCs was found to be minimal in majority of the identified banks and wherever banks had exposures, majority of them were in the public sector. The initial analysis revealed that, prima facie, all the banks under review had some risk management policies, systems and controls in place to tackle the risks posed by the exposure to sensitive sectors. However, in the case of real estate exposure, certain lapses were observed with regard to the implementation of banks' own approved policies. Necessary instructions were, therefore, issued by the Reserve Bank on July 26, 2007 to all commercial banks excluding RRBs, indicating the need for better management of risk by banks at operating levels. Besides providing the banks with an indicative list of deficiencies and irregularities observed from the study, it was prescribed that the loan policy of the banks should explicitly contain the following norms:

- Internal ceilings and sub-ceilings for exposure to the real estate sector.
- Minimum internal rating required for builders and developers.
- Minimum contribution of the promoter in a project to be financed by the bank.
- Requisite security cover a bank should keep for this type of exposure.
- Preparation of panel of approved valuers for valuation of securities.
- Procedure for registration of documents and also for verification by the bank that registration with the appropriate authorities has been done.

Box II.9: Reverse Mortgage - Recent Developments in India

In the Union Budget 2007-08, the Finance Minister announced the introduction of a novel product for senior citizens - the 'reverse mortgage'. This product enables a senior citizen, who is the owner of a house, to avail of a monthly stream of income against the mortgage of his/her house, while remaining the owner and occupying the house throughout his/her lifetime, without repayment or servicing of the loan. Conceptually, reverse mortgage seeks to monetise the house as an asset and specifically the owner's equity in the house. A reverse mortgage is just the opposite of a forward mortgage which requires the payment of the principal loan amount along with interest on a monthly basis. This helps a borrower in retaining his home equity and hence increasing the home value. But with reverse mortgages, there are no such monthly repayments and so the debts go on increasing. The home equity, therefore, reduces to an extremely low value unless the property value keeps increasing. Therefore reverse mortgages are often known as 'rising debt and falling equity'.

The genesis of reverse mortgage can be traced to developed countries where, due to higher standards of living, better access to health care and higher life expectancy, people above 65 years constitute a major chunk of the population. The ever-rising cost of pensions and health care for the old prompted insurance companies to introduce the reverse mortgage in the US, the UK and Australia. In India, the National Housing Bank (NHB) has recently laid down the guidelines on reverse mortgage loans (RML) for senior citizens. RMLs are to be extended by primary lending institutions (PLIs), viz., scheduled banks and housing finance companies (HFCs) registered with NHB. The PLIs would have the freedom in this matter according to their individual perception of the borrower and commercial judgements.

The reverse mortgage scheme would have the following features. The lender makes periodic payments (including lump sum payments) to the borrower, *i.e.*, the payment stream is 'reversed', as compared to a conventional mortgage. The payment mode in such a scheme might be of following types: either periodic payments (monthly, quarterly, half-yearly, annual) to be decided mutually between the PLI and the borrower upfront or lump-sum payments in one or more tranches or line of credit, with an availability period agreed upon mutually, to be drawn down by the borrower. The loan is not required to be serviced, *i.e.*, no payment of installment or interest, as long as the borrower is alive and in occupation of the property. The loan will be repaid on the death of the borrower and the spouse (usually a co-obligant) or on permanent movement through sale of property. After adjusting the principal amount of the loan and accumulated interest, surplus will go to the Estate of the deceased. The loan can be for a maximum period of 15 years and can be prepaid together with accumulated interest at any point in time without any prepayment charges. The interest rate (including the periodic rest) to be charged on the RML to be extended to the borrower(s) may be fixed by PLI in the usual manner based on risk perception, the loan pricing policy and specified to the prospective borrowers. Fixed and floating rate of interest may be offered by the PLIs subject to disclosure of the terms and conditions in a transparent manner, upfront to the borrower.

Principal benefits of the scheme are that it enables senior/elderly citizens owning a house but having inadequate income to meet unexpected lump sum expenditure needs such as renovation/repairs to house, hospitalisation, *etc.* Even after the demise of the borrower, the spouse can continue to stay in the house. If the spouse is co-borrower, he/she will continue to receive payment (up to 15 years from grant of loan). Payment received from a reverse mortgage is considered as 'loan' and not 'income' from tax angle. Such a scheme can be a partial substitute for a social security scheme for home owning senior citizens and it will be particularly useful to those with no/unwilling family to support them. However, the scheme involves re-valuation of the property mortgaged to the lender at intervals that may be fixed by the lender depending upon the location of the property and its physical state. Therefore, the success of such a scheme would depend upon an appropriate valuation/pricing of the property by the lender.

finance companies regulated by the NHB was also reduced from 75 per cent to 50 per cent.

2.92 Keeping in view the market conditions, the Reserve Bank on September 20, 2006 decided that the exposure of banks to entities for setting up special economic zones (SEZs) or for acquisition of units in SEZs which included real estate would be treated as exposure to commercial real estate sector and banks would have to make provisions as also assign appropriate risk weights for such exposures as per the existing guidelines.

Exposure to Inter-Bank Liability

2.93 In order to reduce the extent of concentration on the liability side of the banks, the following measures were prescribed on March 6, 2007: (a) The Inter-Bank Liability (IBL) of a bank should not exceed 200 per cent of its networth as at end-March of the previous year. Individual banks may, with the approval of their boards of directors, fix a lower limit for their inter-bank liability, keeping in view their business model; (b) The banks whose CRAR is at least 25 per cent more than the minimum CRAR of 9 per cent, *i.e.*, 11.25 per cent as on March 31 of the previous year, are allowed to have a higher limit up to 300 per cent of the net worth for IBL; (c) The limit prescribed above will include only fund based IBL within India (including inter-bank liabilities in foreign currency to banks operating within India), in other words, the IBL outside India are excluded; (d) The above limits will not include collateralized borrowings under CBLO and

refinance from NABARD, SIDBI, *etc.*; (e) The existing limit on call money borrowings prescribed by the Reserve Bank will operate as a sub-limit within the above limits; (f) Banks having high concentration of wholesale deposits should be aware of potential risk associated with such deposits and may frame suitable policies to contain the liquidity risk arising out of excessive dependence on such deposits.

Risk Management

2.94 Risk management is critically important for banks and in the emerging economic scenario, there is a greater need for banks to implement risk-based practices. In view of the growing need for banks to be able to identify, measure, monitor and control risks, appropriate risk management guidelines have been issued from time to time by the Reserve Bank, including guidelines on asset-liability management (ALM). These guidelines are intended to serve as a benchmark for banks to establish an integrated risk management system. However, banks can also develop their own systems compatible with the type and size of their operations as well as risk perception and put in place a proper system for covering the existing deficiencies and requisite upgradation. Detailed guidance notes on the management of credit risk, market risk, operational risk, among others, have also been issued to banks by the Reserve Bank. The progress made by banks is monitored on a quarterly basis. With regard to risk management techniques, banks are at different stages of (i) drawing up a comprehensive credit rating system; (ii) undertaking a credit risk assessment on a half-yearly basis; (iii) pricing loans on the basis of risk rating; and (iv) adopting the risk-adjusted return on capital (RAROC) framework of pricing. Some banks stipulate a quantitative ceiling on aggregate exposures in specified risk categories and analyse rating-wise distribution of borrowers in various industries.

Outsourcing

2.95 In keeping with the international trend, banks in India too have been extensively outsourcing various activities which expose them to various risks. Further, outsourcing activities need to be brought within the regulatory purview and the interests of banks customers have to be protected. Against this background, the Reserve Bank had issued draft guidelines on December 6, 2005 laying down a framework for managing the attendant risks in outsourcing. On the basis of the suggestions received from all concerned, the draft guidelines were suitably modified and scheduled commercial banks (excluding RRBs) were advised the following guidelines on November 3, 2006. One, it is entirely for banks to take a view on the desirability of outsourcing as a permissible activity related to financial services having regard to all relevant factors, including the commercial aspects of the decision, subject to necessary safeguards for addressing the risks inherent in such outsourcing being in place. Two, the guidelines are concerned with managing risks in outsourcing of financial services and are not applicable to technology-related issues and activities not related to banking services such as usage of courier, catering of staff, housekeeping and janitorial services, security of the premises, movement and archiving of records. Three, audit-related assignments to Chartered Accountant firms would continue to be governed by the instructions/policy as laid down by the Reserve Bank. Four, the outsourcing agreements should include enabling clauses to allow the Reserve Bank or the persons authorised by it to access the relevant information/records with the service provider relating to outsourced activities within a reasonable time.

Financial Derivatives

2.96 The use of financial derivatives has brought the issue of risk management to the fore. Though forward foreign exchange contracts in India have existed for several decades, credit derivatives are of recent origin (Box II.10). Efforts are also afoot for an appropriate design for interest rate futures and foreign exchange futures. As indicated in the Mid-term Review of Annual Policy for year 2006-07, an Internal Group was constituted by the Reserve Bank to review the existing guidelines on derivatives and formulate comprehensive guidelines on derivatives by banks. Draft comprehensive guidelines on derivatives based on the recommendations of the Group were placed on the Reserve Bank's website for comments from all concerned. Based on the feedback received, the guidelines were suitably revised and issued on April 20, 2007. The guidelines enunciate the broad principles for undertaking derivative transactions, *i.e.*, the major requirements for undertaking any