Chapter III

Policy Environment

This chapter documents monetary, banking (commercial and cooperative), regulatory and financial policy developments during the year 2008-09 and 2009-10 (up to September 2009). In the wake of the global financial crisis, the focus of recent policy initiatives was maintaining financial stability along with arresting the moderation in the growth momentum. Accordingly, the initiatives taken by the Reserve Bank were mainly aimed at strengthening the banking system and financial markets, while ensuring uninterrupted flow of credit to the different sectors of the economy. The prudential regulation and supervisory policies of the banking system were made stronger during the year. The on-going financial inclusion process was strengthened since it is sine qua non for achieving inclusive growth. Initiatives have been taken in the cooperative banking sector to strengthen the capital base of this sector as also to consolidate the sector through the process of merger of weak entities with stronger ones. Several measures were taken to make the banks more customer-friendly. The technological advancement in the banking system was given due priority with a view to facilitating financial inclusion and for increasing the overall efficiency of the banking system. Since the smooth functioning of payment and settlement system plays an important role in ensuring financial stability and also in the transmission of monetary policy, several measures were taken during the year to improve the operational efficiency of the same.

1. Introduction

3.1 The persistence of global recession is providing a testing time for the financial sector in general and banking sector in particular all over the world. Handling the spill-over effects of the financial turmoil has turned out to be more challenging for the Governments and central banks as the impact of the crisis has become wider and deeper. The unsettling conditions in the global financial markets warranted institution of swift and appropriate policy measures. While the Governments all over the world continue to pursue expansionary fiscal policies, central banks took several measures (conventional and non-conventional) to ease liquidity, stimulate demand and moderate the impact of the global downturn and credit crunch on their economies. The crisis once again brought to the fore the issue of financial stability and, thus, triggered a discussion on counter-cyclical fiscal, monetary and prudential measures. The 'originate to distribute' model, which is at the heart of the crisis, also received a relook from many angles. From the regulators' perspective, the crisis reiterated the need for strengthening the regulatory and supervisory framework to handle the risks posed by financial innovations by adapting appropriate capital, liquidity and disclosure requirements.

3.2 The Indian financial sector continues to remain largely resilient in the face of global financial turmoil. The Indian financial markets, though came under pressure following collapse of Lehman Brothers in mid-September 2008, were less volatile and continue to function in an orderly manner. During 2008-09, subsequent to the adoption of Basel II framework by the foreign banks and Indian banks having international presence, all the commercial banks in India have switched over to the simple approaches available in the Basel II framework. During the year, the Reserve Bank has taken several measures to impart liquidity in the

banking system, while ensuring adequate flow of credit to the productive sectors of the economy. The Report of the Committee on Financial Sector Assessment (CFSA), which has attempted a comprehensive assessment of the financial sector of India, was released in March 2009. During the year, the Reserve Bank also announced restructuring schemes to protect the value of assets in the banking sector. With a view to enhancing transparency in the pricing of loan products, a Working Group on Benchmark Prime Lending Rate (BPLR) was constituted in the Reserve Bank. A model scheme of Financial Literacy and Credit Counselling (FLCCs) Centres was also prepared during the year to intensify the financial inclusion process. Guidelines for strengthening the functioning of payment and settlement system were issued, as a safe and efficient payment and settlement systems assumes significance as a conduit of monetary policy. Several measures have taken during the year for improving customer service in the banks.

3.3 This chapter provides a detailed account of various policy measures undertaken by the Reserve Bank during 2008-09 and 2009-10 (up to September 2009). The monetary policy measures during 2008-09 and 2009-10 (up to September 2009) 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 given in Section 5 and Section 6, respectively. Policy initiatives pertaining to Regional Rural Banks (RRBs) have been set out in Section 7. Policy initiatives with regard to cooperative banks both Urban Cooperative Banks (UCBs) and rural credit cooperatives are set out in Section 8. Policy developments in the area of financial markets, *i.e.*, the money market, the government securities market and the foreign exchange market are covered in Section 9. This is followed by an account of measures initiated in the area of customer service by banks in Section 10. Policy measures relating to the payment and settlement systems and technological developments are outlined in Section 11 and Section 12, respectively. Section 13 gives the measures undertaken to strengthen the legal infrastructure and Section 14 draws broad conclusions.

2. Monetary Policy

3.4 During 2008-09, the conduct of monetary policy was confronted with several new challenges thrown out by the global financial and economic crisis. The evolving stance of monetary policy during these turbulent times was conditioned by the need to preserve financial stability on the one hand and arresting the moderation in growth momentum on the other. The stance of monetary policy underwent a shift from monetary tightening in the first half of 2008-09 reflecting the response to rising inflationary expectations to aggressive monetary easing in the second half using multiple, conventional and unconventional tools so as to minimise the impact of global crisis on India. Accordingly, the major policy initiatives taken by the Reserve Bank were aimed at providing ample rupee liquidity, ensuring comfortable dollar liquidity and maintaining a market environment conducive for the continued flow of credit to productive sectors. Measures aimed at expanding rupee liquidity included significant reduction in the cash reserve ratio (CRR) and statutory liquidity ratio (SLR), a special repo window under the liquidity adjustment facility (LAF) for banks for on-lending to non-banking financial companies (NBFCs), housing finance companies and mutual funds, and a special refinance facility (SRF) that banks could access against demand promissory notes covering the principal amount of advances and the prescribed rate of interest. The Reserve Bank also instituted the dollar swap facility for banks and roughly synchronised unwinding the market

stabilisation scheme (MSS) securities with the Government borrowing programme. In addition, a special purpose vehicle (SPV) was set up to provide liquidity support to NBFCs.

3.5 The repo rate under the LAF was increased by 125 points from 7.75 per cent in April 2008 to 9.0 per cent by end-July 2008. In the subsequent period, however, it was reduced by 425 basis points to 4.75 per cent by April 2009. The reverse repo rate was also reduced by 275 basis points from 6.00 per cent in November 2008 to 3.25 per cent by April 2009. The CRR for scheduled banks was increased by 125 basis points from 7.75 per cent of the net demand and time liabilities (NDTL) of banks on April 26, 2008 to 9.00 per cent on August 30, 2008 but was subsequently reduced by 400 basis points during 2008-09 to 5.00 per cent of NDTL by January 17, 2009.

3.6 The Annual Policy Statement for 2008-09 was announced in the background of decelerating global growth, volatile global financial markets, intensified inflationary risks mainly from international prices of fuel, and prices of food and metal, and large swings in domestic market liquidity. The global financial markets in the context of the subprime crisis warranted more intensified monitoring and swift responses with all available instruments to preserve and maintain domestic macroeconomic and financial stability. In view of the lagged and cumulative effects of monetary policy on aggregate demand, the policy endeavour was to bring down inflation from the prevailing high level of above 7.0 per cent to around 5.5 per cent in 2008-09 with a preference for bringing it as close to 5.0 per cent as soon as possible, recognising the evolving complexities in globally transmitted inflation. The First Quarter Review noted that the global developments such as decelerating global growth, waning business and consumer confidence, weak industrial activity, sustained threats to financial stability and inflationary pressures have implications for India's macroeconomic outlook with difficult challenges and dilemmas confronting the setting of monetary policy. The Review noted that the overriding priority for monetary policy is to eschew any further intensification of inflationary pressures and to firmly anchor inflation expectations. In this regard, monetary policy had to urgently address aggregate demand pressures which appeared to be strongly in evidence. The Reserve Bank continued with its policy of active demand management of liquidity through appropriate use of the CRR stipulations and open market operations (OMO) including the MSS and the LAF, using all the policy instruments at its disposal flexibly, as and when the situation warranted.

3.7 The Mid-term Review noted that the global economic conditions worsened and the future path of their evolution turned highly uncertain. Lowering inflation as soon as feasible to tolerable levels and anchoring inflation expectations remained a key concern. The developments in monetary conditions resulted in a tightening of liquidity conditions in domestic financial markets through the second quarter of 2008-09. Despite the expansion in bank credit, there was a perception of lack of credit availability, which could be attributed to reduced flow of funds from non-bank sources, notably the capital market and external commercial borrowings. At the time of Third Quarter Review, the Indian economy experienced a cyclical moderation in growth accompanied by high inflation in the first half of 2008-09 and there was distinct evidence of further slowdown as a consequence of the global downturn. The Reserve Bank continued to pursue the stance of ensuring ample liquidity in the market and maintaining the overnight money market rates within the LAF corridor by employing both conventional and unconventional measures. Along with extending credit to the productive sectors of the economy, the banks were also advised to monitor their loan portfolios to prevent delinquencies down

the line, and thus to safeguard the improvement in asset quality achieved during the recent years.

3.8 The Annual Policy Statement for 2009-10 was set in the context of a deep global economic slump and financial market turmoil. The impact of the crisis on India was much more than expected earlier. Though the GDP growth rate moderated, there were some comforting factors such as well-functioning financial markets, robust rural demand, lower headline inflation and comfortable foreign exchange reserves, which cushioned the economy from the worst impact of the global financial crisis. On the basis of the overall assessment, ensuring a policy regime that would enable credit expansion at viable rates while preserving credit quality so as to support the return of the economy to a high growth path was one of the stances of monetary policy. Keeping in view the global trend in commodity prices and domestic demand-supply balance, WPI inflation was projected at around 4.0 per cent by end-March 2010.

3.9 The First Quarter Review noted some progressive signs of recovery in India such as increase in food stocks, positive industrial production growth, improved corporate performance, optimism in business confidence surveys, among others. The negative signs included delayed and deficient monsoon, food price inflation, rebound in global commodity prices, continuing weak external demand, and high fiscal deficit. It was recognised that an uptrend in the growth momentum is unlikely before the middle of 2009-10. On inflation prospects, WPI inflation for end-March 2010 was projected higher at around 5.0 per cent from 4.0 per cent given in the Annual Policy Statement of April 2009. On the basis of the overall assessment, the stance of monetary policy for the remaining period of 2009-10 was stated to be as managing liquidity actively so that the credit demand of the Government is met while ensuring the flow of credit to the private sector at viable rates. Consistent with the assessment of macroeconomic and monetary conditions, the repo rate, the reverse repo rate and the CRR were kept unchanged. The Reserve Bank reiterated that it will maintain an accommodative monetary stance until there are definite and robust signs of recovery.

Liquidity Facilities

3.10 The Reserve Bank reintroduced the second liquidity adjustment facility (SLAF) with effect from August 1, 2008 on reporting Fridays with a view to fine tuning the management of bank reserves on the last day of the maintenance period. The salient features of SLAF are same as those of LAF, though the settlement for the LAF and SLAF is conducted separately and on gross basis. In September 2008, in view of the current liquidity conditions, the Reserve Bank decided to conduct SLAF on a daily basis.

3.11 The Reserve Bank, decided to conduct a special fixed rate term repo at 9 per cent per annum against eligible securities for a notified amount of Rs.20,000 crore on October 14, 2008, with a view to enabling banks to meet the liquidity requirements of Mutual Funds, in addition to the repo/reverse repo auctions conducted under LAF and SLAF. In November 2008, the Reserve Bank extended this special term repo facility on temporary basis and allowed the banks to avail liquidity support under the LAF at the extant repo rate through relaxation in the maintenance of SLR to the extent of up to 1.5 per cent of their NDTL. In April 2009, this facility was extended up to March 31, 2010 as also to conduct these 14-day term repo auctions on a weekly basis.

3.12 Further, the Reserve Bank allowed the scheduled banks to avail additional liquidity support under the LAF to the extent of up to one per cent of their NDTL as a temporary measure. However, if any shortfall arises in the maintenance of SLR out of the availment of this facility, the bank may apply to Reserve Bank in writing under sub-section (8) of Section 24 of the Banking Regulation Act, 1949 with a request not to demand payment of the penal interest thereon.

3.13 In November 2008, the Reserve Bank introduced a special refinance facility (SRF) under Section 17(3B) of the Reserve Bank of India Act, 1934. Under this facility, scheduled commercial banks (SCBs) (excluding RRBs) are eligible for refinance to the extent of up to 1.0 per cent of each bank's NDTL as on October 24, 2008 for a period of 90 days. Refinance under the SRF are provided at the repo rate under the LAF. Banks are also encouraged to use this facility for the purpose of extending finance to micro and small enterprises. This facility can be rolled over by the banks. In December 2008, the Reserve Bank decided to continue this facility up to June 30, 2009 and later on extended to March 31, 2010.

3.14 In November 2008, the eligible limit of export credit refinance (ECR) facility was enhanced from the existing level of 15 per cent to 50 per cent of the outstanding rupee export credit eligible for refinance as at the end of the second preceding fortnight. The rate of interest charged on the ECR facility will continue to be the prevailing repo rate under the LAF of the Reserve Bank.

3.15 For more effective liquidity management, the Reserve Bank widened the scope of OMO by including purchases of government securities through an auction-based mechanism in addition to operations through NDS-OM with effect from February 2009. Furthermore, with the change in the external accounts in the recent period resulting in attendant draining of primary liquidity reflecting the impact of the Reserve Bank's operations in the foreign exchange market, the MOU on the MSS was amended on February 26, 2009 to permit the transfer of the sterilised liquidity from the MSS cash account to the normal cash account of the Government.

3.16 The total amount of actual/potential liquidity provision so far (since Mid-September 2008) through various modes by the Reserve Bank is provided in Table III.1.

Table III.1: Actual/Potential Release of Primary Liquidity – since Mid-September 2008

(Rs.crore)

Measure/Facility	Amount
1. CRR Reduction	1,60,000
2. Unwinding/Buyback/De-sequestering of MSS Securities	1,55,544
3. Open Market Operations (Purchases)	80,080
4. Term Repo Facility	60,000
5. Increase in Export Credit Refinance	26,576
6. Special Refinance Facility for SCBs (Non-RRBs)	38,500
7. Refinance Facility for SIDBI/NHB/EXIM Bank	16,000
8. Liquidity Facility for NBFCs through SPV	25,000
9. **Total (1 to 8)**	**5,61,700**
Memo:	
Statutory Liquidity Ratio (SLR) Reduction	40,000

Note: 1. Item 3 includes Rs.33,439 crore of Open Market Operations purchases during 2009-10 so far (up to July 27) against the proposed OMO purchases of Rs.80,000 crore during the first half of 2009-10.
2. Item 8 includes an option of Rs.5,000 crore.

Source: First Quarter Review of Statement on Monetary Policy for the year 2009-10.

Interest Rate Structure

3.17 Interest rates have been progressively deregulated in India as part of the financial sector reforms initiated in the early 1990s. Presently, except interest rates on savings bank deposits, non-resident (External) Rupee Accounts [NR (E)RA] deposits, foreign currency non-resident (FCNR) (B) deposits, export credit and small loans up to Rs.2 lakh, all other interest rates are deregulated. This has enhanced competitiveness and efficiency in the resource allocation process in the financial system, while simultaneously improving the monetary transmission mechanism.

Deposit and Lending Rates

3.18 Deposit rates of SCBs across various bank groups showed a generally upward movement during the first half of the year 2008-09. Taking cues from the Reserve Bank monetary policy actions, the SCBs have reduced their deposit rates in the second half of 2008-09. The interest rate ceiling on NRE deposits for one to three year maturity was increased by 175 basis

points during the period September- November 2008. The rate cut effected on interest rate ceiling on FCNR (B) deposits on April 24, 2007 was reversed on September 16, 2008, when following a review the interest rate was raised by 50 basis points to LIBOR/SWAP rates minus 25 basis points. In the light of adverse developments in the domestic money and forex markets following the deterioration in the international financial environment, the interest rate payable on FCNR (B) deposits was increased by further 125 basis points during the period October-November 2008 to LIBOR/ SWAP rates plus 100 basis points. In tandem with the deposit rates, the lending rates of SCBs have also exhibited a declining trend during 2008-09 (also see Table IV.20 in Chapter IV).

3.19 It has been proposed that payment of interest on savings bank accounts by SCBs (including RRBs) and UCBs would be calculated on a daily product basis with effect from April 1, 2010.

Working Group on Bench-Mark Prime Lending Rate (BPLR)

3.20 The concept of BPLR was introduced in November 2003 for pricing of loans by commercial banks with the objective of enhancing transparency in the pricing of their loan products. The Annual Policy Statement 2009-10 noted that BPLR has lost its relevance over time as a meaningful reference rate, as bulk of loans are advanced below BPLR. Further, this also impedes the smooth transmission of monetary signals and makes the loan-pricing system non-transparent. Accordingly, in order to review the present BPLR system and suggest changes to make credit pricing more transparent, the Reserve Bank has constituted a Working Group on Benchmark Prime Lending Rate (BPLR) (Chairman: Shri Deepak Mohanty) on June 11, 2009 with the following terms of reference: (i) Review the concept of BPLR and the manner of its computation; (ii) Examine the extent of sub-BPLR lending and the reasons thereof; (iii) Examine the wide divergence in BPLRs of major banks; (iv) Suggest an appropriate loan pricing system for banks based on international best practices; (v) Review the administered lending rates for small loans up to Rs.2 lakh and for exporters; (vi) Suggest suitable benchmarks for floating rate loans in the retail segment; and (vii) Consider any other issue relating to lending rates of banks. The Group is expected to submit the Report shortly.

3. Credit Delivery

3.21 The credit markets in India functioned normally even during these turbulent times in contrast to the intense credit freeze experienced by some of the advanced economies. However, there was a general decline in demand for credit due to the economic slowdown set in by the spill-over effects of global financial turmoil. In response to the financial turmoil, the Reserve Bank initiated several measures mainly to impart liquidity in the banking system and to channelise the credit to crisis affected sectors. The major policy initiatives by the Reserve Bank during 2008-09 for improving the flow of credit to specific sectors included inclusion of loans to Housing Finance Companies under the priority sector lending; simplification of the procedure for extending loans to agriculture and allied activities; and announcement of further reliefs under the Agriculture Debt Waiver and Debt Relief Scheme, 2008. The Reserve Bank also requested all the SLBCs to ensure that adequate attention is paid to the financial needs of MSE Sector in their respective States/UTs.

Priority Sector Lending

3.22 The objective of priority sector lending guidelines is to channelise credit to some of the vulnerable sectors of the economy, which may not be attractive for the banks from the point of view of profitability but are important for economic development. Loans granted to agriculture, micro and small (manufacturing

and service) enterprises, micro credit, education and housing fall under the ambit of priority sector lending by the Indian banks. Apart from these sectors, the export credit also forms a part of the priority sector lending in case of foreign banks. In 2007, the guidelines on lending to priority sector were revised based on the Report of the Internal Working Group on Priority Sector Lending (Chairman: Shri C. S. Murthy) and feedback received from the governments, banks, financial institutions, NBFCs, associations of industries, media, public and Indian Banks' Association. As per the extant guidelines, the domestic banks and foreign banks have to extend 40 per cent and 32 per cent, respectively of the adjusted net bank credit[1] (ANBC) or the credit equivalent amount of off-balance sheet exposures, whichever is higher, as on March 31st of the previous year to the priority sectors.

3.23 In December 2008, the Reserve Bank widened the scope of priority sector lending by allowing the banks to classify loans granted to Housing Finance Companies (HFCs), which are approved by National Housing Bank (NHB) for the purpose of refinance, for on-lending to individuals for purchase/construction of dwelling units. However, in such cases, the housing loans granted by HFCs do not exceed Rs.20 lakh per dwelling unit per family. Further, the eligibility under this measure shall be restricted to five per cent of the individual bank's total priority sector lending, on an ongoing basis. This special dispensation shall apply to loans granted by banks to HFCs up to March 31, 2010.

3.24 In order to ensure that the sub-target of lending to the weaker sections is achieved, the domestic SCBs were advised that the shortfall in lending to weaker sections as on the last reporting Friday of March of each year, would also be taken into account for the purpose of allocating amounts to the Rural Infrastructure Development Fund (RIDF) maintained with National Bank for Agriculture and Rural Development (NABARD) or funds with other Financial Institutions, as specified by the Reserve Bank, with effect from April 2009.

Credit to Agriculture and Allied Activities

3.25 Several measures were taken during the year to increase the flow of credit to agriculture and allied activities. The Union Budget for 2009-10 set a target of Rs.3,25,000 crore for agricultural credit for the year. Against this, banks (including co-operative banks and RRBs) disbursed Rs.92,070 crore forming 28.3 per cent of the target during April-July 2009.

3.26 In December 2008, the Reserve Bank modified the facility of temporary liquidity support for financing agricultural operations. The limits of the liquidity support availed by scheduled banks under Section 17 (3-B) of RBI Act 1934 and by NABARD under Section 17 (4-E) of RBI Act 1934 was Rs.7,500 crore and Rs.17,500 crore, respectively with effect from December 6, 2008. This facility was extended up to December 16, 2008.

Relief Measure for Agriculture – Interest Rate Subvention

3.27 The Union Budget for 2009-10 proposed to continue the interest subvention scheme to farmers for short term crop loans up to Rs.3 lakh per farmer at the interest rate of 7 per cent per annum. The budget also announced an additional subvention of 1 per cent as an incentive to those farmers who repay their short term crop loans on schedule. Thus, the interest rate for these farmers will come down to 6 per cent per annum.

[1] Net bank credit plus investments made by banks in non-SLR bonds held in the held-to-maturity (HTM) category.

Relief Measures for Poultry Industry

3.28 Keeping in view the loss of income suffered by the poultry industry due to the outbreak of avian influenza in some parts of the country, the Reserve Bank had announced several relief measures to this industry in February 2008. In addition to the above relief measures, Government of India also decided to grant interest subvention at 4 per cent per annum on the outstanding non-overdue loan amount as on January 1, 2008 to the Poultry Units of West Bengal for the period from January 1, 2008 to March 31, 2009. As a follow-up, the Reserve Bank, advised SCBs in February 2009 (and UCBs in March 2009), that the interest subvention on the outstanding non-overdue loan amount as on January 1, 2008 to the Poultry Units of West Bengal will be calculated at four percentage points on the term loans and working capital loans outstanding as on January 1, 2008. This will not include any part of the principal amount that had become overdue before notification of the first occurrence of the bird flu in the State.

Agricultural Debt Waiver and Debt Relief Scheme, 2008

3.29 The Agricultural Debt Waiver and Debt Relief Scheme was announced in the Union Budget 2008-09 covering direct agricultural loans extended to 'marginal and small farmers' and 'other farmers' by SCBs, RRBs, Co-operative Credit Institutions and Local Area Banks (LABs). Under the Scheme, the total value of overdue loans being waived was estimated at Rs.50,000 crore and a one-time settlement (OTS) relief on the overdue loans at Rs.10,000 crore. The Government in consultation with the Reserve Bank and NABARD finalised the modalities of the scheme. It was announced that the cost of the scheme would work out to about Rs.71,680 crore. While the entire 'eligible amount' shall be waived in the case of a small or marginal farmer, in the case of 'other farmers', there will be a OTS scheme under which the farmer will be given a rebate of 25 per cent of the 'eligible amount' subject to the condition that the farmer repays the balance of 75 per cent of the 'eligible amount'.

Norms for the accounts subjected to Debt Waiver and Debt Relief

3.30 As regards the small and marginal farmers eligible for debt waiver, the amount eligible for waiver, pending receipt from the Government of India, may be transferred by the banks to a separate account named "Amount receivable from Government of India under Agricultural Debt Waiver Scheme 2008". The balance in this account should be reflected in Schedule 9 (Advances) of the Balance sheet. The balance in this account may be treated by the banks as a "performing" asset, provided adequate provision is made for the loss in Present Value (PV) terms, computed under the assumption that such payments would be received from Government of India in the following instalments: a) 32 per cent of the total amount due by September 30, 2008, b) 19 per cent by July 31, 2009, c) 39 per cent by July 2010, and d) the remaining 10 per cent by July 2011. However, the provision required under the current norms for standard assets, need not be provided for in respect of the balance in this account.

3.31 Under the scheme, in the case of 'other' farmers, the farmer will be given a rebate of 25 per cent of the "eligible amount", by the Government by credit to his account, provided the farmer pays the balance of 75 per cent of the 'eligible amount". The Scheme provides for payment of share of 75 per cent by such farmers in three instalments and the first two instalments shall be for an amount not less than one-third of the farmer's share. The last dates of payment of the three instalments will be September 30, 2008; March 31, 2009 and June 30, 2009, respectively. In March 2009, the Reserve Bank extended the last date of repayment of first instalment by the 'other farmers' under the Debt Relief Scheme from September 30, 2008 to March 31, 2009. The dates of payment of second and third

instalments remain unchanged at March 31, 2009 and June 30, 2009. However, considering the late arrival of monsoon, the period was extended by six months up to December 31, 2009.

3.32 Where the farmers covered under the Debt Relief Scheme have given the undertaking, agreeing to pay their share under the OTS, their relevant accounts may be treated by banks as "standard"/"performing" provided – (a) adequate provision is made by the banks for the loss in PV terms for all the receivables due from the borrowers as well as the Government; and (b) such farmers pay their share of the settlement within one month of the due dates. The accounts subject to debt relief would stand classified as standard assets after receipt of the aforesaid undertaking from the borrowers. Accordingly, such accounts would also attract the prudential provisioning as applicable to standard assets.

3.33 The Government of India has decided to make the accounts of "other farmers" eligible for a debt relief of 25 per cent, even if they pay their entire share of 75 per cent in one single instalment, provided the same is deposited by such farmers till December 31, 2009. The banks will not charge any interest on the eligible amount till December 31, 2009. If the payments are delayed beyond December 31, 2009, the outstanding amount in the relevant accounts shall be treated as non-performing asset (NPA). The Government of India has also advised that the banks/lending institutions are allowed to receive even less than 75 per cent of the eligible amount under OTS, provided the banks/lending institutions bear the difference themselves and do not claim the same either from the Government or from the farmer. The Government will pay only 25 per cent of the actual eligible amount under debt relief.

Grant of Fresh Loans to the Borrowers Covered under the Debt Waiver and Debt Relief Scheme

3.34 A small or marginal farmer and other farmers will become eligible for fresh agricultural loans upon the eligible amount being waived. The fresh loan granted to 'small or marginal farmer' and 'other farmers' may be treated as "performing asset", regardless of the asset classification of the loan subjected to the 'Debt Waiver' and 'Debt Relief', respectively, and its subsequent asset classification should be governed by the extant income recognition and asset classification (IRAC) norms.

Capital Adequacy

3.35 The amount outstanding in the account styled as "Amount receivable from Government of India under Agricultural Debt Waiver Scheme 2008" shall be treated as a claim on the Government of India and would attract zero risk weight for the purpose of capital adequacy norms. However, the amount outstanding in the accounts covered by the Debt Relief Scheme shall be treated as a claim on the borrowers and risk weighted as per the extant norms. This treatment would apply under the Basel I as well as Basel II Frameworks.

Modifications to the Scheme

3.36 In September 2008, the Reserve Bank modified the procedures for reimbursement of claims and audit of claims under the scheme in view of the difficulties expressed by banks in respect of implementation. The banks were allowed to lodge separate consolidated claims for 'debt waiver' and 'debt relief under OTS' after actually passing on the benefits to the beneficiaries, as envisaged in the Scheme. However, the banks are not allowed to claim interest in excess of the principal amount, unapplied interest, penal interest, legal charges, inspection charges and miscellaneous charges either from the Central Government or recover from the farmer. All such interest/charges should be borne by the lending institutions. In view of this situation, the banks are allowed to utilise, at their discretion, the floating provisions held for 'advances' portfolio, only to the extent of meeting the interest/charges

mentioned above. However, the floating provisions should not be utilised for any other provisioning requirements without the prior approval of the Reserve Bank. In November 2008, the Reserve Bank decided to pay interest payments on the second, third and fourth instalments at the prevailing yield-to-maturity rate on 364-day Government of India Treasury Bills. Further, the banks, including RRBs, need not make any provisions for the loss in PV terms for moneys receivable only from the Government of India, for the accounts covered under the Debt Waiver Scheme and the Debt Relief Scheme.

Credit to Micro and Small Enterprises Sector (MSE)

3.37 MSE sector assumes importance in the economy owing to its employment potential and regional dispersal. This sector also mobilises capital from the lower-middle class sections to invest in productive economic activity. Thus, it encourages the development of entrepreneurial skills and enhances export earnings through the production of a wide range of products. The Code of Banks' Commitment to MSEs was formulated to ease the difficulties faced by small manufacturing and services enterprises in accessing credit. To ensure the credit flow to this sector, especially in the context of the knock-on effects of the global financial turmoil, the Reserve Bank has taken several measures (Box III.1).

3.38 The Public Sector Banks (PSBs) are operationalising specialised MSE bank branches for ensuring uninterrupted credit flow to this sector. As at end-March 2009, PSBs have operationalised 869 specialised MSE bank branches.

3.39 To further ease the credit flow to this sector, the Reserve Bank in December 2008, requested all the SLBCs to ensure that adequate attention is paid to the financial needs of MSE Sector in their respective States/UTs. Further, they were also asked to discuss the problems faced by this sector in all SLBC meetings in future. The banks were also advised in August 2009 that they should not insist on collateral security for loans up to Rs.5 lakh for the MSE sector.

3.40 Further, in the light of the recommendations of the Working Group on Rehabilitation of Sick MSEs (Chairman: Dr. K. C. Chakrabarty) and the Banking Codes Standards Board of India's Code of Commitment for the MSE borrowers, the Reserve Bank asked the banks to undertake a review and put in place a loan policy governing extension of credit facilities, restructuring/ rehabilitation policy for revival of potentially viable sick units/enterprises as also a non-discretionary OTS scheme for recovery of non-performing loans. Subsequent to SCBs, the UCBs were also advised in June 2009, to consider speedy implementation of the recommendations made by the Working Group with regard to timely and adequate flow of credit to the MSE sector. The Regional Offices of the Reserve Bank have been advised in April 2009 to monitor the actions initiated by the State Governments/SLBC convenor banks in this regard and discuss the progress in the SLBC meetings.

3.41 The Union Budget for 2009-10 provided for a special fund worth Rs.4,000 crore to Small Industries Development Bank of India (SIDBI) to facilitate the flow of credit at reasonable rates to MSE sector. This fund will incentivise banks and State Finance Corporations to lend to MSEs by refinancing 50 per cent of incremental lending to MSEs during the current financial year.

Financing of Infrastructure by Banks and Financial Institutions (FIs)

3.42 In respect of infrastructure projects undertaken by public sector units, the banks and FIs may sanction term loans only to corporate entities subject to the condition that such loans are not in *lieu* of or substitutes but supplementary to the budgetary resources. Further, the banks and FIs may ensure that such loans for financing specific monitorable projects

Box III.1: Credit Flow to the Micro and Small Enterprises (MSE) Sector

Role of MSEs

Micro and Small Enterprises constitute an important segment of the industrial and services sectors of India due to their growth potential, employment generation capacity, export generation and their role as seedbed to new entrepreneurship. The contribution of MSEs in the Indian economic development has been immense. The sector currently accounts for about 39 per cent of the manufacturing output and around 33 per cent of the total exports of the country. There are approximately 1.3 crore MSEs which employ nearly 3 crore people. The sector contributes close to 7 per cent of our GDP. Thus, special thrust by the Government to the sector has been consistent with the objectives of employment generation, regional dispersal of industries and fostering of entrepreneurship.

Sources of Credit to the MSE Sector

The principal source of institutional credit of MSE sector is the public sector banks. Besides, credit is extended to this sector through the private sector banks (both new as well as old generation) and foreign banks operating in India. The RRBs and LABs supplement the efforts of the SCBs to some extent. Credit to this sector is also provided by UCBs, State and District Central Cooperative Banks, State Financial Corporations, NBFCs and Small Industries Development Bank of India (SIDBI).

Flow of Credit to the MSE Sector

i) Policy Announcements

On the basis of the Policy Package announced by the Union Finance Minister on August 10, 2005, PSBs were advised to fix their own targets for funding MSEs in order to achieve a minimum 20 per cent year on year growth in credit to MSEs. The objective is to double the flow of credit to the sector from Rs.67,600 crore in 2004-05 to Rs. 1,35,200 crore by 2009-10, *i.e.*, within a period of 5 years. This target was surpassed in the financial year ending March 2008 itself.

The outstanding credit to the MSE sector as at the end of years 2006-07, 2007-08 and 2008-09 by public and private sector banks and foreign banks is provided in the Table.

Table: The Outstanding Credit to the MSE Sector

As March 31 of	Public Sector on Banks	Private Sector Banks	Foreign Banks
2007	1,02,550 (24.40)	13,136 (26.05)	11,637 (38.04)
2008	1,51,137 (47.38)	46,912 (257.12)	15,489 (33.10)
2009 P	1,91,307 (26.58)	47,916 (2.14)	18,138 (17.10)

P : Provisional.

Note: Figures in brackets indicate the percentage growth as compared to the previous year.

Source: Reserve Bank of India.

ii) Refinance Facilities and Funding Support for MSEs

In the context of the global developments and the knock on effects in the domestic credit markets, Reserve Bank has taken several measures to enhance credit delivery to the employment intensive MSE sector. One of the measures was that a refinance amount of Rs. 7,000 crore was provided to the SIDBI under the provisions of Section 17(4H) of the Reserve Bank of India Act, 1934 on December 6, 2008 to enhance credit delivery to the sector. This refinance will be available against: (i) the SIDBI's incremental direct lending to MSE; and (ii) the SIDBI's loans to banks, NBFCs and State Financial Corporations (SFCs) against the latter's incremental loans and advances to MSEs. The incremental loans and advances will be computed with reference to outstandings as on September 30, 2008. This refinance facility will be available up to March 31, 2010. The utilisation of funds will be governed by the policy approved by the Board of the SIDBI. The outstanding amount of refinance availed by SIDBI stood at Rs 6,095 crore as on June 30, 2009.

In pursuance of the announcement made in the Union Budget 2008-09, MSME (Refinance) Fund and MSE (Risk Capital) Fund were set up with SIDBI in June 2008. Contributions to the Funds were made by SCBs which failed to achieve their priority sector lending targets. The present corpus of the MSME (Refinance) Fund stood at Rs.1,600 crore and MSE (Risk Capital) Fund stood at Rs.1,000 crore. Taking into account the need to ensure the growth momentum in the employment-intensive sectors of micro and small enterprises and as announced by the Governor, on November 15, 2008, a series of measures were taken for liquidity management and improving credit flow. The corpus of MSME (Refinance) Fund, 2008-09 was enhanced by Rs. 2,000 crore.

iii) Special Refinance Facility

In order to provide liquidity support to SCBs (excluding RRBs), a special refinance facility was introduced on November 1, 2008 under Section 17

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(3B) of Reserve Bank of India Act 1934, whereby banks were advised to draw up to 1 per cent of their NDTL as on October 24, 2008, for a period of 90 days. Banks were encouraged to use this facility for the purpose of lending to MSEs. This facility has been extended up to March 31, 2010.

iv) Focused attention in 388 Identified Clusters

Earlier, as part of the "Policy package for stepping up of credit to MSMEs", banks were advised to treat cluster based approach for financing MSE sector as a thrust area. The Reserve Bank's Annual Policy Statement for 2007-08 announced that banks were required to review their institutional arrangements for delivering credit to the MSE sector, especially in 388 clusters identified by United Nations Industrial Development Organisation (UNIDO) spread over 21 States in the country.

v) Working Group on Rehabilitation of Sick MSEs

In recognition of the problems being faced by the MSE sector, particularly with respect to rehabilitation of potentially viable sick units, the Reserve Bank constituted a Working Group under the Chairmanship of Dr. K.C. Chakrabarty. The Working Group, in its report submitted in April 2008, dealt with the entire gamut of issues and problems confronting the sector. The Group recommended setting up of several funds namely (i) Rehabilitation Fund, (ii) Fund for Technology Upgradation, (iii) Marketing Development Fund and (iv) National Equity Fund by the Government of India to facilitate credit flow to the MSE sector. These recommendations have been forwarded to the Government of India and SIDBI for their consideration and necessary action. Banks were advised to put in place Loan Policy on extension of credit facilities, restructuring/rehabilitation policy and non-discretionary OTS to the MSE sector.

vi) Formulation of "Banking Code" for MSE Customers

The Banking Codes and Standard Board of India (BCSBI) has formulated a Code of Bank's Commitment to Micro and Small Enterprises. This is a voluntary Code, which sets minimum standards of banking practices for banks to follow when they are dealing with MSEs as defined in the MSMED Act, 2006. It provides protection to MSEs and explains how banks are expected to deal with MSEs for their day to-day operations and in times of financial difficulty. The Code is expected to (a) give a positive thrust to the MSE sector by providing easy access to efficient banking services, (b) promote good and fair banking practices by setting minimum standards in dealing with MSEs, (c) increase transparency, (d) improve understanding of business through effective communication, (e) encourage market forces through competition, to achieve higher operating standards, (f) promote a fair and cordial relationship between MSEs and banks, (g) ensure timely and quick response to banking needs, and (h) foster confidence in the banking system.

Credit Guarantee Schemes

Availability of bank credit without the hassles of collaterals/ third party guarantees would be a major source of support to the first generation entrepreneurs to set up MSE of their own. Keeping this object in view, Ministry of Micro, Small and Medium Enterprises (MSME), Government of India launched Credit Guarantee Scheme (CGS) so as to strengthen credit delivery system and facilitate flow of credit to the MSE sector. To operationalise the scheme, Government of India and SIDBI set up the Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE).

The main objective of the scheme is that the lending institution should give importance to project viability and secure the credit facility purely on the primary security of the assets financed instead of insisting the secondary collateral. Any collateral/ third party guarantee free credit facility (both fund as well as non fund based) extended by eligible institutions, to new as well as existing micro and small enterprise, including service enterprises, with a maximum credit cap of Rs.1 crore, are eligible to be covered under the CGS. For the unit covered under CGTMSE and becoming sick due to factors beyond the control of management, assistance for rehabilitation extended by the lender could also be covered under the scheme provided the overall assistance is within the credit cap of Rs.1 crore.

As the Credit Guarantee Scheme of CGTMSE has not picked up, it was announced in the Reserve Bank's Annual Policy Statement for the year 2009-10 that the Standing Advisory Committee on MSEs will review the CGTMSE scheme so as to enhance the flow of credit to the MSE sector. Accordingly, a Working Group (Chairman: Shri V K Sharma) has been constituted to review the present CGTMSE scheme, identify the weaknesses and suggest measures to simplify the existing procedures for obtaining cover and lodging of claims under the scheme and to examine the feasibility of introduction of a whole turnover cover for the micro and small enterprises and modalities for the same. The Working Group is expected to submit its report shortly.

are not used for financing the budget of the State Governments in case the loan is extended to a SPV. The banks and FIs may also undertake a due diligence on the viability and bankability of the projects financed by such loans to ensure that the revenue stream from the project is sufficient to take care of the debt servicing obligations. The banks are advised to follow these instructions while making investment in bonds of sick State public sector undertakings as part of the rehabilitation effort.

3.43 The Union Budget for 2009-10 has given greater flexibility to India Infrastructure Finance Company Limited (IIFCL) to stimulate public investment in infrastructure. The budget stated that the IIFCL would, in consultation with banks, evolve a 'takeout financing' scheme which could facilitate incremental lending to the infrastructure sector. Government has decided that IIFCL will refinance 60 per cent of commercial bank loans for public-private partnership projects in critical sectors over the next fifteen to eighteen months. The IIFCL and banks are now in a position to support projects involving a total investment of Rs.100 thousand crore in infrastructure.

Financing the Export Sector

3.44 In June 2009, the Reserve Bank reiterated that the SLBC convenor banks have to set up a sub-committee under the SLBC to discuss exporters' problems in relation to export finance and other bank related issues at the State level and hold meetings at prescribed intervals for the captioned purpose. They were also requested to ensure that the intimation of the dates of convening forthcoming meetings are communicated to all concerned well in advance so that issues of the export sector are well represented.

3.45 The Government of India extended interest rate subvention of 2 percentage points with effect from December 1, 2008 till March 31, 2009 on pre- and post-shipment rupee export credit, for certain employment oriented export sectors as under: (i) textiles (including Handloom); (ii) handicrafts; (iii) carpets; (iv) leather; (v) gems and jewellery; (vi) marine products, and (vii) small and medium enterprises. Under this dispensation, banks were allowed to charge interest rates not exceeding BPLR minus 4.5 percentage points on pre-shipment credit up to 270 days and post-shipment credit up to 180 days on the outstanding amount for the period December 1, 2008 to March 31, 2009 to the above-mentioned sectors, which was extended later on to September 30, 2009 and subsequently to March 31, 2010. However, the total subvention will be subject to the condition that the interest rate, after subvention, will not fall below 7 per cent which is the rate applicable to the agriculture sector under priority sector lending. Banks are to ensure that the benefit of the 2 per cent interest subvention is passed on completely to the eligible exporters.

3.46 In view of the difficulties faced by exporters on account of weakening of external demand and in realising the dues within the stipulated time, in September 2009 it has been decided to dispense with the requirement of overdue export bills not exceeding 10 per cent of the previous year's export turnover, for one year, *i.e.*, from April 1, 2009 to March 31, 2010, under the Gold card scheme for exporters.

Relief Measures for Diamond Industry in Gujarat

3.47 A Task Force convened by the Reserve Bank of India to look into the distressed diamond industry in Gujarat, has recommended measures for expeditious restructuring which include, fresh financing of existing borrowal accounts as per the Reserve Bank's guidelines, financing diamond sector units not financed earlier, re-training/re-skilling/rehabilitation of displaced diamond workers and providing financial relief to diamond workers. These measures were recommended by the Task Force based on discussions with various stakeholders and deliberations in the meetings.

4. Financial Inclusion

3.48 Financial Inclusion by providing financial services at affordable cost to those who tend to be excluded from the formal financial system is vital for sustaining long term equitable development in India, since there exists significant sections of unbanked population and regions. Despite the expansion of the banking network during the last four decades, a sizeable proportion of the households, especially in rural areas, do not have a bank account. Thus, it has been the endeavour of the Government and the Reserve Bank to facilitate providing formal financial services to the hitherto unbanked/under banked areas. The Reserve Bank used the term 'financial inclusion' for the first time in its Annual Policy Statement of 2005-06. Since then, the Bank has taken several measures for promoting financial inclusion such as advising banks to open 'no frills' accounts, introduction of Business Correspondent (BC)/Business Facilitator (BF) model, promotion of financial literacy, and adoption of Information and Communication Technology solutions for achieving greater outreach (Also see Boxes IV.3 and IV.4 of RBI Annual Report 2008-09).

3.49 The Union Budget for 2009-10 stated that the SLBCs will identify the under-banked or unbanked areas in their respective States/ UTs and formulate an action plan for providing banking facilities to all these areas within the next three years. The Budget proposed to set aside a one-time grant-in-aid of Rs.100 crore to ensure provision of at least one centre/Point of Sales (POS) for banking services in each of the unbanked blocks in the country.

3.50 In the Reserve Bank's Annual Policy Statement for the year 2007-08 it was announced that an evaluation of the progress made in the districts that have reported 100 per cent financial inclusion would be taken up by independent external agencies. Accordingly, studies were conducted in 26 districts in the states of Andhra Pradesh, Gujarat, Himachal Pradesh, Karnataka, Orissa, Punjab, Rajasthan and West Bengal. Based on these studies, banks have been advised in January 2009 to ensure that steps are taken to provide banking services nearer to the location of the no-frills account holders through a variety of channels such as satellite offices, mobile offices, and BCs. Banks can also consider providing General Credit Card (GCC)/small overdrafts along with no-frills accounts to encourage the account holders to actively operate the accounts; conduct awareness drives so that the no-frills account holders are made aware of the facilities offered; review the extent of coverage in districts declared as 100 per cent financially included so as to meet the gaps, if any, in providing banking facilities to those desirous of obtaining such facilities; and efficiently leverage on the technology enabled financial inclusion initiatives being implemented in various States with Reserve Bank support.

3.51 In order to give an impetus to information technology (IT) enabled financial inclusion, the Reserve Bank formulated a scheme to quicken the pace of adoption of the biometric access/smart card based Electronic Benefit Transfer (EBT) mechanism by the banks and roll out the EBT system in the States that are ready to adopt the scheme. As per the Scheme, the Reserve Bank would partially reimburse the banks, for a limited period, the cost of opening accounts with bio-metric access/ smart cards at the rate of Rs.50 per account through which payment of social security benefits, National Rural Employment Guarantee Act (NREGA) payments and payments under other government benefit programmes would be routed. The payment to banks would be dependent on the State Governments agreeing to pay to the transacting banks, a transaction fee which the State Governments and banks can mutually agree upon. The scheme was originally implemented in Andhra Pradesh for July 1, 2008 to June 30, 2009 and has since been extended all over the country up to June 30, 2010.

3.52 The Reserve Bank had in the recent past constituted Working Groups on Improvement of Banking Services in different States/Union Territories to suggest measures for improving the outreach of banks and their services, and promoting financial inclusion in certain less developed States/Union Territories, such as Bihar, Uttarakhand, Chhattisgarh, Himachal Pradesh, Jharkhand, Lakshadweep and those in the North-Eastern Region. These Working Groups have made specific recommendations for enhancing the outreach of banks and promoting financial inclusion, strengthening of financial institutions, improving currency and payments systems, and for revitalisation of the RRBs and UCBs in the respective regions. The recommendations of these Groups are under implementation.

3.53 The Report of Committee on Financial Sector Reforms (Chairman: Prof.Raghuram Rajan) also put forward a roadmap for further intensifying the on-going financial inclusion process in the country among other things. The recommendations of the Report with regard to financial inclusion are provided in Box III.2.

3.54 In August 2008, SCBs, including RRBs and LABs were advised that they could engage companies registered under Section 25 of the

Box III.2: The Report of the Committee on Financial Sector Reforms (CFSR) – Recommendations with Regard to Financial Inclusion

The Report of the Committee on Financial Sector Reforms has come out with several recommendations to intensify the process of financial inclusion in the country. Financial inclusion is not only about credit, but involves providing a wide range of financial services, including saving accounts, insurance, and remittance products. The Committee opined that the most important financial services to the poor are vulnerability reducing instruments. Thus, access to safe and remunerative methods of saving, remittances, insurance, and pensions needs to be expanded significantly.

The CFSR further recommended that an inclusive banking structure may be developed in an economy by creating and promoting small finance banks on the one hand and by creating strong linkages between large banks and small local entities. These linkages will facilitate the retailing of large banks' financial products to small clients. The CFSR reiterated the need to broaden the definition of "Business Correspondent" following the recommendations of the Rangarajan Committee on Financial Inclusion.

The opening of 'no-frills' accounts may be promoted further to provide 90 per cent of Indians access to formal financial system. These accounts can also be used for the disbursement of existing subsidies and cash transfers to the poor under different Government programmes such as NREGS. A nationwide electronic financial inclusion system (NEFIS) could also be created by linking the 'no-frills' accounts which will enable the electronic transfer of funds to these accounts.

The Committee opined that the priority sector lending requirements need to be made uniform for both the domestic and foreign banks. In view of the shortfall in meeting the priority sector lending targets by different banks, the CFSR proposed the introduction of priority sector lending certificate (PSLC). The Committee has indicated that the PSLCs would be issued by any registered lender such as MFIs, NBFCs, co-operatives, and registered money lenders for the amount of loans granted by them to various categories of priority sector, and also by banks for the amounts in excess of stipulated priority sector lending norms. These certificates could be traded in an open market and the banks having shortfall in achievement of priority sector lending targets could be permitted to buy such certificates and, thus, achieve the priority sector lending norms.

The Committee has, further, indicated that in the process of buying PSLCs by the banks, the actual loans would remain on the books of the original lender, unlike outright purchase of loan assets, and the buyer bank would show the amount in its priority sector lending requirements.

The Committee further opined that there is a clear need to increase the commercial viability of reaching the poor. Product innovation, organisational flexibility, and superior cost efficiency are essential in reaching the excluded and offering them financial services that they will want to use. The Committee, however, recognises that greater commercial viability cannot be truly achieved for all sections of the poor, and therefore, some kind of mandated coverage will always be required.

The Committee also opined that a significant investment in financial literacy is required if the poor are to make effective use of various initiatives to foster financial inclusion.

Companies Act, 1956, as BCs provided those companies were stand-alone entities or not more than 10 per cent of their equity was held by NBFCs, banks, telecom companies and other corporate entities or their holding companies. For engaging Section 25 companies as BCs, banks had to strictly adhere to the distance criterion of 15 kms/5 kms, as applicable, between the place of business of the BC and the branch. In April 2009, the Reserve Bank increased the maximum distance criteria for the operation of a BC for rural, semi-urban and urban areas from the existing 15 kms. to 30 kms.

3.55 Banks were advised in August 2008 that in case duly appointed BCs of banks desire to appoint sub-agents at the grass-root level to render the services of a BC, banks have to ensure that (i) the sub-agents of BCs fulfil all relevant criteria stipulated for BCs in terms of the Reserve Bank's extant guidelines (ii) the BC appointed by them carries out proper due diligence in respect of the sub-agent to take care of the reputational and other risks involved and (iii) the distance criterion of 15 kms./5 kms., as applicable, from the base branch should invariably be fulfilled in the case of all sub-agents. Banks were also advised that where individuals under the permitted categories have been appointed as BCs, they cannot in turn appoint sub-agents.

3.56 In view of the demand from various quarters for enlarging the eligible entities that can function as BCs, the Reserve Bank constituted a Working Group to review the Business Correspondent Model in the Annual Policy 2009-10. The Working Group (Chairman: Shri P Vijaya Bhaskar), *inter alia*, reviewed the experiences gained in implementing the BC Model and suggested measures to enlarge the category of persons/entities that can act as BCs of banks, after examining the various regulatory and other incidental issues relating to the Model (Box III.3).

Financial Literacy and Credit Counselling

3.57 The Reserve Bank has been taking a number of initiatives to promote financial literacy. 'Project Financial Literacy' has been undertaken to educate the common person on financial matters. The initiatives taken by the Reserve Bank to promote financial literacy, *inter alia*, include conducting essay/quiz/inter-school debate competitions for school children on topics related to banking and financial inclusion, distributing materials such as comic books, pamphlets and posters on financial literacy free-of-cost, participating in fairs/ exhibitions to disseminate information on the Reserve Bank's role as a central bank and educating the general public about the Reserve Bank's clean note policy, security features of currency notes and detection of forged notes. The Reserve Bank has undertaken a project for setting up a permanent exhibition centre on financial education in Mumbai. A pilot project on developing and including chapters on financial education as part of the curriculum in schools has been undertaken in collaboration with the Karnataka Government.

3.58 In accordance with the announcement made in the Mid-term Review for 2007-08, the Reserve Bank placed on its website a concept paper on 'Financial Literacy and Counselling Centres' on April 3, 2008. Based on the feedback received, a Model Scheme for FLCCs has been formulated and communicated to banks in February 2009. The main objective of the model Scheme is to provide free financial literacy/education and credit counselling. The specific objectives of the scheme, *inter alia*, include financial counselling services through face-to-face interaction, educating people with regard to various financial products and services, and making the people aware of the advantages of being connected with the formal financial sector (Box III.4) (also see Box IV.6 of RBI Annual Report 2008-09).

Box III.3: Working Group to Review the Business Correspondent (BC) Model: Major Recommendations

As announced in the Annual Policy Statement for the year 2009-10, a Working Group was constituted (Chairman: P. Vijaya Bhaskar) to examine the experience to date of the BC model and suggest measures, to enlarge the category of persons that can act as BCs, keeping in view the regulatory and supervisory framework and consumer protection issues.

The Working Group submitted its Report on August 18, 2009. The major recommendations of the Working Group are summarised below:

Additional Eligible Entities as BCs

The following entities may be considered for appointment as BCs in rural and semi-urban areas, in addition to the entities presently permitted: (i) Individual kirana/medical /Fair Price shop owners (ii) Individual Public Call Office (PCO) operators (iii) Agents of Small Savings schemes of Government of India/Insurance Companies (iv) Individuals who own Petrol Pumps (v) Retired teachers and (vi) Authorised functionaries of well run Self Help Groups (SHGs) linked to banks. Further, non-deposit taking NBFCs in the nature of loan companies whose microfinance portfolio is not less than 80 per cent of their loan outstanding may be permitted as BCs in the financially excluded districts as identified by the Committee on Financial Inclusion(Chairman: Dr.C.Rangarajan), only for liability products.

As regards the North Eastern Region, Reserve Bank may issue suitable instructions to banks to implement the recommendation made by the Committee on Financial Sector Plan (CFSP) for the North Eastern Region (Chairperson: Smt. Usha Thorat) that where a local organisation/association, which does not fall under any of the forms of organisation listed in the Reserve Bank guidelines, is proposed by a bank, after due diligence and is recommended by DLCC for being approved as Business Correspondent, the Regional Office of the Reserve Bank may be given powers to grant suitable exemption from the Reserve Bank guidelines.

Ensuring Viability of BC Model

Banks may be permitted to collect reasonable service charges from the customer, in a transparent manner, for delivering services through the BC model. Suitable guidelines may be issued by the Reserve Bank in this regard, especially keeping in view the profile of customers using these services.

Banks may bear the initial set up cost of the BCs and extend a handholding support to the BCs, at least during the initial stages. Banks may also need to bear the costs relating to transit insurance of the cash handled by BCs.

In order to improve the viability of the BC model, banks may consider providing reasonable temporary overdrafts to the BCs free of interest charges.

Banks may need to have a relook at the compensation structure for BCs. The range of services to be delivered through the BC should be ramped up to include suitable small savings, micro-credit, micro-insurance, and small value remittances.

Regulatory Issues

Reserve Bank may permit banks to allow, with suitable safeguards, the BCs in the North Eastern Region to account for the transactions in the bank's books by the end of the second working day from the date of the transaction.

As regards cases referred to DCCs for relaxation of distance criteria, they should give their decisions at the earliest and in any case within a period of three months from the date of reference to them. In case no decision is conveyed by DCCs within this period, the banks may be permitted to treat it as a 'no objection' for relaxation of the distance criterion.

Financial Education and Consumer Protection

Banks need to scale up their efforts substantially towards educating the clientele in their respective vernacular languages regarding the benefits of banking habit. For this purpose, extending necessary financial support from the Financial Inclusion Fund administered by NABARD may be considered.

Information regarding BCs engaged by banks may be placed on the banks' websites. The Annual Reports of banks should also include the progress in respect of extending banking services through the BC model and the initiatives taken by banks in this regard. Banks may also use print and electronic media (including in the vernacular language) to give wide publicity about implementation of BC model by them.

The banks need to ensure the preservation and protection of the security and confidentiality of customer information in the custody or possession of the BCs.

Banks may put in an appropriate grievance redressal mechanism, which should be widely publicised and also placed in public domain. The details of the grievance redressal officer should be displayed at the premises of the BC as also at the base branch and made available by the bank/BC at the request of the customer.

Risk Mitigation Measures

To address the various risks involved in rendering banking services through the BC model, banks need to put in place suitable and adequate risk mitigation measures. Further, banks may be guided by the instructions contained in the guidelines on ' Outsourcing of Financial Services' issued by the Reserve Bank on November 3, 2006, as relevant, while implementing the BC model.

Others

The Reserve Bank may issue suitable clarification to the banks to the effect that in case the customer desires, he may be allowed to carry out the transactions at the base branch.

Box III.4: Financial Literacy and Credit Counselling (FLCC) Centres

Financial education/literacy has assumed great importance in the recent years, as financial markets have become increasingly complex and there is also an information asymmetry leading to making informed choices difficult for the common person. In India, the need for financial education is greater considering the low levels of literacy and the large section of the population, which is still out of the formal financial set-up. Banks, as financial intermediaries can play an important role in providing financial education to its customers as well as others.

A model scheme on financial literacy and credit counselling (FLCC) centres was formulated and communicated to all SCBs and RRBs in February 2009 with the advice to set up the centres as distinct entities maintaining an arm's length from the bank so that the FLCC's services are available to even other banks' customers in the district.

The salient features of the Scheme are as under:

Objectives

The broad objective of the FLCCs will be to provide free financial literacy/education and credit counselling. The specific objectives of the FLCCs would be:

(i) To provide financial counselling services through face-to-face interaction as well as through other available media like e-mail, fax, and mobile as per convenience of the interested persons, including education on responsible borrowing, proactive and early savings, and offering debt counselling to individuals who are indebted to formal and/or informal financial sectors;

(ii) To educate the people in rural and urban areas with regard to various financial products and services available from the formal financial sector;

(iii) To make the people aware of the advantages of being connected with the formal financial sector;

(iv) To formulate debt restructuring plans for borrowers in distress and recommend the same to formal financial institutions, including cooperatives, for consideration;

(v) To take up any such activity that promotes financial literacy, awareness of the banking services, financial planning and amelioration of debt-related distress of an individual;

FLCCs should not, however, act as investment advice centres /marketing centres for products of any particular bank/banks. Counsellors may refrain from marketing/ providing advice regarding investment in insurance policies, investment in securities, value of securities, and purchase/sale of securities, or promoting investments only in bank's own products.

Organisational/Administrative Set-up

To start with, banks may set up Trusts/Societies for running the FLCCs, singly or jointly with other banks. A bank may induct respected local citizens on the Board of such a Trust/Society. Serving bankers may not be included in the Board. The trust may also be represented by senior citizens.

To begin with, FLCCs may be fully funded by the bank/s. Initially, if the branch premises are used to minimise cost, the FLCC should be kept completely separated with a separate entrance, and different look and feel from that of the bank's branch so as to maintain a distinct identity from the parent bank. The banks' officers may, for effective supervision and monitoring of activities of such Trusts/Societies, make dummy calls or incognito visits.

It is necessary that these centres should not be perceived as recovery or marketing agents of the bank concerned, and the general public/banks' constituents should feel comfortable in voluntarily approaching the centres. The independence of the counselling centres has to be ensured so that non-partisan and objective guidance is provided to the customers.

Coverage

While credit counselling services may be provided in rural, semi urban, urban and metropolitan areas, banks may adopt a segmented approach specific to different categories of borrowers, rather than broad-based generalised one. For instance, the centres in rural and semi urban areas could concentrate on financial literacy and counselling for farming communities and those engaged in allied activities.

In order to have maximum coverage, FLCCs may need to be set up at all levels, *viz*., block, district, town and city levels. However, to begin with, lead banks may take the initiative for setting up FLCCs in the district headquarters. The SLBCs could oversee the activities of FLCCs and provide support and guidance wherever required.

FLCCs may not take up cases of wilful defaulters.

Charges

Counselling and debt management services may be provided free of charge to the customers so as to put no additional burden on them.

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Infrastructure

Proper infrastructure would have to be put in place by banks with adequate communication and networking facilities.

Types of Credit Counselling

Debt counselling/credit counselling can be both preventive and curative. In case of preventive counselling, the centres could provide awareness regarding cost of credit, and availability of backward and forward linkages, where warranted. The clients could be encouraged to avail of credit on the basis of their repaying capacity. Preventive counselling can be through the media, workshops and seminars.

FLCCs may consider introducing a generic financial education module in vernacular language. Broadly, the module content can include the need for savings, budgeting, advantages of banking with formal financial institutions, concept of risk and rewards and time value of money, various products offered by banks, and insurance companies.

Since promoting awareness is one of the primary objectives, the FLCCs should give due emphasis to customers' rights under fair practices code, benefits of nomination facilities, and operation of accounts.

In the case of curative counselling, the clients may approach the counselling centres to work out individual debt management plans for resolving their unmanageable debt portfolio.

Preventive counselling may be made mandatory for individual borrowers based on their income level or size of loan. Such mandatory credit counselling could be made a part of fair lending practice of banks.

Mechanism for Credit Counselling and Debt Settlement

Banks may encourage their own customers in distress or customers of any bank to approach the FLCCs set up by them. Information about such FLCCs can be provided through the various fora available under the Lead Bank Scheme. Banks may evolve trigger points to refer cases, where there are early warning signals, to the counselling centres before taking measures for recovery.

The counsellors should be mandated to refer cases to banks and work out Debt Management Plans for distressed borrowers with a view to facilitating restructuring/rescheduling their debts.

The choice of finally accepting or rejecting a debt restructuring proposal suggested by the FLCCs may be left to the bank/banks concerned.

The FLCCs would, however, not involve themselves in recovering and distributing money. This may be left to the bank concerned, or the bank having the largest exposure to act on behalf of all the banks.

Qualification and Training of Counsellors

It is necessary that only well qualified/trained counsellors are selected to man the centre on a full time basis. The FLCCs could consider appointing people with domain knowledge in agriculture for counselling related to agriculture and allied activities.

To ensure that there is no conflict of interest, persons managing the FLCC should not be staff of the bank.

Individuals such as retired bank officers, and ex-servicemen may be allowed to be appointed, among others, as credit counsellors.

The Reserve Bank's College of Agriculture Banking, Pune, Bankers' Institute of Rural Development, Lucknow or the training colleges of banks may consider conducting training programmes for the counsellors.

Types of Interface

Counselling centres should be equipped to deal with requests received in person, by phone, e-mails, and post. They should have a toll free line, e-mail and fax facilities for easy contact.

Monitoring

The functioning of the FLCCs in each State may be monitored by a Committee headed by the Regional Director of the Reserve Bank of India and feedback provided to the banks on a regular basis. The Committee may comprise SLBC convenor bank, other banks, NABARD, IBA, consumer organisations, and NGOs working in the area.

Transparency/Disclosure of Information

To help the customers make informed decisions, all banks may display on their websites necessary information regarding fees, and charges. The details of the services offered by the FLCCs opened by the banks may also be placed on the websites of banks concerned.

Publicity

Banks may ensure that the list of counselling centres is appropriately publicised.

Progress

Banks have reported setting up 148 credit counselling centres in various States of the country up to March 2009.

Lead Bank Scheme

3.59 The concept of 'Lead Bank Scheme (LBS)' was first mooted by the Gadgil Study Group, which submitted its report in October 1969. Pursuant to the recommendations of the Gadgil Study Group and Nariman Committee suggesting adoption of 'area approach' in evolving credit plans and programmes for development of banking and the credit structure, the LBS was introduced by the Reserve Bank in December, 1969. The scheme envisaged allotment of districts to banks to enable them to assume leadership in bringing about banking developments in the respective districts.

3.60 During 2008-09 (July-June) and 2009-10 (up to August 2009), the eight newly formed districts in six States and one UT were assigned to various SCBs, to function as Lead Banks, *viz.*, (i) Narayanpur and Bijapur in Chhattisgarh to State Bank of India (ii) Alirajpur and Singrauli in Madhya Pradesh to Bank of Baroda and Union Bank of India; (iii) Palwal in Haryana to Oriental Bank of Commerce; (iv) South Andaman, and North and Middle Andaman (Andaman was bifurcated into two districts), to State Bank of India; (v) Tiruppur in Tamil Nadu to Canara Bank; and (vi) Kanshiram Nagar in Uttar Pradesh to Canara Bank, respectively.

High Level Committee to Review the Lead Bank Scheme

3.61 Pursuant to the announcement made in the Reserve Bank's Mid-term Review of the Annual Policy Statement for 2007-08, a High Level Committee (Chairperson: Smt. Usha Thorat) was constituted in November 2007, to review the LBS and improve its effectiveness, with a focus on financial inclusion and recent developments in the banking sector. The Committee had several rounds of discussions with different State Governments, banks and other stake holders, including academicians, micro finance institutions and NGOs. The broad view that had emerged was that while greater banking and credit penetration by the formal financial institutions for facilitating inclusive growth should be the primary objective of the scheme, it would also be necessary to strengthen the institutions and processes through which the scheme is implemented. The Committee submitted its draft report on May 21, 2009 and it was placed on the Reserve Bank's website for public comments. Based on the feedback/ comments/ suggestions received from the public, banks, institutions, the Committee submitted the final report on August 20, 2009, which was placed on RBI website on August 24, 2009. The major recommendations of the Committee are furnished in the Box. III.5 (also see Box IV.2. 'Draft Report of the High Level Committee to Review the Lead Bank Scheme' in RBI Annual Report 2008-09).

Special Task Force in North-Eastern Region

3.62 A Special Task Force (Chairperson: Smt. Usha Thorat) was constituted in order to give a fresh impetus for setting up of banking facilities at additional centres in North-Eastern region perceived as essential as per public policy. A scheme of providing financial support to banks by the Reserve Bank for setting-up banking facilities (currency chests, extension of foreign exchange and Government business facilities) at centres in the North-Eastern region, which are not found commercially viable by banks, was formulated, requiring the State Governments to make available necessary premises and other infrastructural support. The Reserve Bank as its contribution would bear one time capital cost and recurring expenses for a limited period of five years as per the lowest bid offered by a bank.

3.63 To begin with, bids were invited for the 'agreed centres' identified by the State Government of Meghalaya, on pilot basis. The Government of Meghalaya agreed to the proposal of providing premises and security. Bids have been received from the PSBs for setting-up branches at eight centres and these have been allotted to the lowest bidder.

Box III.5: Report of the High Level Committee to Review the Lead Bank Scheme

Background: The Lead Bank Scheme (LBS) was introduced by the Reserve Bank in 1969. Over the four decades since the introduction of the LBS, several changes have taken place in the country, especially after 1991 with the beginning of globalisation and liberalisation of the Indian economy. The reforms have encompassed all sectors including the financial sector. The commercial banks are much more focused today on their financials and have improved their competitiveness and efficiency. Although priority sector obligations have continued to be in force for both private sector and PSBs, attention has increasingly been drawn to the fact that large sections of the population remain outside the formal banking structure and the real and financial sectors continue to lag behind in certain regions. While policies are in place to facilitate flow of credit to the more vulnerable sectors/sections of society, there is a need to ensure greater dissemination and implementation of these policies at the grass root level, besides getting timely information and better assessment of outcomes.

A need was, therefore, felt for a comprehensive review of the LBS. Accordingly, as announced in the Reserve Bank's mid-term review of Annual Policy for the year 2007-08, a Committee was constituted (Chairperson: Smt. Usha Thorat) to review the LBS with focus on financial inclusion and the recent developments in the banking sector.

Roadmap for Financial Inclusion: The Committee noted that it is critical that banking services is seen as a public good and is accessible to all sections of population and regions of the country at affordable cost. The Committee, therefore, recommended the overarching objective of LBS shall be to enable banks and State Governments work together to achieve inclusive growth.

Considering the overarching need to provide a banking outlet at locations closer to the rural population, the Committee recommends that in every district, a Sub-Committee of the DCC may draw up a road map to provide banking services through a banking outlet at every village with population of over 2000 at least once a week on a regular basis through various forms, *viz*., mobile banking, extension counters, satellite offices as also BCs. By March 2010, the Sub-Committee should come out with a time frame within which this can be achieved and the time frame needs to cover all villages having population of more than 2000 with a banking outlet not later than March 2011. In States where the existing penetration is good, the targets could be brought forward appropriately.

A monitoring system may be instituted by the DCC to periodically assess the position regarding achieving the roadmap and report the same in each meeting of the DCC.

IT based Financial Inclusion: In achieving banking penetration, banks need to take the maximum advantage of available IT solutions. Since State Governments are also keen to disburse NREGA and social security funds through bank accounts, partnerships can be explored between banks and State Governments and leverage the same infrastructure for achieving financial inclusion. The funding arrangements available under Financial Inclusion Technology Fund (with NABARD) or other options such as the support offered for distribution of Government payments by the Reserve Bank may be explored for this purpose.

Role of State Governments: The role of the State Governments ranges from ensuring conducive law and order situation, water supply and irrigation facilities, road and digital connectivity, developing proper land records, to assist in the identification process, publicity drives, and recovery. In centres where bank branches are required as per public policy for general banking, currency, forex and government business, but banks are constrained to open the branches due to lack of infrastructure, absence of viability and security concerns, State Governments will need to extend support by providing premises, and security. State Governments should also be able to leverage on the benefits of undertaking government business accruing to banks to incentivise their involvement in Government sponsored schemes and programmes which may not always have business benefits.

State Level/District Level Development Plan: The Committee has recommended preparation of a one-time comprehensive State Level/District Level Development Plan (SDP/DDP) for each State and district on the lines prepared for the North Eastern Region by the Committee on Financial Sector Plan for North Eastern Region. This plan should identify the 'enablers' and 'impeders' in banking development and lending to the priority sectors, besides delineating the role and responsibilities of banks, State Governments and other stakeholders for taking specific actions, to be monitored periodically at the State Level Banker's Committee (SLBC) and District Consultative Committee (DCC). The State level plan may be prepared by a sub-committee headed by convenor of SLBC and include officials from the State Government, the Reserve Bank and NABARD besides the major participating banks. At the district level, a sub committee of the DCC with the LDM as convenor and members comprising the DDM of NABARD, district level government officials, bank functionaries and others may prepare such a plan. Regional offices of the Reserve Bank may provide necessary guidance.

(Contd. ....)

(....Concld.)

SLBC and DCC Machinery: More time of the SLBC/DCC machinery may, therefore, be utilised to discuss specific issues inhibiting and enabling financial inclusion as delineated in the State Level/District Level Development plan, rather than narrowly on the government sponsored schemes.

In view of the large membership of the SLBC, it is desirable for the SLBC to constitute sub committees for specific tasks. These sub committees may examine the specific issues in-depth and come out with solutions/ recommendations for consideration of the SLBC.The secretariat/offices of SLBC should be sufficiently strengthened to enable the SLBC convenor bank to effectively discharge its functions.At the DCC level, sub committees as appropriate may be set up to work intensively on specific issues and submit reports to the DCC for its consideration.

An annual conference of Chief Secretaries/Development Commissioners, CMDs of SLBC convenor banks may be convened by the Reserve Bank to discuss important policy issues in the area of financial inclusion and priority sector lending at the national level.

A small committee, comprising representatives of RBI, Central Office, IBA, Regional Director, the Reserve Bank and Chief General Manager, NABARD of the State concerned may review the performance of the SLBC Convenor banks and lead banks so as to bring about corrective action, including changing the convenorship of SLBC/DCC, if needed.

Lead District Manager's (LDM's) Office – Role and Set-up: The Committee noted that the effectiveness of the entire Lead Bank Scheme depends on the dynamism of the District Collector and the LDM, with supportive role of the Regional/ Zonal office. The new functions envisaged for the LDMs include drawing up the road map for banking penetration, preparation of one time comprehensive Development Plan for the district, associate with the setting up of Financial Literacy and Credit Counselling (FLCCs) Centres, setting up of Rural Self Employment Training Institutes, holding annual sensitisation workshops for banks and government officials with participation by NGOs/PRIs, arranging for quarterly awareness and feedback public meetings.

Financial Literacy and Credit Counseling: Each lead bank is expected to open a FLCC Centre in every district where it has lead responsibility by following the recent guidelines issued by RBI in this regard.

Capacity Building/Training/Sensitisation Programmmes: The Committee observed that there is need for sensitising the DCs on the banks and banking in general apart from the specific scope and role of the LBS. The SLBC may arrange for exposure visits for the DCs to the SLBC convenor's office for sensitisation and understanding of the LBS. Similarly, soon after their posting, exposure visits to the State capital, development departments/ZP and Collectorate may be arranged for LDMs for understanding the priorities of the State Government.

Staff at the operational level of banks and Government agencies associated with implementation of the LBS need to be aware of the latest developments and emerging opportunities. There is need for staff sensitisation/ training/seminars at periodic intervals on an ongoing basis. Training institutions of individual banks together with national level training colleges of the Reserve Bank and NABARD as also NIBM, IIBM, and NIRD should develop suitable modules for this from the current year.

Quarterly Public Meetings and Grievance Redressal: Every quarter, lead banks may organise an awareness and feedback public meeting at various locations in their lead districts. Wide publicity may be given to these meetings so that members of public, media representatives, local leaders as also NGOs/CSOs working in the district attend these meetings.

Greater role for Private Sector Banks: The Committee observed that priority sector lending targets including those for grant of weaker section loans apply equally to the private sector banks also and hence there is a significant role for these banks in the implementation of the LBS. The Committee, therefore, recommends that private sector banks should involve themselves more actively by bringing in their expertise in strategic planning and leveraging on Information Technology. The lead banks, on their part, should also ensure that private sector banks are more closely involved in the LBS, both while drawing up and in implementing the Annual Credit Plan.

Initiatives for Urban Areas: In urban areas, the State Government machinery may assist in the opening of bank accounts where there are large settlements of households and obtaining proof of address and identity may be difficult. Banks having the largest presence in each city with more than one million population (to start with) may take the leadership in convening a meeting of bankers and allocating responsibility for various wards to different banks, to ensure that all urban households have easier access to bank accounts and banking services. Regional Directors of the Reserve Bank at different centres may facilitate the setting up of such a forum.

Revised SAMIS Reporting System: The Committee suggested implementation of revised Priority Sector Monitoring and Information System (PSMIS) on a pilot basis in one/two States initially and thereafter extending to the rest of the country with effect from April 1, 2010. The Committee has also suggested constitution of a small Working Group by the Reserve Bank to formulate the modalities and work on implementation of the revised framework.

Swarna Jayanti Gram Swarozgar Yojna (SGSY)

3.64 The Union Budget for 2009-10 emphasised on formation of women Self Help Groups under the scheme 'The Swarna Jayanti Gram Swarozgar Yojna'. Apart from providing capital subsidy at an enhanced rate, it is also proposed to provide interest subsidy to poor households for loans up to Rs.1 lakh from banks. Further, in August 2009, the Reserve Bank advised all PSBs excluding RRBs that the individual loans up to Rs.1 lakh and group loans up to Rs.10 lakh under the Scheme would receive the exemption of secondary collateral security.

The Rashtriya Mahila Kosh

3.65 The corpus of 'The Rashtriya Mahila Kosh' is proposed to be raised to Rs.500 crore over the next few years in recognition of its importance in facilitating credit support or micro finance to poor women.

Self Employment Scheme for Rehabilitation of Manual Scavengers (SRMS)

3.66 In place of the Scheme of Liberation and Rehabilitation of Scavengers (SLRS), the Government of India approved a new and improved scheme named "Self Employment Scheme for Rehabilitation of Manual Scavengers" (SRMS), aimed at rehabilitating the remaining scavengers and their dependents by March 2009. The scheme contains provisions for capital subsidy, concessional loans and capacity building for rehabilitation of manual scavengers in alternative occupations. The scheme provides loans for projects costing up to Rs.5 lakh. In June 2009, following the decision taken by the Government of India to extend this scheme beyond March 2009, the Reserve Bank instructed the banks to complete the implementation of the scheme by September 30, 2009.

Differential Rate of Interest (DRI) Scheme

3.67 The Union Budget for 2008-09 proposed to raise the borrower's eligibility criteria for availing loans under the Differential Rate of Interest (DRI) Scheme. Accordingly, the Reserve Bank advised banks in April 2008 that borrowers with annual family income of Rs.18,000 in rural areas and Rs.24,000 in urban areas would be eligible to avail of the facility as against the earlier annual income criteria of Rs.6,400 in rural areas and Rs.7,200 in urban areas. In August 2008, the Reserve Bank clarified that the revised eligibility income criteria of Rs.24,000 for urban areas is also applicable for the semi-urban areas. The target for lending under the DRI scheme was maintained at one per cent of the previous year's total advances.

5. Prudential Regulation

3.68 In the wake of heightened concerns of financial stability triggered by the on-going financial turmoil in the US, the regulatory initiatives by the Reserve Bank during the year continued to focus on adapting the international best practices. The migration of the commercial banking system to the Basel II framework had made considerable progress during the year. One of the important initiatives taken during the year was regarding the restructuring of advances in the banking system. Measures were also taken to broaden the instruments that can form a part of the Tier I and Tier II capital of the banks. The prudential regulation for the off-balance sheet exposures of the banking system was also strengthened given its importance in ensuring financial stability.

3.69 In response to the global financial turmoil, the G-20 Working Group came out with a Report titled 'Enhancing Sound Regulation and Strengthening Transparency' in March 2009. The recommendations of the Report are consistent with the recognition that robust regulation in each country, based on effective global standards, is vital to future financial stability. The recommendations of the Report are summarised in Box III.6.

Box III.6: G-20 Working Group Report on 'Enhancing Sound Regulation and Strengthening Transparency' – Summary of Recommendations

The Working Group deliberated upon various aspects of regulation and transparency in order to strengthen the international regulatory standards and enhance transparency in global financial markets. The aspects which received the attention of the Group are: (i) system-wide approach to financial regulation, (ii) scope of regulation, (iii) oversight of credit rating agencies, (iv) private pools of capital, (v) transparent assessment of regulatory regimes, (vi) pro-cyclicality, (vii) capital, (viii) liquidity, (ix) infrastructure for over-the-counter (OTC) derivatives, (x) compensation schemes and risk management, (xi) accounting standards, (xii) transparency, (xiii) enforcement, and (xiv) technical assistance and capacity building in emerging market economies. The key recommendations of the Group are summarised below:

The Group opined that as a supplement to sound micro-prudential and market integrity regulation, national financial regulatory frameworks should be reinforced with a macro-prudential overlay that promotes a system-wide approach to financial regulation and oversight, and mitigates the build-up of excess risks across the system. In most jurisdictions, this will require improved coordination mechanisms between various financial authorities, mandates for all financial authorities to take account of financial system stability, and effective tools to address systemic risks. It will also require an effective global table to bring together national financial authorities to jointly assess systemic risks across the global financial system and coordinate policy responses.

Further, the scope of regulation and oversight should be expanded to include all systemically important institutions, markets and instruments. This will require enhanced information for financial authorities on all material financial institutions and markets, including private pools of capital. Large complex financial institutions require particularly robust oversight given their size and global reach. The regulatory and oversight framework should strive to treat similar institutions and activities consistently, with greater emphasis on functions and activities, and less emphasis on legal status.

Once conditions in the financial system have recovered, international standards for capital and liquidity buffers should be enhanced, and the build-up of capital buffers and provisions in good times should be encouraged so that capital can absorb losses and be drawn down in difficult times.

Through the expanded Financial Stability Forum (FSF) (India has been co-opted as a member), the International Monetary Fund (IMF) and the international standard setters, international standards, including those for macro-prudential regulation, the scope of regulation, capital adequacy and liquidity buffers, should be coordinated to ensure a common and coherent international framework, which national financial authorities should apply in their countries consistent with national circumstances. The financial regulatory and oversight frameworks and their implementation in all G-20 countries should be reviewed periodically, validated internationally and made public.

Sound micro-prudential and market-conduct regulation supplemented with an effective macro-prudential framework requires enhancements to a range of supporting policies and infrastructure, including: compensation practices that promote prudent risk taking in line with principles developed by the FSF; the greater standardisation of derivatives contracts and the use of risk-proofed central counterparties; improved accounting standards that better recognise loan-loss provisions and dampen adverse dynamics associated with fair-value accounting; effective enforcement of regulation that is coordinated internationally including the enforcement of the adherence of credit rating agencies to the substance of the International Organisation of Securities Commission code of conduct; and national authorities and international standard setters working together and assisting each other in strengthening financial regulatory and oversight frameworks and their implementation across the G-20 and beyond.

Basel II - Implementation

3.70 All commercial banks in India excluding RRBs and LABs have become Basel II compliant as on March 31, 2009. To begin with, the Standardised Approach for Credit Risk, Basic Indicator Approach for operational risk and Standardised Duration Approach for market risk have been implemented in India. However, the implementation of advanced approaches under the Basel II framework is expected to bring about the up-gradation of risk management framework and also capital efficiency to the Indian banking system. Keeping these in mind and also emerging international trend in this regard, the Reserve Bank has laid down a timeframe for implementation of these approaches, which is provided in Table III.2.

3.71 The banks are also advised to undertake an internal assessment of their preparedness for migration to advanced approaches, in the light of the criteria envisaged in the Basel II document, as per the aforesaid time schedule,

Table III.2: Timeframe for the Adoption of Advanced Approaches under Basel II

Approach	The earliest date of making application by banks to the Reserve Bank	Likely date of approval by the Reserve Bank
1	2	3
a. Internal Models Approach (IMA) for Market Risk	April 1, 2010	March 31, 2011
b. The Standardised Approach (TSA) for Operational Risk	April 1, 2010	September 30, 2010
c. Advanced Measurement Approach (AMA) for Operational Risk	April 1, 2012	March 31, 2014
d. Internal Ratings-Based (IRB) Approaches for Credit Risk (Foundation- as well as Advanced IRB)	April 1, 2012	March 31, 2014

and take a decision, with the approval of their Boards, whether they would like to migrate to any of the advanced approaches. The banks deciding to migrate to the advanced approaches may approach the Reserve Bank for necessary approvals, in due course, as per the stipulated time schedule.

3.72 In the light of the experience gained in the parallel run of the new capital adequacy framework (NCAF) over the last two years, and also with a view to ensuring a degree of standardisation in their reporting to the Boards and to the Reserve Bank, a reporting format has since been prepared for adoption by all the banks. The reporting in the format is expected to continue till March 2011/March 2012, as per the date of migration to the NCAF by a bank, for monitoring compliance with Prudential Floors. The banks are also advised to adopt the format for reporting to their Boards with effect from the quarter ending December 31, 2008.

Banks' Exposures to Central Counter-Parties (CCPs)

3.73 Banks have been exposed to CCPs attached to stock exchanges while settling contracts like currency futures and interest rate futures. As per the extant guidelines, the instruments traded on futures and options exchanges which are subject to daily mark-to-market and margin payments are exempted from the capital requirements. The exposures to CCPs on account of derivatives trading and securities financing transactions (*e.g.* collatarised borrowing and lending organisations, Repos) outstanding against them, will be assigned zero exposure value for counterparty credit risk, as it is presumed that the CCPs' exposures to their counterparties are fully collateralised on a daily basis, thereby providing protection for the CCP's credit risk exposures. The deposits/collaterals kept by banks with the CCPs will attract risk weights appropriate to the nature of the CCP. In the case of Clearing Corporation of India Ltd. (CCIL), the risk weight will be 20 per cent and for other CCPs, it will be according to the ratings assigned to these entities as per the NCAF. The above prescriptions about the adequacy of margin, quality of collateral and risk management systems of the clearing house/CCP will be reviewed after one year.

Exposures to Commercial Real Estate (CRE)

3.74 In view of a number of queries received from banks and other quarters as to whether or not certain exposures should be treated as CRE Exposures, as also in the light of switching over to Basel-II Framework which has specific provisions relating to such exposures, the definition of CRE Exposure was reviewed and a circular was issued on September 9, 2009. Accordingly, if the repayment primarily depends on other factors such as operating profit from business operations, quality of goods and services, and tourist arrivals, the exposure would not be counted as Commercial Real

Estate. It is possible for an exposure to get classified simultaneously into more than one category, as different classifications are driven by different considerations. In such cases, the exposure would be reckoned for regulatory/ prudential exposure limit, if any, fixed by the Reserve Bank or by the bank itself, for all the categories to which the exposure is assigned. For the purpose of capital adequacy, the largest of the risk weights applicable among all the categories would be applicable for the exposure.

Issue of Preference Shares by Banks

3.75 Guidelines for issuing preference shares as part of regulatory capital was partially modified in April 2009. Part payment of dividend for Perpetual Non-Cumulative Preference Shares (PNCPS) in Tier I Capital and Coupon payment on Perpetual Cumulative Preference Shares/Redeemable Non-Cumulative Preference Shares/ Redeemable Cumulative Preference Shares in Upper Tier II Capital, was permitted by the modification. Further, in September 2009, the banks are permitted to issue subordinated debt as Tier II capital with call and step-up options, subject to certain terms and conditions.

SLR Securities

3.76 In September 2009, the Reserve Bank informed the SCBs including RRBs that the cash management bill will be treated as Government of India Treasury Bill and as such it shall be treated as SLR securities.

Regulations for Primary Dealer (PD) Activities of Banks

3.77 The existing guidelines on issue of subordinated debt stipulates that the interest rate spread of the instrument over the yield of comparable residual maturity of the Government of India dated security at the time of issue shall not exceed 200 basis points. On a review, it has been decided to remove the ceiling on the interest rate spreads at the time of issue of the subordinated instruments by the PDs under Tier II and Tier III capital requirements, with immediate effect. The PDs may, hereinafter, issue subordinated Tier II and Tier III bonds at coupon rates as decided by their Boards of Directors. The banks undertaking PD activities may have to follow these instructions in regard to issue of subordinated debt instruments.

Instalment of Off-site Automatic Teller Machines (ATMs)

3.78 The Reserve Bank, in June 2009, permitted SCBs to install Off-site ATMs at centres/places identified by them, without having the need to take permission from the Reserve Bank in each case. This would, however, be subject to any direction which the Reserve Bank may issue, including for closure/shifting of any such Off-site ATMs, wherever so considered necessary by the Reserve Bank. The banks should report full details of the Off-site ATMs installed by them in terms of the above general permission to the Reserve Bank immediately after operationalisation and in any case not later than two weeks.

Cross-holding of Capital by Banks

3.79 With regard to the cross-holding of capital among banks, in October 2008, the Reserve Bank detailed that the aggregate ‘proprietary’ holdings of a bank and its group entities should be limited to 5 per cent of the investee bank’s paid-up capital. While calculating this 5 per cent limit, the ‘fiduciary’ holdings of an asset management company (AMC) belonging to the group would not be reckoned. The investee bank may contact the Reserve Bank for acknowledgement if the total holdings including fiduciary holdings are more than this limit. Further, the AMC should not exercise voting rights on its holdings in the investee bank and should not have any Board representation in the investee bank.

3.80 The Reserve Bank, in December 2008, advised the banks (UCBs in January 2009) that audit firms should not undertake statutory audit assignment while they are associated with internal assignments in the bank during the same year. In case the firms are associated with internal assignment it should be ensured that they relinquish the internal assignment before accepting the statutory audit assignment during the year.

Risk Weights for Exposures to Corporates, Commercial Real Estate and NBFC-ND-SI

3.81 All unrated claims, long-term as well as short-term, regardless of the amount of claim, on the corporates attract a risk weight of 100 per cent since November 2008 for SCBs. Risk weight on the claims secured by commercial real estate and exposure to systemically important non-deposit taking NBFCs were fixed at 100 per cent both for SCBs and UCBs.

Off-Balance Sheet Exposures of Banks

3.82 The Reserve Bank has initiated several steps in the recent past to strengthen the prudential framework in respect of on-balance sheet exposures of banks. Such measures included additional risk weights and provisioning requirements for exposures to specific sectors. In view of the recent developments in the global financial markets, it was felt necessary to review the current stipulations regarding conversion factors, additional risk weights and provisioning requirements for specific off-balance sheet exposures of banks and prescribe prudential requirements as appropriate. Accordingly, in May 2008, the draft guidelines incorporating the required modifications were put up on the Reserve Bank's website for comments from the public. Based on the feedback received, guidelines were issued in August 2008. These guidelines were discussed in the Report on Trend and Progress of Banking in India 2007-08.

3.83 In October 2008, the Reserve Bank advised the banks that the overdue receivables representing positive mark-to-market value of a derivative contract should be treated as a NPA. Accordingly, as per the existing asset classification norms, all other funded facilities granted to the client shall also be classified as NPA.

3.84 In view of the changed scenario of the banking industry where banks extend long term loans for periods longer than 10 years for various projects, the Reserve Bank in April 2009 allowed banks to issue guarantees for periods beyond 10 years. However, while issuing such guarantees, banks are advised to take into account the impact of very long duration guarantees on their Asset Liability Management. Further, banks may evolve a policy on issuance of guarantees beyond 10 years as considered appropriate with the approval of their Board of Directors.

3.85 It is observed that certain banks, have been issuing guarantees on behalf of corporate entities in respect of non-convertible debentures issued by such entities. In this regard, in May 2009, the Reserve Bank clarified that the extant instructions apply only to loans and not to bonds or debt instruments. Guarantees by the banking system for a corporate bond or any debt instrument not only have significant systemic implications but also impede the development of a genuine corporate debt market. Banks are advised to strictly comply with the extant regulations and in particular, not to provide guarantees or equivalent commitments for issuance of bonds or debt instruments of any kind.

Restructuring of Advances by Banks

3.86 In August 2008, the Reserve Bank issued the revised guidelines on restructuring of advances by banks. While the Reserve Bank advised the banks that they were to restructure the accounts of viable entities classified under 'standard', 'sub-standard' and 'doubtful' categories, it clarified that the banks cannot restructure these accounts with retrospective

effect. The asset classification, income recognition and provisioning norms under the scheme are detailed below:

Asset Classification Norms

3.87 The banks have to follow the usual asset classification norms while the restructuring proposal is under consideration. The asset classification status as on the date of approval of the restructured package by the competent authority would be relevant to decide the asset classification status of the account after restructuring/rescheduling/renegotiation. Before taking up an account for restructuring, the bank may determine financial viability of the account by employing some acceptable viability benchmarks on a case-by-case basis. In the case of non-viable accounts, the banks have to accelerate the process of recovery and cannot initiate the process of restructuring. Any restructuring done without looking into cash flows of the borrower and assessing the viability of the projects/activity financed by banks would be treated as an attempt at ever greening a weak credit facility and would invite supervisory concerns/action. In the case of borrowers classified as wilful defaulters, the bank has to satisfy itself that the borrower is in a position to rectify the wilful default before taking up restructuring. In such cases, restructuring has to be done with the approval of the Board.

3.88 The Reserve Bank specified that the accounts classified as 'standard assets' should be immediately re-classified as 'sub-standard assets' upon restructuring. The NPAs would continue to have the same asset classification as prior to restructuring and slip into further lower asset classification categories as per extant asset classification norms with reference to the pre-restructuring repayment schedule. However, all the accounts classified as NPAs upon restructuring would be eligible for up-gradation to the 'standard' category after observation of 'satisfactory performance' during a period of one year from the date when the first payment of interest or instalment of principal falls due under the terms of restructuring package. However, if the 'satisfactory performance' is not evidenced after this period, the asset classification of the restructured account would be governed as per the applicable prudential norms with reference to the pre-restructuring payment schedule. Further, any additional finance may be treated as 'standard asset' up to a period of one year after the first interest/principal payment whichever is earlier, falls due under the approved restructuring package. However, the interest income on the additional finance, in the case of 'sub-standard' and 'doubtful' pre-restructuring facilities, should be recognised only on cash basis.

Income Recognition Norms

3.89 The interest income in respect of restructured accounts classified as 'standard assets' will be recognised on accrual basis and that in respect of 'NPAs' will be recognised on cash basis, unless specified otherwise.

Provisioning Norms

3.90 Banks have to hold provisions against the restructured advances as per the existing provisioning norms. In addition, the banks have to measure the diminution in the fair value of the advance which may arise on account of reduction in the rate of interest or reschedulement of repayment of principal amount as part of restructuring. Such diminution will have an impact on the bank's market value of equity and is an economic loss for the bank. "The erosion in the fair value of the advance should be computed as the difference between the fair value of the loan before and after restructuring. Fair value of the loan before restructuring will be computed as the present value of cash flows representing the interest at the existing rate charged on the advance before restructuring and the principal, discounted at a rate equal to the bank's BPLR

as on the date of restructuring plus the appropriate term premium and credit risk premium for the borrower category on the date of restructuring". Fair value of the loan after restructuring will be computed as the "present value of cash flows representing the interest at the rate charged on the advance on restructuring and the principal, discounted at a rate equal to the bank's BPLR as on the date of restructuring plus the appropriate term premium and credit risk premium for the borrower category on the date of restructuring". The banks have to make specific provisions for this purpose in addition to the provisions as per existing provisioning norms. Further, this has to be kept in an account distinct from that for normal provisions. The total provision required against an account is capped at 100 per cent of the outstanding debt amount.

Prudential Norms for Conversion of Principal into Debt/Equity

3.91 The debt/equity instruments created by converting a part of the outstanding principal amount will be classified in the same asset category in which the restructured advance has been classified. These instruments should be held under 'available for sale' category and valued as per usual valuation norms.

Prudential Norms for Conversion of Unpaid Interest into 'Funded Interest Term Loan' (FITL), Debt or Equity Instruments

3.92 The FITL/debt or equity instruments created by conversion of unpaid interest will be classified in the same asset classification category in which the restructured advance has been classified. The unrealised income represented by FITL/Debt or equity instrument should have a corresponding credit in an account styled as 'Sundry Liabilities Account (Interest Capitalisation)'. Valuation and provisioning norms would be the same as in the case of conversion of principal into debt/equity.

3.93 In November 2008, the special regulatory treatment was made applicable to housing loans by removing the ceiling of 10 years for the repayment period of the restructured advances. However, the restructured housing loans should be risk weighted with an additional risk weight of 25 percentage points. In December 2008, the special regulatory treatment was extended to commercial real estate exposures which are restructured up to June 30, 2009. Further, in view of the temporary cash flow problems faced even by the viable units, the second restructuring done by banks of exposures up to June 30, 2009 have also made eligible for exceptional/special regulatory treatment as a one-time measure.

3.94 In January 2009, the Reserve Bank extended the exceptional/special regulatory treatment to all the accounts which were standard as on September 1, 2008. However, to avail this extension, the bank has to take up restructuring on or before January 31, 2009 and later extended up to March 31, 2009. Further, the restructuring package had to be put in place within a period of 120 days from the date of taking up the restructuring package. It was further clarified that the cases where the accounts were standard as on September 1, 2008 but slipped to NPA category before 31st March 2009, can be reported as standard as on March 31, 2009 only if the restructuring package is implemented before 31st March 2009 and all conditions prescribed in this regard so far.

3.95 The exceptional/special regulatory treatment was also extended to all 'standard' and 'sub-standard' accounts even where full security cover for working capital term loan (WCTL) is not available. However, this is subject to the conditions that bank keeps adequate provisions for these loans, *i.e.*, 20 per cent for standard assets, 20 per cent during the first year which is increased by 20 per cent every year for sub-standard assets, and 100 per cent for the

unsecured portion of the accounts ineligible for upgradation after the specified period. All these were one-time measures taken by the Reserve Bank applicable to restructuring packages implemented till June 30, 2009.

Risk Management

3.96 Risk management has once again come to the fore in the wake of the on-going global financial crisis. In view of this, the Reserve Bank has been issuing various guidelines on asset classification and provisioning. Several initiatives were taken during the year to strengthen risk management systems in banks such as modification in the provisioning.

Income Recognition, Asset Classification and Provisioning

Asset Classification

3.97 Asset classification norms remained unchanged, except for those applicable to projects under implementation involving time overrun, where the projects pertain to infrastructure. The asset classification norms for infrastructure projects alone were modified with effect from 31 March 2008. Consequently, infrastructure projects should be treated as sub-standard if the date of commencement of commercial production extends beyond a period of two years after the originally envisaged date of completion of the project, as against the earlier stipulation of one year. For the infrastructure projects financed by the banks/ FIs after May 28, 2002, if the date of commencement of commercial production/ operation extends beyond a period of two years after the date of completion of the infrastructure project, as originally envisaged at the time of initial financial closure of the project, the account should be treated as a substandard asset with effect from March 31, 2008. Thus, if a project is approaching the said two-year period, the banks are expected to undertake a viability study of the project to assess its eligibility for restructuring and if necessary, consider restructuring the asset to ensure that the asset quality is maintained.

Provisioning for Standard Assets

3.98 As a countercyclical measure, to mitigate the impact of the current economic slowdown, the provisioning requirements for all types of standard assets were reduced with effect from November 15, 2008, to a uniform level of 0.40 per cent except in the case of direct advances to agricultural and SME sectors, which shall continue to attract a provisioning of 0.25 per cent, as hitherto.

Prudential Treatment of Provisions

3.99 The regulatory norms for provisioning represent the minimum requirement. The banks may voluntarily make specific provisions for NPAs at rates which are higher than the rates prescribed under the existing regulations if such higher rates are based on a policy approved by the Board of Directors to provide for estimated actual loss in collectible amount and the policy is consistently adopted from year to year. In this regard, in March 2009, the Reserve Bank stated that in the case of sale of standard asset, if the sale consideration is higher than the book value, the excess provisions may be credited to the profit and loss account. Further, the SCBs and UCBs can admit the excess provisions arising out of sale of NPAs as Tier II capital subject to the overall ceiling of 1.25 per cent of total risk weighted assets.

3.100 Floating provisions cannot be reversed by credit to the profit and loss account but can only be utilised for making specific provisions in extraordinary circumstances. In August 2009, the Reserve Bank stated that until such utilisation, these provisions can be netted off from gross NPAs to arrive at disclosure of net NPAs, or alternatively, they can be treated as part of Tier II capital within the overall ceiling of 1.25 per cent of total risk weighted assets.

However, this policy will be modified once the on-going work by FSB, BCBS, CGFS and accounting standard setters on measures to mitigate pro-cyclicality including counter cyclical provisioning is finalised.

Prudential Norms on Unsecured Advances

3.101 In order to enhance transparency and ensure correct reflection of the unsecured advances in Schedule 9 of the banks' balance sheet, it was advised in April 2009 that for determining the amount of unsecured advances for reflecting in schedule 9 of the published balance sheet, the rights, licenses, and authorisations, charged to the banks as collateral in respect of projects (including infrastructure projects) financed by them, should not be reckoned as tangible security. Hence such advances shall be reckoned as unsecured. Banks were also advised to disclose the total amount of advances for which intangible securities such as charge over the rights, licenses, and authority, have been taken as also the estimated value of such intangible collateral.

Presence of Foreign Banks in India

3.102 At the end-June 2009, 32 foreign banks were operating in India with 293 branches. Besides, 43 foreign banks were operating in India through representative offices. In February 2005, the Government of India and the Reserve Bank released the 'Roadmap for Presence of Foreign Banks in India' laying out a two-track and gradualist approach aimed at increasing the efficiency and stability of the banking sector in India. One track was the consolidation of the domestic banking system, both in private and public sectors, and the second track was the gradual enhancement of the presence of foreign banks in a synchronised manner. The roadmap was divided into two phases, the first phase spanning the period March 2005 - March 2009, and the second phase beginning April 2009 after a review of the experience gained in the first phase. In view of the current global financial market turmoil, there are uncertainties surrounding the financial strength of banks around the world. Further, the regulatory and supervisory policies at national and international levels are under review. In view of this, it has been decided, for the time being, to continue with the current policy and procedures governing the presence of foreign banks in India. The proposed review will be taken up after due consultation with the stakeholders once there is greater clarity regarding stability, recovery of the global financial system, and a shared understanding on the regulatory and supervisory architecture around the world.

Committee on Financial Sector Assessment

3.103 A self assessment of India's financial sector was carried out by the Committee on Financial Sector Assessment (CFSA) (Chairman: Dr. Rakesh Mohan) set up by the Government of India and the Reserve Bank in September 2006. The Committee submitted its Report in March 2009. This self assessment is motivated by the desire to ensure compatibility of the Indian financial sector with international standards and assess its overall stability. The financial assessment process is based on three, mutually reinforcing pillars: Pillar I (Financial stability assessment and stress testing), Pillar II (issues relating to the institutional and legal infrastructure) and Pillar III (assessment of financial standards and codes). To conduct the independent and impartial assessment, four independent Advisory Panels were appointed. The reports put forward by these Advisory Panels, *inter alia*, identified gaps in adherence to international standards and codes, and suggested possible policy actions. These advisory panel reports were also peer reviewed by reputed international experts in the field. These independent reviews have further ensured an objective and impartial assessment. The Committee's observations regarding the commercial banking system in India is provided in the Box III.7.

Box III.7: Observations of CFSA regarding the Commercial Banking System in India

Based on the stability assessment and stress testing of the financial institutions, the CFSA has found that commercial banking system in India is broadly sound. While the banks were generally in a position to absorb significant shocks due to credit, liquidity and market risks, there were some concerns relating to liquidity risk due to increasing illiquidity in banks' balance sheets. There is, therefore, a need to strengthen liquidity management. Looking forward, the stress tests need to be conducted on a more systemic basis, to capture second round and contagion risks.

The Government ownership of commercial banks poses dilemmas as it has been argued that this could lead to a conflict of roles and regulatory forbearance. The possibility of conflicts of interest could be minimised through even-handed regulation which has been the case in India. Also, the cost of recapitalisation of Indian PSBs has also been relatively low.

The Government has, in the past, consistently shown willingness to contribute capital and the growth of PSBs has so far not been constrained because of lack of capital. But, capital augmentation of these banks in future could be a challenge. This could be managed through a variety of ways, such as, amalgamation where commercial synergies exist, raising capital through newer instruments (like issuance of perpetual preference shares in foreign currency). If no other alternative is available, there could be case for selective dilution of government equity which would require amendment of existing legislation.

There is a need for capacity building in the commercial banking sector with accent on training, succession planning, lateral recruitment and improved remuneration (particularly for public sector banks) while at the same time discouraging excessive risk-taking through an appropriate and balanced incentives structure. A well considered approach for entry of foreign banks in India needs to be followed, while adhering to the WTO commitment and norms. Recommending that competition must be encouraged, CFSA has advised encouraging market-based consolidation of banks.

The CFSA notes that the power of the Competition Commission regarding combination could result in delay of amalgamation of banks. Also, certain provisions in the Competition (Amendment) Act 2007 may result in regulatory overlaps and conflicts between the Commission and the statutory regulatory authorities. In the view of CFSA, Central Government could give necessary exemption under Section 54 of the Competition (Amendment) Act 2007 in respect of banks to avoid regulatory conflicts.

The CFSA highlights risk management as a priority area and notes that the counter-cyclical prudential norms imposed by the Reserve Bank have paid dividends in the recent times. It highlights the growing requirement of appropriate accounting and disclosure norms, particularly with regard to derivatives transactions as well as better management of liquidity risk. In this context, the report recommends earmarking a specific capital charge if dependence on purchased liquidity by a commercial bank goes beyond a threshold.

6. Supervision and Supervisory Policy

3.104 Supervision of financial entities presumes equal importance as regulation, since it will ensure compliance with the various regulatory policies prescribed by the Reserve Bank towards strengthening the banking system and maintaining financial stability. The Board for Financial Supervision (BFS) was constituted in 1994 to provide undivided attention to the supervision of financial entities. Some of the major issues dealt with by the BFS during 2008-09 included frauds monitoring, supervision of overseas operations of banks, supervision of financial conglomerates, among others (also see Annex III.1).

Supervision of Overseas Operations of Indian Banks

3.105 At present, supervision of overseas operation of Indian banks, both on and off site, is broadly done based on the recommendations of informal Working Group on supervision of foreign branches of Indian banks. The various supervisory tools presently being used by the Reserve Bank to exercise oversight on the bank's overseas operations are as follows.

Off-site Monitoring

3.106 There are seven quarterly DSB (O) returns which are submitted by banks under Section 27 (2) of Banking Regulation Act, 1949. They primarily cover the financial aspects of the position of overseas branches, *viz.*, Assets, Liabilities and Off-balance Sheet Exposures, Structural Liquidity, Problem Credits and Investments, Large Exposures, Country Exposure and Maturity, Profitability and Frauds.

3.107 In terms of extant guidelines, banks submit a quarterly report by way of D.O. letter, addressed to the Executive Director in charge of banking supervision and regulation, covering the developments during the quarter with focus on the working of the overseas branches. It covers areas such as changes in the regulatory framework affecting the banks, details of any non-compliance with the host country regulations indicating the circumstances under which the noncompliance has occurred, business environment, credit and control areas, instances of frauds/serious irregularities, major features brought out in the audit/inspection reports and action to be taken/proposed to be taken to set right the matters.

3.108 In some cases, inspection reports/ratings assigned to the branches of Indian banks are received from some host country regulators/ supervisors. Compliance Officers of banks are also required to report incidents of overseas regulatory violations and related issues to their Board of Directors and to the Reserve Bank on a monthly basis and submit a nil report even in cases where there is no such violation. During financial inspection of Indian banks, their overseas operations are examined on the basis of records available at the Head Office. The Reserve Bank also keeps a watch on the developments reported in the press.

On-site Inspection

3.109 On-site inspection of the overseas branches is taken up occasionally by the Reserve Bank based on need. The present supervisory framework for overseas operation of Indian banks predominantly rests on off-site monitoring and the system for on-site inspection has not been formally articulated in detail. Taking into consideration the increasing size and complexity of both on and off balance sheet items, a need was felt to examine the existing supervisory and regulatory framework relating to overseas operations of Indian banks. Accordingly, in the Annual Policy statement of 2008-09, constitution of two Working Groups was announced, one to lay down road map for adoption of a suitable framework for cross-border supervision and supervisory cooperation with overseas regulators including the legal issues, and the other on review of regulatory and supervisory framework for overseas operations of Indian banks, including those of off-site reporting system.

3.110 The Reserve Bank in December 2008 advised the banks that if their foreign branches and subsidiaries are undertaking an activity which is not permitted under the BR Act/the respective statute of the PSB, they have to obtain necessary permission under Section 6 (1) (m) or 19 (1) (c), as the case may be, from the Reserve Bank/Government of India for undertaking such activities. Further, no prior approval from the Reserve Bank would be required if these branches and subsidiaries are transacting in plain-vanilla financial products, even if these products are not available in the Indian market and on which no specific prohibition has been currently placed by the Reserve Bank. However, the banks have to seek specific guidance from the Reserve Bank, if the extant prudential norms do not specify prudential treatment of these financial products. These products would attract the prudential norms such as capital adequacy, credit exposure, periodical valuation, and all other applicable norms. The banks should also report these exposures in the extant off-site returns furnished to the Reserve Bank. On the other hand, the banks have to obtain prior approval from the Reserve Bank, if their branches and subsidiaries propose to handle structured financial products. In such cases the banks have to furnish full particulars of these products, including the regulatory prescriptions by the host-country regulators as also the risk management systems in place in the branch/ subsidiary to deal with such products, to the Reserve Bank.

3.111 In December 2008, the Reserve Bank clarified that if the banks are resorting to off-shore outsourcing of financial services relating to Indian operations, they have to make sure that the off-shore service provider is a regulated entity, the relevant off-shore regulator will neither obstruct the arrangement nor object to the Reserve Bank's inspection visits/visits of banks internal and external auditors. Further, the regulatory authority of the offshore location should not have access to the data relating to Indian operations of the bank and the jurisdiction of the courts in the off shore location where data is maintained should not extend to the operations of the bank in India simply on the ground that the processing is being undertaken there (not applicable if off shore processing is done in the home country of the bank). Moreover, the banks have to maintain the original records in India. In April 2009, banks are further advised to submit an Annual Compliance Certificate giving the particulars of outsourcing contracts, the prescribed periodicity of audit by internal/ external auditor, major findings of the audit and action taken through Board to the Reserve Bank.

Consolidated Supervision and Financial Conglomerate (FC) Monitoring Mechanism

3.112 In India, Financial Conglomerates (FC) Monitoring Mechanism is in place since June 2004 following the acceptance of the recommendations of the Working Group (Convenor: Smt. Shyamala Gopinath) on monitoring of Systemically Important Financial Intermediaries. The existing FC monitoring framework primarily has two major components – (i) off-site surveillance through receipt of quarterly returns and (ii) half-yearly discussions with the Chief Executive Officers of the major entities of the FC in association with other principal regulators. The quarterly reporting mechanism focuses on monitoring of intra-group transactions and exposures (ITEs) appearing in the books of the regulated entities. The intra-group transactions are monitored with a view to tracking migration/transfer of 'losses', detecting regulatory/supervisory arbitrage situations and identifying cases of non-compliance with arms length principles. The monitoring of ITEs also helps in tracking of build-up of large exposures to entities within the Group, to outside counterparties and to various financial market segments (equity, debt, money market, and derivatives market).

Recent Supervisory Initiatives for Financial Conglomerates Supervision

3.113 In terms of BFS directions, an Internal Group was constituted in the Reserve Bank to recommend a framework for FC Supervision. The recommendations made by the Internal Group as part of its Report on Financial Conglomerates Supervision were examined in the Bank and final recommendations were placed before the BFS for considerations. The BFS has accepted the recommendations and directed to implement the same. The recommendations made by the Internal Group are covered under two sub-heads – i) those pertaining to the FCs led by banks and ii) those pertaining to FCs led by non-banks. While the set of recommendations applicable to the FCs led by banks would be implemented by issuing necessary guidelines/directives by the Reserve Bank, for other FCs, the recommendations would be made applicable with due concurrence of the Technical Committee of the Reserve Bank regulated entities, which is an inter-regulatory forum.

3.114 The Group has emphasised the need for developing a clear understanding of the FCs' operations including changes in its risk profile, 'material' intra-group transactions and risk concentrations, efficacy of the risk management systems, and quality of governance systems. Accordingly, the Group has recommended putting in place a system of 'close and continuous' supervision of the banking conglomerates by integrating on-site and off-site

supervision processes covering bank specific supervision, consolidated supervision of 'banking group' and conglomerate supervision of the identified FCs within a separate division in the Department of Banking Supervision. The other recommendations made by the Group focus on greater/sharper emphasis on Risk Management Systems and Governance Framework for the FCs including application of 'fit and proper' principles, management of risks arising out of ITEs and credit concentrations covering both banking and non-banking conglomerates.

Risk Management Systems and Governance Framework

3.115 The Group has recommended capital adequacy assessment on a conglomerate-wide basis for the banking conglomerates broadly in line with consolidated capital adequacy assessment process. The parent bank/lead entity may be encouraged to put in place a governance framework to enable the Board and senior management team to obtain a comprehensive view of its group-wide activities, resources and risks. While the Group has left the decision on an appropriate group-wide governance framework to the individual FCs and their Principal Regulators themselves, it has recommended certain high-level principles that the conglomerates may adhere to as part of best practices. The Group has also made recommendations for strengthening the existing working arrangements amongst supervisors including provisions for quarterly regulatory discussions.

Development in Monitoring of Frauds in Banks

Cautioning Banks against Intermediaries Involved in Frauds

3.116 With the increase in the retail loans portfolio of banks in recent years, there has been a steady rise in frauds reported in this segment. An analysis of the trend showed that such frauds were perpetrated to a large extent with the help of intermediaries and third party service providers such as lawyers, valuers, chartered accountants, statutory auditors, real estate agents, real estate developers, builders, warehouse owners, motor vehicle dealers, agricultural equipment dealers, and travel agents. With a view to taking deterrent action against such unscrupulous intermediaries who aid the perpetration of frauds jeopardising the interests of banks, it was decided that banks would advise the IBA the names of such entities so that IBA could prepare a caution list for circulation amongst the member banks. The banks would now forward names of such intermediaries including professionals involved in frauds to IBA after satisfying themselves of the involvement of the third parties concerned and after providing them with an opportunity of being heard. In this regard, the banks have been advised to follow a formal procedure and the process followed should be suitably recorded.

Special Monitoring Mechanism for Banks Identified as Outliers on account of High Concentration of Frauds

3.117 The Board for Financial Supervision (BFS) directed that a 'Special Monitoring Mechanism' should be put in place for outlier banks. As per the directions, the Reserve Bank is in the process of introducing a mechanism for identification of outlier banks. For this purpose first the "Residual Operational Risk" on gross basis would be assessed taking into account the trend in incidents of frauds and concentration of frauds, in the banks over a given period of time. Thereafter, it would be netted for arriving at the "Net Residual Operational Risk" taking into account the recoveries made, punitive action taken against staff involved and other steps taken by the bank with regard to the fraud. In tune with this, guidelines are being framed to ensure that the incidences of frauds are factored in while

carrying out Supervisory Review and Evaluation Process (SREP) in the banks for the purpose of assessing the "Fraud Risk" in specific and "Residual Operational Risk" in general. This aspect will, henceforth, be covered in the Quarterly Discussions with the banks as also the AFI meetings with them. Similarly, necessary modifications in relevant parameters are being carried out in the Systems and Controls component of CAMELS (capital, asset, management, earnings, liquidity and systems) rating framework which would reflect the status of the bank as an outlier or not based on incidences of frauds and the strength/ weaknesses of banks' associated systems and controls. Based on the parameters banks would be categorised as outlier banks. Once they are categorised as outliers, the relevant information with regard to those banks would be conveyed to the Reserve Bank for regulatory response, if any.

Report of the High Level Group on Systems and Procedures for Currency Distribution

3.118 In July 2008, the Special Task Force of the Uttar Pradesh Police seized a large number of counterfeit notes in Rs.500 and Rs.1,000 denomination. In order to address the systemic concerns thrown-up by this incident, the Reserve Bank constituted a High Level Group (Chairman: Smt.Usha Thorat) in August 2008 to review the existing arrangements for stocking and distribution of currency notes with a view to enhancing the integrity and efficiency of the systems and procedures, and suggest appropriate measures (Box III.8).

Closure of Fraud Cases - Relaxation in the Existing Norms

3.119 Banks report cases of fraud to the Reserve Bank which monitors such cases on a regular basis. Such cases can be closed by banks only after cases pending with CBI/Police/ Court have been finally disposed off, staff accountability has been completed, insurance claim wherever applicable has been settled, amount of fraud has been recovered or written off and bank has reviewed the systems and procedures, identified the causative factors, plugged the lacunae and the relative facts have been certified by appropriate authority (Board/ Audit Committee of the Board). On a review, it was decided to allow banks to close the old cases of fraud in which all actions at their end had been completed except investigation by CBI /Police or where court cases filed by these agencies but were still pending in courts of law for several years. It has been decided that banks would be allowed, for limited statistical/ reporting purposes, to close those fraud cases involving up to Rs.25 lakh where the investigation is on or challan/charge sheet not filed in the Court for more than three years from the date of filing of First Information Report by the CBI/Police or the trial courts after filing of charge sheet/challan by CBI/Police, has not started or is in progress subject to fulfillment of other conditions. However, the banks are required to maintain all records pertaining to all such closed cases in a separate system till they are finally decided by the Legal System in India.

Multiple Finance of Housing Loans against the Same Property

3.120 In recent times, incidence of fraud in housing loan sector through registration of mortgage of same property at different Sub-Registrar's office has been reported by several banks. One of the most common *modus operandi* adopted by the fraudsters is to submit fake title deeds in respect of same immovable property for availing multiple-finance. In this context, while granting finance to specific housing/development projects, SCBs including RRBs are advised to stipulate the following as a part of the terms and conditions: (i) the builder/developer/company would disclose in the Pamphlets/Brochures the name(s) of the bank(s) to which the property is mortgaged, (ii) the builder/developer/company would append the information relating to mortgage while publishing advertisement of

Box.III.8: Report of the High Level Group on Systems and Procedures for Currency Distribution – Summary of Recommendations

The Group submitted its Report in August 2009. After detailed deliberations and interaction with major banks, leading manufacturers and suppliers of Note Sorting Machines (NSMs)/Desktop Sorters as well as Cash-in-Transit (CIT) companies, the Group made recommendations mainly in four areas, *viz*., measures for facilitating detection of counterfeit notes and maintaining quality of notes in circulation, measures relating to cash holding and distribution, measures for strengthening security systems and procedures, and measures for developing human resources.

Measures for Facilitating Detection of Counterfeit Notes and Maintaining Quality of Notes in Circulation

The Group recommended that the NSMs/Desktop Sorters may be installed in all bank branches in a phased manner for early detection of counterfeit notes. Banks may switch over to the 'cassette swap' system for feeding the ATMs. New ATMs installed may be provided with in built note detectors. Over a period existing ATMs may also be required to have in built note detectors. Performance parameters of NSMs may be standardised by the Reserve Bank to ensure that all NSMs installed adhere to the laid down standards for detection of counterfeit notes. The Reserve Bank may ensure that the plan for withdrawal of notes of old series is implemented strictly as formulated and that the new series of banknotes with more robust security features be introduced as early as possible. The Reserve Bank may also facilitate R and D efforts for development of new security features. Where any person inadvertently in possession of counterfeit notes up to five pieces tenders the same at a bank counter, the requirement of filing FIR may be done away with. A simple report may be filed with the branch which in turn may include this in the Counterfeit Currency Report (CCR) to FIU-IND/Reserve Bank. The Reserve Bank may review the system of incentives and disincentives for detection and disclosure of counterfeit notes while assisting the enforcement agencies in dealing appropriately with those involved in making and distribution of counterfeit notes.

Measures Relating to Cash Holding and Distribution

The Reserve Bank may stipulate suitable cash holding limits for all currency chests beyond which the cash should necessarily be moved to a chest with larger limits or to the Reserve Bank. Each Reserve Bank office may undertake a review of the requirement of currency chests in their jurisdiction based on the volume and nature of transactions, accessibility of the chest and other factors including security so as to rationalise the number of chests and upgrade the facilities thereat for better security and efficiency. To tap advantages arising out of economies of scale, minimise overnight cash risks at bank branches and to benefit from sophisticated logistics techniques banks may be encouraged to establish Currency Processing Centres, which should be permitted to charge other banks for processing services. As NSMs have to be installed at all branches for sorting notes before dispensation, banks will have to make necessary investments. The cost of such investments will need to be recovered from the bulk tenderers of cash. Banks may put in place a transparent policy for such charges of cash handling/processing with the approval of their respective boards as already advised by the Reserve Bank. The Reserve Bank may take initiatives in promoting use of cards and electronic means of payment.

Measures for Strengthening Security Systems and Procedures

The Reserve Bank may explore enlisting the services of a specialised and dedicated force/other approved agencies to provide security at chests and for movement of treasure. The Reserve Bank may explore upgradation of the security systems in currency chests and the Reserve Bank vaults incorporating electronic bio-metric access, electronic locking of bins, and surveillance through Closed Circuit Television (CCTVs). Networking of CCTVs at chests within the jurisdiction of a controlling office of the bank may be explored for better surveillance. Tamper-proof shrink wrapping of soiled notes with bar coding of details of the branch remitting them may be introduced. A system of quarterly security audit of currency chest branches by controlling offices may be introduced. Comprehensive guideline/format may be prepared by the Reserve Bank/IBA. A system of risk based inspection of currency chests may be introduced by banks/the Reserve Bank taking into account various parameters for evaluating the extent of risk. Banks may draw up a contingency plan/disaster management plan in consultation with local police. The Reserve Bank may explore the possibility of introducing a defacing system of self inking/marking of banknotes in transit or in chests, which would automatically trigger-in if there is an attack/attempted robbery/theft.

Measures for Developing Human Resources

Banks may modify their transfer pricing policy or equivalent policy so as to pass on the benefit on account of having a currency chest to the branch where the chest is maintained. Rotation of staff posted at currency chests may be ensured to prevent vested interest and entrenched non adherence of laid down systems and procedures. Where deviations and irregularities are found, controlling offices may take immediate punitive action after fixing accountability. Bank may accord recognition to currency handling operations as a sensitive and skilled activity and provide necessary incentives and training.

particular scheme in newspapers/magazines, and (iii) the builder/developer/company would indicate in the Pamphlets/Brochures that they would provide No Objection Certificate (NOC)/ permission of the mortgage bank for sale of flats/ property, if required.

Consortium/Multiple Banking Arrangements

3.121 In view of frauds being reported against borrowers enjoying credit facilities under 'multiple banking arrangement', the banks were advised to put in place an arrangement to share information regarding such fraudsters. All the banks which have financed a borrower under consortium/'multiple banking' arrangements should take co-ordinated action, based on commonly agreed strategy, for legal/criminal actions, follow up for recovery, exchange of details on *modus operandi*, achieving consistency in data/information on frauds reported to the Reserve Bank. Preferably, the co-ordination efforts should be driven by the bank which detects the fraud first or by the bank which has the maximum exposure, depending on circumstances. Further, the consortium leader should take the lead role in monitoring the unhedged foreign exchange exposures of clients as per the norms prescribed by the Reserve Bank on the matter. The UCBs were also advised in January 2009 to take due diligence while lending under consortium/multiple banking arrangements.

7. Regional Rural Banks

3.122 The RRBs have a special place in ensuring financial inclusion on the one hand and adequate credit flow to agriculture and the rural sector, on the other. RRBs are also opening 'no frill' accounts with zero or low minimum balance and have been advised to explore the provision of small clean overdraft facility in such accounts without any linkage to purpose. They are also issuing General Purpose Credit Cards and have been allowed to use the services of Non-Governmental Organisations/Self Help Groups/Micro Finance Institutions/and other Civil Society Organisations as intermediaries in providing financial and banking services through the use of BF and BC models. RRBs formed an important plank of the package of policies announced by the Government of India in June 2004 for doubling the credit by banks to the agricultural sector in three years. Understanding the importance of RRBs, the Reserve Bank has been taking various measures to strengthen them as well as to improve their performance. Several initiatives were also taken to facilitate the diversification of their business operation into new areas. The recent policy initiatives on RRBs include recapitalisation and amalgamation of RRBs, liberalised branch licensing policy and technology upgradation of RRBs, among others.

Recapitalisation and Amalgamation of RRBs

3.123 The process of consolidation through amalgamation of RRBs is now almost complete, resulting in a decline in the total number of RRBs to 84 as on August 31, 2009 (which includes a new RRB set up in the Union Territory of Puducherry). The process of recapitalisation of RRBs with negative net worth as on March 31, 2007 is also almost complete, with 27 RRBs fully recapitalised with an amount of Rs.1,796 crore as on July 31, 2009.

Liberalisation of Branch Licensing Norms for Expansion of RRBs

3.124 In pursuance of the announcement made in the Annual Policy Statement for the year 2006-07, the procedure for licensing of branches of RRBs was simplified and the work relating thereto was delegated to Empowered Committees set up at Regional Offices since June 13, 2006. Certain measures were taken to further liberalise the branch licensing policy for RRBs. These include relaxation of conditions for opening branches in hitherto uncovered

districts and opening of service branches/ Central Processing Centres/Back Offices. In order to give further impetus to branch expansion programmes of RRBs, and as announced in the Mid-Term Review of the Annual Policy Statement for the year 2008-09, the RRBs have been allowed greater flexibility in opening new branches as long as they fulfill the following conditions to become eligible for opening of new branch/es: (i) It should not have defaulted in maintenance of SLR and CRR during the last two years, and (ii) It should be making operational profits, its net worth should show improvement and its net NPA ratio should not exceed 8 per cent.

3.125 During the financial year 2008-09, the Reserve Bank has granted 785 licences to RRBs for opening branches, of which 734 were opened. Various policy initiatives taken by the Reserve Bank and NABARD to facilitate diversification of their business operations into new areas and to make RRBs stronger, viable and self- supporting, have started showing results. Now RRBs are venturing into new areas by opening currency chests, accepting FCNR (B) deposits and opening NRE/NRO accounts, taking agency work in distribution of insurance and mutual fund products, and providing locker facility, and in the process, earning non-fund income.

3.126 In order to strengthen the capital structure of RRBs as also in the context of financial stability of the whole system, and pursuant to the announcement made in the Mid-Term Review of the Annual Policy Statement for the year 2007-08, RRBs were advised to disclose the level of capital to risk weighted assets ratio (CRAR) as on March 31, 2008 in their Balance Sheets and thereafter every year as 'Notes on Accounts' to their Balance Sheets. The CFSA (Chairman: Dr. Rakesh Mohan and Co-Chairman: Shri Ashok Chawla) has suggested a phased introduction of CRAR in the case of RRBs, along with the recapitalisation of RRBs after consolidation of these entities. It has, therefore, been announced in the Annual Policy Statement for the year 2009-10 to introduce CRAR for RRBs in a phased manner, taking into account the status of recapitalisation and amalgamation. In order to bring the CRAR of RRBs to at least 9 per cent in a time bound manner, the Government of India has constituted a Committee (Chairman: Dr. K. C. Chakrabarty) to study the current levels of CRAR of RRBs and suggest a roadmap for achieving CRAR of 9 per cent by March 2012 and accordingly also suggest the required capital structure for RRBs given their business level so that their CRAR is sustainable and provides for future growth and compliance with regulatory requirements. The Committee is required to submit its report within three months.

Working Group on Technology Upgradation of Regional Rural Banks

3.127 In order to prepare the RRBs to adopt appropriate technology and migrate to core banking solutions (CBS) for better customer services, a Working Group (Chairman: Shri G. Srinivasan) was constituted in December 2007 to prepare a roadmap for migration to CBS by the RRBs. The Working Group submitted its Report in August 2008. The Working Group reviewed the present status of computerisation in RRBs and viewed that RRBs could not remain isolated from the technological developments sweeping the banking sector and that the "one strategy fits all" approach is not workable. The Group also examined the use of solar power as an alternative source of energy for powering branches located in remote places and suggested that although heavy initial cost was involved in installation of solar power units, the long-term benefits would justify powering branches through solar power. The Report, among other things, set September 2011 as the target for all RRBs to move towards CBS, with all branches of RRBs opened after September 2009 to be CBS compliant from day one. The Report was forwarded to all sponsor banks to take necessary action. The issue of sharing the funding cost of CBS project among the owners

of RRBs, *viz*., the Government of India, the State Governments and sponsor banks, is under examination in consultation with the NABARD.

Working Group to Recommend Modalities of Providing Financial Assistance to RRBs for Defraying part of their Initial Cost in Implementing ICT Based Solutions

3.128 A Working Group (Chairman: Shri G. Padmanadbhan) was constituted in November 2007 to explore various affordable ICT-based solutions suitable for RRBs and to identify the cost elements and recommend the manner and criteria for funding such ICT solutions. The Group submitted its Report in August 2008. The Group examined the existing constraints (both financial and infrastructural) in initiating financial inclusion initiatives by RRBs for identifying their menu of requirements. It has also explored the various available technology options and models necessary to achieve financial inclusion by the RRBs. After assessing the various cost elements involved in the process of ICT-enablement, the Group has suggested modalities of the Reserve Bank support to finance ICT solutions for the RRBs. The Group's Report was placed on the Reserve Bank's website in August 2008 for comments from public. It was announced in the Annual Policy Statement for the year 2009-10 that a scheme will be worked out, in consultation with NABARD, the manner of providing assistance to RRBs adopting ICT solutions for financial inclusion in districts identified as having high level of exclusion by the Committee on Financial Inclusion. On examination, it was felt appropriate that ICT implementation would have to be preceded by CBS implementation. The matter of implementation of CBS in RRBs is being pursued with the sponsor banks.

Classification of Investment by RRBs

3.129 The exemption granted to RRBs up to the financial year 2007-08 from 'mark to market' norms in respect of their investments in SLR securities has been extended by one more year, *i.e.*, for the financial year 2008-09. Accordingly, RRBs will have the freedom to classify their entire investment portfolio of SLR securities under 'Held to Maturity' category for the financial year 2008-09 with valuation on book value basis and amortisation of premium, if any, over the remaining life of securities.

Inter-Bank Participation Certificate

3.130 The Reserve Bank allowed the RRBs in August 2009 to issue Inter-Bank Participation Certificate of a tenor of 180 days on risk sharing basis to SCBs against their priority sector advances in excess of 60 per cent of their outstanding advances. This will help them to tide over their short-term liquidity problems.

8. Cooperative Banks

3.131 The cooperative banking sector, consisting of both Urban Cooperative Banks (UCBs) and rural credit cooperatives, are the oldest *albeit* weak segment of the Indian banking system. These institutions, if financially strengthened, have the potential to become an important instrument for achieving 100 per cent financial inclusion owing to their widespread geographical penetration. The Reserve Bank and the NABARD have taken various policy measures in respect of UCBs and rural credit cooperatives during the recent years to bring them on par with commercial banks in terms of financial soundness.

Urban Cooperative Banks

3.132 The major policy initiatives in the UCB sector during the recent years include implementation of the Vision Document - 2005, initiatives for financial restructuring and asset liability management.

Vision Document - 2005

3.133 The Vision Document – 2005, the most important structural initiative undertaken by the Reserve Bank, primarily aims at addressing

the issue of dual regulatory control of the Reserve Bank and State Governments over the UCB sector. In line with the recommendations of Document, the Government of India (for multi-State UCBs) and various State Governments (for single-State UCBs) entered into Memoranda of Understanding (MoUs) with the Reserve Bank. The progress of the implementation of the Vision Document continued satisfactorily during the year 2008-09. With the addition of two States, *viz*., Orissa and Jharkhand, and the Union Territory (UT) of Puducherry signing MoUs with the Reserve Bank, the total number of States/UTs who have signed MoUs increased to 26 by end-July 2009 (also see Box V.1 in Chapter V).

3.134 Following the recommendation of the Vision Document, the MoUs were followed by the constitution of a State level Task Force for Cooperative Urban Banks (TAFCUB) in order to identify the viable and non-viable UCBs in the concerned States and suggest time bound plans for the revival of the viable UCBs while making way for a non-disruptive exit for the non-viable entities.

3.135 Since June 2005, TAFCUBs have been formed in all the 26 States, which have entered into MoU with the Reserve Bank. The process of consolidation has received an impetus with the Reserve Bank issuing transparent and objective guidelines for granting 'no-objection' to merger proposals of UCBs. These guidelines aim at streamlining the process of mergers by specifying the exact requirements and procedure to be adopted by the concerned UCBs. While considering proposals for merger/amalgamation, the Reserve Bank confines its approval to the financial aspects of the merger taking into consideration the interests of depositors and financial stability. The considerations of depositors' interests and financial stability are evident from the fact that of the 71 UCBs which were merged, 50 (70.4 per cent) were in Grade IV followed by nine UCBs in Grade III, eight UCBs in Grade I and four in Grade II (Box III.9).

UCBs with Negative Net Worth

3.136 With a view to strengthening the UCB sector as a whole, merger or amalgamation of UCBs was going on in the sector since 2005. As per the extant instructions, the acquirer bank is expected to protect the deposits of the acquired bank either on its own or with upfront financial support from State Governments. However, in January 2009, it has been decided that in legacy cases pertaining to UCBs having negative net worth as on March 31, 2007, the Reserve Bank may also consider scheme of amalgamation that provides for payment to depositors under Section 16(2) of the Deposit Insurance and Credit Guarantee Corporation Act, 1961, financial contribution by the transferee bank and sacrifice by large depositors.

3.137 The merging of weak and non-viable UCBs with stronger UCBs provided a non-disruptive exit route for non-viable UCBs during the recent years. However, it is observed that wherever the deposit erosion is large, even the financially stronger banks are not willing to acquire the weaker ones. In this context, the Reserve Bank adopted financial restructuring as an additional option for resolution of UCBs having negative net worth and large erosion in deposit base, subject to certain norms. These norms are discussed in detail in the Report on Trend and Progress of Banking in India 2007-08.

Innovative Options for Augmenting Capital

3.138 The Reserve Bank has been adopting several structural initiatives to help UCBs strengthen their capital base. In line with these initiatives, on July 15, 2008, the Reserve Bank permitted the UCBs to issue preference shares, *viz*., Perpetual Non-Cumulative preference shares (PNCPS), Perpetual Cumulative preference shares (PCPS), Redeemable Non-Cumulative preference shares (RNCPS) and

Box III.9: Consolidation and Strengthening of the UCB Sector

The consolidation of the sector through the process of merger of weak entities with stronger ones has been set in motion by providing transparent and objective guidelines for granting no-objection to merger proposals. The Reserve Bank, while considering proposals for merger/amalgamation, confines its approval to the financial aspects of the merger taking into consideration the interests of depositors and financial stability. Almost invariably it is a voluntary decision of the banks that approach the Reserve Bank for obtaining no objection for their merger proposal. The guidelines on mergers are intended to facilitate the process by delineating the pre-requisites and steps to be taken for merger between banks.

Pursuant to the issue of guidelines on merger of UCBs, the Reserve Bank received 128 proposals for merger in respect of 113 banks. The Reserve Bank has issued no objection certificate (NOC) in 89 cases. Of these, 72 mergers became effective upon the issue of statutory orders by the Central Registrar of Co-operative Societies (CRCS)/Registrar of Co-operative Societies (RCS) concerned. Twenty two proposals for merger were rejected by the Reserve Bank, four proposals were withdrawn by the banks and the remaining 13 are under consideration (Table 1 and 2). Out of the 72 banks for which orders of merger have been received from the RCS/CRCS, 45 were having negative net worth. The profit making banks were also permitted to merge with the aim of consolidation and strengthening the sector and in some cases as they were not considered viable on a stand-alone basis in the long run.

Table 1: State-wise Break up of Acquirer Banks
(as at end-September, 2009)

Sr. No.	Multi State/State	No. of acquirer banks	No. of proposals submitted	No. of NOC issued	No. of proposals withdrawn	No. of proposals under consideration	No. of proposals rejected
1	Multi-State	13	61	46	2	4	9
2	Maharashtra	18	30	16	-	5	9
3	Gujarat	6	14	11	1	1	1
4	Andhra Pradesh	7	8	6	-	2	-
5	Karnataka	3	4	3	-	-	1
6	Rajasthan	2	3	1	-	1	1
7	Punjab	1	1	1	-	-	-
8	Uttarakhand	2	3	2	1	-	-
9	Madhya Pradesh	2	3	2	-	-	1
10	Chhattisgarh	1	1	1	-	-	-
	Total	**55**	**128**	**89**	**4**	**13**	**22**

Table 2: State-wise Break-up of Target Banks
(as at end-September, 2009)

Sr. No.	Multi-State/State	No. of target banks	No. of proposals submitted	No. of NOC issued	No. of banks merged	No. of proposals withdrawn	Proposals under consideration	Proposals rejected
1	Multi-State	1	1	1	1	-	-	-
2	Maharashtra	50	57	34	27	2	8	13
3	Gujarat	30	34	28	20	1	3	2
4	Andhra Pradesh	12	12	10	9	-	2	-
5	Karnataka	6	8	6	6	-	-	2
6	Goa	1	1	1	1	-	-	-
7	Rajasthan	1	1	-	-	-	-	1
8	Delhi	1	1	-	-	-	-	1
9	Punjab	1	1	1	1	-	-	-
10	Madhya Pradesh	7	8	5	4	-	-	3
11	Uttarakhand	2	3	2	2	1	-	-
12	Chhattisgarh	1	1	1	1	-	-	-
	Total	**113**	**128**	**89**	**72**	**4**	**13**	**22**

Redeemable Cumulative preference shares (RCPS). As an additional instrument, UCBs were also permitted to raise long term deposits for a minimum period of not less than 5 years. The details are discussed in the Report on Trend and Progress of Banking in India 2007-08.

Cash Reserve Ratio

3.139 The Reserve Bank successively brought down the CRR since October 2008 following the deepening of the global financial crisis. The Cash Reserve Ratio for scheduled UCBs (as well as for scheduled StCBs) is kept at the same level as that for SCBs. With effect from January 17, 2009, the ratio stands at 5.0 per cent.

3.140 In January 2009, in view of the representations received from the urban banking sector with regard to the non-eligibility of the balance maintained by them in current account with Industrial Development Bank of India (IDBI) Bank Ltd. for the purpose of CRR/ SLR, the Reserve Bank reviewed the existing policy and advised the UCBs that they are exempted from the obligation of maintenance of CRR under section 18 or assets in the form of cash, gold or unencumbered approved securities under section 24 (read with section 56 of the Banking Regulation Act, 1949), to the extent of the amounts deposited by them with IDBI Bank Limited, in current account.

Statutory Liquidity Ratio

3.141 The Reserve Bank revised the Statutory Liquidity Ratio (SLR) to be maintained in the form of Government and other approved securities by non-scheduled UCBs in November 2008 in the following manner: (i) Non-scheduled UCBs in Tier I were asked to maintain SLR in the form of Government and other approved securities not less than 7.5 per cent of their NDTL by September 30, 2009 and 15.0 per cent by March 31, 2010; (ii) The non-scheduled UCBs in Tier II would be allowed to maintain the existing SLR requirement of up to 15.0 per cent of their NDTL up to March 31, 2010; (iii) From March 31, 2011 onwards, all non-scheduled UCBs would have to maintain SLR up to 25.0 per cent in the above-said manner.

3.142 As per the extant instructions, for the computation of SLR requirement the amount of loan availed by UCBs from DCCBs/StCBs, with which they are maintaining deposits, would be deducted from the deposits, irrespective of whether lien has been marked on such deposits or not. However, in view of the difficulties expressed by Salary Earners' Cooperative Banks in complying with this advice, the Reserve Bank extended the time period for Salary Earners' Cooperative Banks to comply with this advice up to March 31, 2009.

3.143 As per the extant instructions, Tier I UCBs were exempted from maintaining SLR in Government and other approved securities up to 15 per cent of their NDTL provided the amount was held in interest-bearing deposits with the State Bank of India and its subsidiary banks, and the PSBs, including IDBI Ltd. In view of various representations received from UCBs and their federations, it has been decided to continue the exemption, provided with effect from October 1, 2009, such exemption shall not exceed 7.5 per cent of NDTL. Further, the exemption shall stand withdrawn effective from April 1, 2010.

Liberalisation and Rationalisation of Branch Licensing Policy

3.144 Following the announcement made in the Annual Policy Statement for 2008-09, the Reserve Bank further liberalised and rationalised the branch licensing policy for well managed and financially sound UCBs operational in States that had entered into MoUs (Box III.10).

Asset Classification and Provisioning Norms

3.145 The Reserve Bank advised Tier II UCBs to maintain a uniform provisioning requirement of 0.40 per cent on all 'standard assets' except in case of direct advances to agriculture and Small and Medium Enterprises (SME) for which, the provisioning requirement stood at 0.25 per cent. As against this, Tier I UCBs were asked to make lower level of general provision at the rate of 0.25 per cent on all 'standard assets'.

Box III.10: Liberalisation of Branch Licensing Policy for UCBs

The Reserve Bank has taken steps to liberalise and rationalise the branch licensing norms for UCBs to provide an incentive to financially sound UCBs to expand their branch network. It was indicated in the Annual Policy Statement 2004-05 that fresh issuance of licenses to UCBs would be considered only after a comprehensive policy on UCBs, including an appropriate legal and regulatory framework for the sector, was put in place and a policy for improving the financial health of the UCB sector was formulated. Following this announcement, the grant of licenses for opening of new branches to UCBs was also put on hold. Subsequently, in the Annual Policy for 2007-08, it was decided to allow the opening of new branches/extension counters to banks that were registered under the Cooperative Societies Act of the States that had signed MoUs with Reserve Bank or under the Multi State Cooperative Societies Act, 2002 subject to certain parameters. Pursuant to the announcement in the Annual Policy Statement for 2008-09, branch licensing norms were liberalised for well-managed and financially sound UCBs operational in the MoU States and those registered under the Multi-State Cooperative Societies Act. The Reserve Bank decided to grant approvals for branch expansion including off-site ATMs in respect of such UCBs on the basis of their Annual Business Plans subject to certain conditions, which included the maintenance of a minimum CRAR of 10 per cent on a continuous basis and other regulatory comfort.

Based on the Annual Business Plans submitted by UCBs for 2008-09 and 2009-10, 275 banks were allotted centres to open 402 branches, 23 extension counters, 21 off-site ATMs and conversion of 16 extension counters into full-fledged branches as on March 31, 2009.

3.146 Following the announcement made in the Annual Policy Statement for 2008-09, the Reserve Bank enhanced the limit in respect of bank loans for housing for applicability of risk weights for capital adequacy purposes from Rs.20 lakh to Rs.30 lakh in June 2008. It was specified that such loans would carry a risk weight of 50 per cent.

Asset Liability Management

Scheduled UCBs

3.147 The Reserve Bank issued detailed guidelines on asset-liability management of Scheduled UCBs (all Scheduled UCBs are Tier II UCBs) in 2002. As per the extant guidelines, the liquidity mismatches (negative gap) during the time buckets of 1-14 days and 15-28 days should not exceed 20 per cent of the cash outflows in the respective time buckets. In view of the felt need to have a sharper assessment of the efficacy of liquidity management, the Reserve Bank advised the banks to split the first time bucket (1-14 days) into three time buckets, *viz.*, next day, 2-7 days and 8-14 days. While preparing this Statement, the banks are advised to take concerted and requisite efforts to ensure coverage of 100 per cent data in a timely manner. Further, it is also advised that the net cumulative negative mismatches during the next day, 2-7 days, 8-14 days and 15-28 days buckets should not exceed 5 per cent, 10 per cent, 15 per cent and 20 per cent of the cumulative cash outflows in the respective time buckets. This has been done with a view to recognise the cumulative impact on liquidity. The banks are asked to prepare the Statement of Structural Liquidity on daily basis, however, the reporting to the Reserve Bank can continue as hitherto, *i.e.*, fortnightly.

Non-Scheduled Tier II UCBs

3.148 In order to effectively address the issues related to liquidity, interest rate and currency risks, (in addition to scheduled UCBs for which guidelines were put in place in 2002) all Tier II non-scheduled UCBs were asked to introduce Asset-Liability Management (ALM) systems. To begin with, non-scheduled Tier II UCBs were asked to ensure coverage of at least 60 per cent of their liabilities and assets. For the remaining 40 per cent, non-scheduled Tier II UCBs could include the position based on their estimates. Further, they had to set interim targets so as to cover 100 per cent of their business by April 1, 2010. Once the ALM system is stabilised, non-scheduled Tier II UCBs were asked to prepare themselves to switch to more sophisticated

techniques, such as Duration Gap Analysis and Simulation and Value at Risk for interest rate risk management.

3.149 In order to capture the maturity structure of the cash inflows and outflows, non-scheduled Tier II UCBs were asked to prepare a statement of structural liquidity, to begin with on a quarterly basis. The reporting system was made fortnightly with effect from December 2008. Further, banks were asked to include only rupee assets, liabilities and off balance sheet positions in the quarterly Statement of Interest Rate Sensitivity. In this regard, non-scheduled Tier II UCBs are advised to move onto a monthly reporting system with effect from April 1, 2010. In order to enable the banks to monitor their liquidity on a dynamic basis over a time horizon spanning 1-90 days, a statement of Short-term Dynamic Liquidity should be prepared as on each reporting Friday. Non-scheduled Tier II UCBs were asked to prepare the first such set of ALM return comprising Statement of Structural Liquidity, Statement of Interest Rate Sensitivity along with Statement of Short-Term Dynamic Liquidity to the ALCO/Top Management as on the last reporting Friday of December 2008.

Liquidity Risk Management of Tier I UCBs

3.150 Reserve Bank issued basic liquidity risk management guidelines to Tier I UCBs (all Tier I UCBs are non-scheduled UCBs) in September 2008. As per the guidelines, the tier I UCBs have to assess the future cash flows in the following time bands, *viz.*, 1-14 days, 15-28 days, 29 days-3 months, 3-6 months, 6 months – 1 year, 1-3 years, 3-5 years and over 5 years. UCBs are also expected to monitor their cumulative mismatches across all time bands by establishing internal prudential limits with the approval of the Board. Further, the mismatches during 1-14 days and 15-28 days time bands in normal course should not exceed 20 per cent of the cash flows in each time band. The Tier I UCBs may also prepare a Statement on short-term dynamic liquidity on the basis of business projections and other commitments for planning purposes. These banks were asked to prepare separate returns on a quarterly basis starting from the quarter ending December 2008.

Advances against Pledge of Gold/Silver Ornaments

3.151 In order to mitigate the inherent risks attached to sanction of loans and advances against Gold/Silver ornaments, UCBs were advised to observe certain safeguards regarding, *inter alia,* i) ownership of ornaments, ii) proper valuation and appraisal of the ornaments to be pledged from an approved valuer/shroff.

Introduction of Currency Futures

3.152 The Reserve Bank *vide* its circular dated September 17, 2008 allowed UCBs, which were recognised as Authorised Dealers (Category I and II), to participate in designated currency futures exchanges recognised by Securities Exchange Board of India (SEBI) as clients only for the purpose of hedging their underlying forex exposures.

Rating Model for UCBs

3.153 In order to bring about supervisory convergence between UCBs and commercial banks, the rating models were revised from the inspection cycle beginning March 31, 2009. With the introduction of revised rating model, the gradation system of UCBs was dispensed with. The revised CAMELS rating model was made applicable to UCBs with deposits of Rs.100 crore and above, and a revised simplified version of the same was made applicable to UCBs with deposits of less than Rs.100 crore. The UCBs had to be rated on the basis of the CAMELS components, *viz.*, Capital, Asset Quality, Management, Earnings, Liquidity, and Systems and Control on a scale of 1 to 100, and based on the weighted average of the ratings of the components, UCBs had to be assigned rating of A+ to D.

Placement of Deposits with other Banks and Acceptance of other Banks' Deposits

3.154 The Reserve Bank raised the limit for UCBs of holding deposits with other banks (inter-bank) from 10 per cent to 20 per cent of their total deposits as on March 31st of the previous year. The balances held in deposits with commercial banks and in permitted Scheduled UCBs, and invested in Certificates of Deposits (CDs) issued by commercial banks were included in this 20 per cent limit. UCBs were advised that within the inter-bank exposure limit, deposits with a single bank should not exceed 5 per cent of the depositing bank's total deposit liabilities as on March 31 of the previous year. Interest bearing deposits of Tier I non-scheduled UCBs with the PSBs and IDBI Bank Ltd. eligible for SLR, were exempted from the prudential limit on inter-bank exposure limit.

Extension of Area of Operation

3.155 The Annual Policy Statement for 2009-10 announced that the Reserve Bank would henceforth consider requests from sound and well functioning single State Tier II UCBs (registered in States that have entered into MoU with the Reserve Bank) for expansion of area of operation to the entire State of registration. While considering such applications, due consideration would be given to system of internal controls prevailing in the bank and supervisory comfort. In respect of Tier I banks, the existing norms will continue to be applicable.

Declaration of Dividend by UCBs

3.156 Following the introduction of revised rating system for UCBs based on CAMELS model from the inspection cycle of March 2009, UCBs were allowed to declare dividend without prior permission of the Reserve Bank subject to compliance with certain parameters, *inter alia*, (i) compliance with prescribed CRAR norms, (ii) net NPAs were less than 10 per cent after making all necessary provisions as per the assessment made by Reserve Bank in its last inspection report, (iii) no default in CRR/SLR during the year for which dividend was proposed, (iv) all the required provisions have been made for NPAs, investments and other assets as per the prescribed prudential norms, and (v) dividend is paid out of the net profit and after making all statutory provisions and adjustment for accumulated losses in full. UCBs complying with all other parameters except (ii) could approach the concerned Regional Office of the Reserve Bank for permission for dividend declaration.

Investments in Non-SLR Securities

3.157 On January 30, 2009, the Reserve Bank revised the guidelines for UCBs on investments in Non-SLR securities in the following manner: (i) The UCBs were advised that the non-SLR investments would continue to be limited to 10 per cent of a bank's total deposits as on March 31 of the previous year; (ii) UCBs were allowed to invest in (a) "A" or equivalent and higher rated Commercial Papers (CPs), debentures and bonds, (b) Units of Debt Mutual Funds and Money Market Mutual Funds; (iii) Restrictions were prescribed on investment in specific types of instruments, *inter alia,* perpetual debt instruments, unlisted securities and investment in mutual funds other than debt and money market mutual funds; (iv) UCBs were asked to put in place proper risk management systems for capturing and analysing the risk in respect of Non-SLR investments and taking remedial measures in time; and (v) Certain aspects of the non-SLR investment such as total business during the reporting period, compliance with the prescribed prudential limits, and extent of non-performing investments in the non-SLR category, among others.

Supervision of UCBs

3.158 An Off-Site Surveillance (OSS) software was developed for UCBs to facilitate the preparation and submission of all supervisory

and regulatory returns to the Reserve Bank electronically (Box III.11).

Rural Credit Cooperatives

3.159 The recent policy initiatives in the rural credit cooperative sector were aimed at strengthening this sector by wiping out unlicensed entities and by strengthening the capital base of these institutions. There was no new banking license that was granted to cooperative banks during the year (July 2008 to June 2009). The total number of licensed StCBs and DCCBs as on June 30, 2009 stayed unchanged at 89 (comprising 14 StCBs and 75 DCCBs). Further, during the year, no StCB was granted scheduled status for inclusion in the Second Schedule under Section 42 of the RBI Act, 1934. Thus, the total number of scheduled StCBs remained at 16.

Box III.11: OSS Reporting System: A Step towards Effective Supervision of the UCB Sector

The Reserve Bank developed Prudential Supervisory Reporting System in the form of Off-Site Surveillance (OSS) for the UCBs to obtain relevant information on areas of prudential interest as well as to address the management information needs and to strengthen the MIS capabilities within the UCBs. The system was designed to monitor compliance and obtain information in areas of prudential interest including information on balance sheet and off-balance sheet exposures, profits and profitability, asset quality and sector/segment-wise concentration of advances. A collateral objective of the reporting system was to sensitise managements of banks to prudential concerns of the supervisory authority and thereby help in self-regulation.

The OSS reporting system was first introduced in April 2001 for the scheduled UCBs comprising 10 OSS returns. With a view to reducing the volume of data required to be reported by banks, while increasing the breadth and depth of information obtained from them, the Reserve Bank rationalised the OSS returns and reduced their number from ten to eight (one annual and seven quarterly) returns for the scheduled UCBs with effect from March 2004.

Further, this set of eight returns introduced for scheduled UCBs were also made applicable to non-scheduled UCBs with deposits of over Rs.100 crore from June 2004 and then to non-scheduled UCBs having deposits between Rs.50 crore and Rs.100 crore and with branches in more than one district from June 2006. For banks that had deposits between Rs.50 crore and Rs.100 crore and whose branch network was limited to a single district, a simplified set of five (four quarterly and one annual) returns (defined as Simplified OSS (SOSS)) was made applicable from June 2006 onwards. From December 2008 onwards, SOSS was extended to Tier I UCBs that had deposits below Rs.50 crore and OSS returns were made applicable to Tier II UCBs with deposits below Rs.50 crore. As such, all UCBs are now covered under the OSS system – a set of eight (OSS) returns to Tier II UCBs and a set of five returns (SOSS) to Tier I UCBs.

For an effective OSS system, a computerised environment is a pre-requisite. Accordingly, a software has been developed by the Reserve Bank to enable preparation of OSS/SOSS returns and also other regulatory/supervisory returns directly by UCBs and their electronic submission to the Reserve Bank. The software also enables generation of analytical reports at Regional Office and Central Office of Urban Banks' Department (UBD). This has facilitated the development of a Development Support System (DSS) that has the capacity of generating standard and ad-hoc output reports.

For the UCBs, following are the benefits of the software:

Preparation and submission of returns in a computerised environment;

Automatic calculation and eliminates keying-in repetitive data and thus improves data quality;

Storage of data at the bank level enables UCBs to analyse their data and improves their MIS and facilitates self regulation;

For the Reserve Bank, the benefits of the software include:

Substantial reduction in data loading time for UCB returns;

Instant tracking of banks for non-submission or delayed submission of returns and timely follow-ups with such banks;

Facilitates better inspection of banks as the software is installed in the laptops of inspecting officers of the Bank.

Quick access to data on UCBs and instant generation of various reports based on the data;

Cross checks within each return, across returns and across time to ensure integrity of data. Quality of data can also be checked through the software at ROs by comparing on-site with off-site data for the same period as even on-site data are submitted by inspecting officers through the same software;

Ensures more effective supervision through the generation of early warning reports at monthly and quarterly intervals, which indicate incipient stress in liquidity position and highlight decline in quality of assets, credit to deposits ratios, and growth in deposits and advances of UCBs.

3.160 As on June 30, 2009, five StCBs and 110 DCCBs did not comply with the provisions of Section 22 (3)(a) of the B. R. Act, 1949 (AACS) with respect to their capacity to pay their depositors in full as and when their claims accrued. Further, 21 StCBs and 324 DCCBs did not comply with Section 22 (3) (b) of the said Act as the affairs of these banks were conducted in a manner that was detrimental to the interests of their depositors.

3.161 With regard to the policy of licensing, the CFSA observed the need to draw up a roadmap for ensuring that only licensed banks operated in the cooperative space. The Committee further suggested the need for a roadmap to ensure that banks which failed to obtain a licence by 2012 should not be allowed to operate. This would expedite the process of consolidation and weeding out of non-viable entities from the cooperative space. Accordingly, the Reserve Bank announced in its Annual Policy Statement for 2009-10 that a roadmap would be worked out for achieving this objective in a non-disruptive manner in consultation with NABARD. After consulting with NABARD, it was decided to license those banks which have achieved a CRAR of 7 per cent and not committed CRR and SLR default (barring stray incidents) during the last two consecutive years (*i.e.*, 2007 and 2008). Licensing of unlicensed StCBs was to be taken up first and towards that end, NABARD was requested to furnish a list of StCBs, which had complied with the above parameters. It was decided to subsequently obtain similar data from NABARD in respect of DCCBs. Further, NABARD was to take up inspection of the StCBs not complying with the said parameters on a priority basis with reference to their financial position as on March 31, 2009.

3.162 At present, CRAR norms do not apply to StCBs/DCCBs. However, in the interest of systemic stability of the financial system as a whole, and pursuant to the announcement in the Mid-Term Review of Annual Policy Statement for 2007-08, all StCBs/DCCBs were advised to disclose the level of CRAR as on March 31, 2008 in their Balance Sheets and thereafter, every year as 'Notes on Accounts' to their Balance Sheets. They were also advised to furnish an annual return to the Regional Office of Reserve Bank/ NABARD indicating capital funds and risk assets ratio in the prescribed format. In this regard, the CFSA observed that the migration to Basel I could be considered for these institutions with the implementation of the revival package based on the Vaidyanathan Committee recommendations.

3.163 The Reserve Bank indicated to StCBs and DCCBs to desist from financing commercial real estate sector given that the primary role of rural cooperative banks is to lend for activities related to agriculture and rural development and that taking exposure in sensitive areas may not be in the interest of short-term cooperative credit structure. For the credit facilities already extended to this sector, the StCBs and DCCBs were asked to ensure that such exposures were well secured and adequate provisioning were made, wherever required, as per the existing prudential guidelines. Further, banks were asked not to renew the credit facilities.

3.164 Based on the recommendations of the Task Force on Revival of Rural Co-operative Credit Institutions (Chairman: Prof. A. Vaidyanathan) and in consultation with the State Governments, the Government of India also approved a Package for revival of the short-term rural co-operative credit structure (STCCS).

9. Financial Markets

3.165 Developing broad-based, deep and liquid financial markets has been the endeavour of the Reserve Bank through its policy prescriptions. The financial markets generally remained stable during 2008-09, barring a few brief spells of volatility. The impact of the global financial turmoil on the Indian financial markets was mainly in the form of reduction in net capital flows and corrections in the domestic stock

markets. There was a pressure on the domestic foreign exchange market owing to the withdrawal of funds from the Indian equity markets and reduction in the availability of foreign funds to Indian entities. The advance tax flows and the scaling up of the Reserve Bank's forex market operations caused some volatility in the call money market. However, pre-emptive liquidity management undertaken by the Reserve Bank in the context of the indirect effects of the global financial turmoil and strong balance sheets of the banks contributed to absence of counterparty risk in the Indian financial system.

Developments in the Money Market

3.166 The inter-bank money market has been working normally throughout the period, in contrast to those of certain advanced economies. In general, the daily weighted average call rate mostly remained within the informal corridor of LAF interest rate barring the brief period of September and October 2008. Interest rates in the collateralised segments of the money market moved in tandem with, but remained generally below the call money rate during the year.

Developments in the Government Securities Market

3.167 The global financial turmoil once again brought the government securities market to the fore on account of the elevated market borrowing programme of the Central and State Governments on the one hand and investors' preference for safety during these turbulent times on the other. Accordingly, the Reserve Bank has taken several measures to ensure the smooth functioning of the Government securities market during the year. The various policy measures initiated by the Reserve Bank in this market segment during the year included: (i) improving the efficiency of auction process, (ii) new issuance structure for floating rate bonds (FRBs), (iii) operational readiness for introduction of STRIPS, (iv) new settlement mechanism for non-current account holders, (v) clearing and settlement of OTC rupee interest rate derivatives and (vi) revision of repo accounting norms. These policy developments in the Government securities market also have a bearing on the functioning of banks, since banks are active participants of the Government securities market.

Interest Rate Futures Market

3.168 With a view to developing a robust interest rate futures (IRF) market, the Reserve Bank, in August 2007, constituted a Working Group on Interest Rate Futures (Chairman: Shri V.K. Sharma) following the recommendation made by the TAC on the Money, Foreign Exchange and Government Securities Markets. The Final Report of the TAC was posted on the Reserve Bank's website on August 8, 2008. The Annual Policy Statement for the year 2009-10, had indicated that an exchange-traded IRFs contract on the 10-year notional coupon bearing government bond was expected to be launched shortly. Subsequently, RBI-SEBI STC had been entrusted with the work relating to the operationalisation of the recommendations of the TAC Report. The Committee has submitted its report in May 2009.

3.169 The Report detailed the product design, margins and position limits for 10-year notional coupon-bearing GoI security futures. The notional coupon rate applicable on the security would be 7 per cent compounding semi-annually. The quotation would be similar to the quoted price of the GoI security. In the absence of last half an hour trading the theoretical price, to be determined by the exchanges, would be considered as Daily Settlement Price. The exchanges will be required to disclose the model/methodology used for arriving at the theoretical price. The contract would be settled by physical delivery of deliverable grade securities using the electronic book entry system of the existing Depositories (NSDL and CDSL) and Public Debt Office (PDO) of the Reserve Bank. The Interest Rate Derivative contracts

shall be traded on the Currency Derivative Segment of a recognised Stock Exchange. The members registered by SEBI for trading in Currency/Equity Derivative Segment shall be eligible to trade in Interest Rate Derivatives also, subject to meeting the Balance Sheet net worth requirement of Rs.1 crore for a trading member and Rs.10 crore for a clearing member. A SEBI-RBI constituted committee would meet periodically to sort out issues, if any, arising out of overlapping jurisdiction of the IRF market. As a follow up, the Reserve Bank issued guidelines to all SCBs, PDs, UCBs, NBFCs and specified All India Financial Institutions on August 28, 2009 in this regard.

Developments in the Foreign Exchange Market

3.170 The impact of the financial crisis, which worsened mid-2008, led to the slowdown of capital flows into the country. However, the external sector exhibited ample resilience in the face of the current global financial crisis, largely attributable to the country's approach to financial globalisation with a more cautious and calibrated approach towards the opening up of the capital account. The policy responses in India have been designed largely to mitigate the adverse impact of the global financial crisis on the Indian economy. The key policy initiatives taken by the Reserve Bank since September 2008 were essentially to improve foreign exchange liquidity by selling dollar into market, forex swap facility for the banks and raising interest rate ceilings on FCNR(B) and NR(E)RA deposits.

3.171 The policy on the premature buyback of foreign currency convertible bonds was liberalised in December 2008, recognising the benefits accruing to the Indian companies as well as to the economy.

3.172 The AD Category-I dealer banks were allowed, in October 2008, to borrow funds from their head office, overseas branches, and correspondents and overdrafts in the Vostro accounts up to a limit of 50 per cent of their unimpaired Tier I capital as at the close of the previous quarter or USD 10 million (or its equivalent) (excluding borrowings for financing of export credit in foreign currency and capital instruments), whichever is higher, as against the existing limit of 25 per cent.

3.173 In October 2008, the borrowers were granted the flexibility to keep their ECB proceeds off-shore or keep it with the overseas branches/ subsidiaries of Indian banks abroad or to remit these funds to India for credit to their rupee accounts with AD Category-I banks in India, pending utilisation for permissible end-uses.

3.174 With a view to ensuring that there are no concealed overdrafts in vostro accounts, AD Category–I banks were permitted in August 2008 to designate drawee branches under Rupee Drawing Arrangements (RDA) beyond 300, provided such branches are under Core Banking Solution. The AD Category-I banks were allowed to issue guarantees/standby letters of credit to cover payment obligations relating to commodity derivative transactions in November 2008.

3.175 The Reserve Bank, in August 2008, permitted the AD category-I banks to make advance remittance without any limit on behalf of their importer constituents for import of goods. However, for advance remittance exceeding USD 5,00,000 or its equivalent, AD Category – I banks are required to obtain an unconditional, irrevocable standby Letter of Credit or a guarantee from an international bank of repute situated outside India or a guarantee of an AD Category – I bank in India, if such a guarantee is issued against the counter guarantee of an international bank of repute situated outside India.

3.176 With a view to liberalising the facilities available to exporters and to simplify the procedures, the AD category-I banks were allowed to regularise cases of dispatch of shipping documents up to USD 1 million or its

equivalent per export shipment, direct to the consignee or his agent resident in the country of the final destination of goods, if the export proceeds have been realised in full, if the exporter is a regular customer of the bank for at least six months and if the exporter's account is fully compliant with Reserve Bank's extant KYC/AML guidelines and Bank is satisfied about the bonafides of the transaction.

3.177 In December 2008, the Reserve Bank informed the banks that the Board policy of the banks regarding unhedged foreign exchange exposure of clients should cover SMEs apart from other clients. Further, banks which have large exposures to clients whose total foreign currency exposure is relatively large (say, about USD 25 million or its equivalent) should monitor and review the unhedged portion of the foreign currency exposures of those clients on a monthly basis through a suitable reporting system. The review of unhedged exposure for SMEs should also be done on a monthly basis.

3.178 As a measure of rationalisation of the existing procedures, AD Category - I banks have been allowed in April 2009 to convey 'no objection' under the Foreign Exchange Management Act (FEMA), 1999 for creation of charge on immovable assets, financial securities and issue of corporate or personal guarantees in favour of overseas lender/security trustee, to secure the ECB to be raised by the borrower, for issue of corporate guarantee in favour of the overseas lessor, for operating lease in respect of import of aircraft/aircraft engine/helicopter subject to compliance of prescribed conditions.

3.179 In May 2009, the banks have been asked to continue to make efforts for reconciliation in respect of outstanding debit/credit entries of individual value USD 2,500 and above or equivalent in nostro accounts.

3.180 After examining the recommendations of an Internal Working Group (Chairman: Shri Salim Gangadharan) in consultation with the SEBI and representatives of various market participants, the Reserve Bank permitted AD Category I banks to become trading/clearing members of the currency derivatives segment to be set up by the Stock Exchanges recognised by SEBI subject to certain conditions. In August 2008, persons resident in India were permitted to participate in the currency futures market in the country.

3.181 In April 2009, it has been decided to enhance the existing cap of Rs.20 lakh to Rs.100 lakh on loans against security of funds held in NR(E)RA and FCNR(B) deposits either to the depositors or third parties. The banks are also advised not to undertake artificial slicing of the loan amount to circumvent the aforesaid ceiling.

10. Customer Service in Banks

3.182 During 2008-09, focused attention is given to the customer service dimension of the banking sector by sensitising banks to render good and efficient customer service, and encourage involvement of Boards of banks in evolving policies keeping in view the needs and aspirations of customers. The Reserve Bank has set up a full-fledged Customer Service Department with a view to making the banks more customer-friendly. The Reserve Bank has taken a number of steps to disseminate instructions/guidelines relating to customer service and grievance redressal by banks through the multi-lingual website by placing all customer related notifications and press releases in a specific page titled 'For Common Person'. Customers of commercial banks can also approach the Reserve Bank with their grievances and queries through 'Contact Us' mode of the website. A complaint form for lodging complaints with the Banking Ombudsman has also been made functional.

3.183 Further, with a view to strengthening the Grievance Redressal Mechanism, banks are asked to display the names of the concerned Nodal Officer appointed at their Regional/Zonal

Offices along with the names of the officials who can be contacted for redressal of complaints as per provisions of the Banking Ombudsman Scheme (BOS), 2006. The Banks may also display these information on their web-sites.

3.184 During the year under review a comprehensive Master Circular on Customer Service was issued on July 1, 2009 incorporating various issues such as customer service, operations of deposit accounts, levy of service charges, service at counters, disclosure of information, operation of accounts by old and incapacitated persons, facilities to visually impaired persons, guardianship in deposit accounts, remittances, drop box facility, collection of instruments, dishonour of cheques, dealing with complaints, erroneous debits due to wrong/ fraudulent transactions, safe deposit lockers, nomination facility, settlement of claims of deceased depositor/missing person, unclaimed deposits and in operative accounts, customer confidentiality obligations, transfer of internal account in branch, switching of bank, co-ordination of officers of CBDT, implementation of recommendation of Working Groups/ Committees, and BCSBI's code of commitment to customers and instructions issued thereon.

3.185 The BOS was revised during the year 2008-09. The major revisions made to the Scheme are provided in Box III.12.

3.186 For reducing the risk of frauds, instructions have been issued to banks in August 2008 (to UCBs in September 2008) to be more pro-active in finding out the whereabouts of the customer if the account remains inoperative for two years or more

Box III.12: Revision of the Banking Ombudsman Scheme 2006 (BOS)

Based on the experience gained since January 1, 2006 in implementing the BOS, the Customer Service Department of the Reserve Bank has revised the BOS during the year. The salient features of the amendments carried out to the Scheme 2006 are as follows:

The scope of BOS was widened to include deficiencies arising out of internet banking. Under the amended Scheme, a customer would also be able to lodge a complaint against the bank for its non-adherence to the provisions of the fair practices code for lenders or the Code of Bank's Commitment to Customers issued by the Banking Codes and Standards Board of India (BCSBI). Further, non-observance of the Reserve Bank's guidelines on engagement of recovery agents by banks has also been brought specifically under the purview of the Scheme. The amended Scheme, however, does not include certain banking transactions, such as failure to honour bank guarantee or letter of credit. Complaints on these areas of banking services are insignificant in number.

Any customer who has a grievance against a bank can complain to the Banking Ombudsman in whose jurisdiction the branch of the bank complained against is located. Some banks have centralised certain transactions, like housing loans and credit cards. If there are complaints regarding such transactions, complaints would have to be made to the Banking Ombudsman in the State in which the bank customer receives the bill/ statement of dues. As per the amended Scheme, the Banking Ombudsman can award compensation not exceeding Rs.one lakh to the complainant in the case of complaints arising out of credit card operations, taking into account the loss of the complainant's time, expenses incurred by him/her as also, harassment and mental anguish suffered.

In addition, the Reserve Bank has also simplified the format for lodging complaint with the Banking Ombudsman. Though the complainant need not lodge the complaint in a specific format, the Scheme now provides for an easy-to-fill format for lodging complaints, in case complainants prefer to use the same. The jurisdictions of the Banking Ombudsman at Kanpur, New Delhi, Chandigarh, Chennai and Thiruvananthapuram have been rationalised to include/exclude certain areas taking into account the geographical proximity of those areas to the respective Office of the Banking Ombudsman. For wider dissemination, the Reserve Bank has asked all banks to place a copy of the Banking Ombudsman Scheme on their website.

Wherever any of the complaints are not redressed within one month, the concerned branch/controlling office should forward a copy of the same to the concerned nodal officer under the Banking Ombudsman Scheme (BOS) and keep him updated regarding the status of the complaint. To ensure that the customer is made aware of his rights to approach the concerned Banking Ombudsman in case he is not satisfied with the bank's response, banks were advised to indicate in the final letter sent to the customer regarding redressal of the complaint, that the complainant can also approach the concerned Banking Ombudsman if he/she is not satisfied with the bank's reply or redressal action.

consecutively. Operations in such an account should be after due diligence and the banks should not charge any fee for activation of such account. Banks have to ensure proper audit of such accounts and interest should be credited on periodical interval as per extant instructions. Further, banks are also instructed in September 2008 (UCBs in October 2008) to pay interest on frozen accounts by them either by renewing the deposits or by paying interest for the overdue period as per policy of bank. The renewal of such deposits should be informed to concerned Government departments under advice to customers. In case of savings bank accounts frozen by the enforcement authorities, banks may credit the interest on regular basis.

3.187 Banks (including UCBs)/FIs are advised to ensure that all information relating to charges/fees for processing are invariably disclosed in the loan application forms. Further, the banks must inform 'all-in-cost' to the customer to enable him to compare the rates charged with other sources of finance.

3.188 The sub-section (2) of the Section 21 of the Credit Information Companies (Regulation) Act, 2005, specifies that every credit institution shall on receipt of request, as indicated in sub-section (1), shall furnish to such person a copy of the credit information subject to payment of charges specified by the Reserve Bank under the Regulations. The Reserve Bank, in Credit Information Companies Regulations, 2006, framed under the Act, has already prescribed in Regulation 12(3) a maximum fees of Rs.50 (Rupees fifty only) for the purpose.

3.189 The major recommendations of the Committee on Customer Services (Chairman: Shri H.Prabhakar Rao) in respect of Government business, currency management, foreign exchange and customer service have been complied with by the respective Central Office Departments and draft on retail function on Customer Service measures initiated by bank as per recommendation of committee has been prepared by Department of Government Bank Accounts of the Reserve Bank.

3.190 Department of Administrative Reforms and Public Grievances (DARPG) with technical support from National Informatics Centre (NIC) has developed a Public Portal, *viz.*, Public Grievances Redress and Monitoring System (CPGRAMS) for prompt and effective redressal of grievances of citizens. The system is to record and receive the grievances online and redress them indicating action at different levels. The Government of India is monitoring the system. All the PSBs, Offices of the Banking Ombudsman, the Reserve Bank, SIDBI, IDBI Bank, and NABARD have been listed by Government of India as subordinate offices and given username and password to access the DARPG portal to enable them to dispose of the grievances against banks online.

3.191 Efforts are made to sensitise banks to ensure that customers are empowered to take financially literate decisions by ensuring that the language in bank documents is simple and understandable and that transparency norms are adhered to in all customer- banker relationships. The customer service department of the Reserve Bank will publish four booklets during the year on Rights and Obligations of customers on the Credit card, Service Charges, Housing Loans (Payment options) and Collection of cheques.

3.192 Banks including UCBs are advised to take necessary steps to provide all existing ATMs/future ATMs with ramps so that wheel chair users/persons with disabilities can easily access them and also make arrangements in such a way that the height of the ATM does not create an impediment in its use by a wheelchair user. Further, banks should make at least one third of new ATMs installed as talking ATMs with Braille keypads and place them strategically in consultation with other banks to ensure that at least one talking ATM with Braille keypad is generally available in each

locality for catering to needs of visually impaired persons. Banks may also bring the locations of such talking ATMs to the notice of their visually impaired customers.

Credit Card Operations of Banks

3.193 A study on the credit card operations of banks was undertaken, based on the complaints received by the Reserve Bank as also the offices of the Banking Ombudsman. Based on the recommendations made in the study report, detailed guidelines were issued to banks on their credit card operations in July 2008. These included the gist of the recommendations of the study report, together with the existing Reserve Bank instructions on the subject and the action required to be taken by banks in this regard.

3.194 On the issue of unsolicited cards, banks were advised that the person in whose name the card was issued could approach the Banking Ombudsman who would determine the amount of compensation payable by the bank to the recipient of the unsolicited credit card as per the provisions of the BOS, 2006, *i.e.*, for loss of complainant's time, expenses incurred, harassment and mental anguish suffered by him. Furthermore, it was clarified that any loss arising out of misuse of such unsolicited cards would be the responsibility of the card issuing bank only and the card recipient could not be held responsible for the same. Banks were also advised that in cases where they offered insurance cover to their credit card holders, in tie-ups with insurance companies, they should obtain from the credit card holder the details of nominee/s for the insurance cover in respect of accidental death and disablement benefits. Banks were also advised to ensure that the relevant nomination details were recorded by the insurance company. They should also consider issuing a letter to the credit card holder indicating the details regarding the name, address and telephone number of the insurance company that would handle the claims relating to the insurance cover.

National Do Not Call Registry

3.195 With a view to reducing the number of unsolicited marketing calls received by customers, the Reserve Bank, through circulars issued in October 2007 and September 2008, advised banks that all telemarketers, *viz*., direct selling agents/direct marketing agents engaged by them should be registered with the Department of Telecommunications (DoT).

Comprehensive Display Board

3.196 Commercial banks (in August 2008) and (UCBs in September 2008) were advised to categorise the instructions on their display boards under 'customer service information', 'service charges', 'grievance redressal' and 'others'. Only the important aspects or mandatory instructions relating to the above four categories are required to be placed in a comprehensive display, with detailed information being made available in a booklet form. Furthermore, banks are required to display aspects such as 'working days, working hours and weekly off-days' outside the branch premises. In September 2008, banks were advised to display information relating to interest rates and service charges to enable customers to obtain the desired information at a quick glance.

11. Payment and Settlement Systems

3.197 Effective functioning of financial system as well as effective transmission of monetary policy signals requires a safe and efficient payment and settlement system. The Payment and Settlement Systems (PSS) Act, 2007 was enacted in December 2007 and the Act as well as Regulations framed under the Act came into effect from August 12, 2008. The Act casts the responsibility of regulation and supervision of payment systems in the country on the Reserve Bank of India. The PSS Act provides for constitution of a Committee of the Central Board to be known as Board for Regulation and Supervision of Payment and Settlement Systems

(BPSS) for exercising the powers and performing the functions and discharging the duties conferred on the Bank under the Act. Accordingly, the BPSS was reconstituted after the notification of the Board for Regulation and Supervision of Payment and Settlement Systems Regulations, 2008 under the Act.

3.198 The key areas of activity under the directions of the BPSS included (i) Notification of the Act and the Regulations framed under the Act; (ii) Grant of authorisation to various payment system operator in terms of PSS Act; (iii) Guidelines on Mobile Banking transactions; (iv) Guidelines on Issuance and Operations of prepaid payment instruments; (v) Rationalisation of charges for electronic payment products and outstation cheques; (vi) Further migration of large value payments to more secure electronic modes and discontinuing of separate High Value paper based clearing in a non-disruptive manner; (vii) Streamlining the cheque collection policies of banks, including foreign currency denominated instruments, (viii) Incentivising the usage of satellite communication for penetration of banking services to remote areas, and (ix) RTGS membership to central counterparties.

3.199 The Reserve Bank of India exercising its powers to regulate and supervise the payment and settlement systems received a number of applications from entities operating/proposing to operate payment systems like central counterparty, card companies, ATM network operators, cross- border and domestic money transfer operators, and prepaid card issuers. The Reserve Bank examined these applications under the provisions of the PSS Act 2007, its regulation, *i.e.*, Payment and Settlement System Regulations 2008, and internal guidelines. Thirty entities have so far been granted authorisation under the PSS Act 2007.

Paper Based Clearing and Settlement

3.200 The paper based clearing systems comprise the following: MICR Clearing, Non-MICR clearing and High Value clearing.

3.201 In a bid to encourage customers to move from paper- based systems to electronic systems the Reserve Bank has rationalised and made transparent the charges the banks could levy on customers for electronic transactions. The Reserve Bank on its part has extended the waiver of its processing charges for electronic modes of payment up to the end of March 2011. Towards this, in April 2009 the banks have also been advised to increase the threshold amount of cheque eligible to be presented in High Value (HV) Clearing from Rs.1 lakh to Rs.10 lakh and gradually discontinue the scheme in an undisruptive manner over a period of next one year. HV clearing has since been discontinued at 6 centres and the threshold limit for presentation has been raised at all remaining centres. However the facility of MICR/Non-MICR clearing will continue to be available for paper based instruments.

3.202 Number of initiatives have taken to address the problem of cheque collection by way of streamlining the policies of banks. The banks have been advised to reframe their Cheque Collection Policies (CCPs) to include local and outstation cheque collection timeframe, usage of funds after return clearing, timeframe for collection of cheques drawn on State capitals/ major cities/other locations, as also the rate of interest payable for delay.

3.203 The introduction of 'Speed Clearing' in June 2008 for collection of outstation cheques has significantly brought down the time taken for realisation of outstation cheques from 10-14 days on par with local clearing and now the funds are available to customers on T+1 or T+2 basis. With the availability of Speed Clearing at 53 out of 66 MICR centres, the Inter-city Clearing has been discontinued at 14 Reserve Bank locations and is available only at Guwahati.

3.204 The Cheque Truncation System (CTS) was implemented in the National Capital Region in February 2008 to enhance the efficiency of the paper based clearing system. This has

addressed the problems relating to the movement of cheques from presenting branches/banks to clearing houses and to the drawee bank/branches as also the risks like loss of cheques/theft/tampering of cheques. With all member banks of the New Delhi Bankers' Clearing House participating in the CTS, effective from July 1, 2009 the separate paper based clearing has been discontinued. A fee of Rs.0.50 per instrument each for the presenting bank and the paying bank in CTS has been introduced as against the Re.1 each levied earlier on both presenting and paying bank in the MICR clearing.

3.205 The banks levy charges on customers for collection of outstation cheques. For rationalising these charges and bringing in transparency, the Reserve Bank issued directive whereby a maximum charge of Rs.50, Rs.100 and Rs.150 for cheques of the value Rs.10,000, Rs.10,000 - Rs.1,00,000, and above Rs.1,00,000, respectively have been prescribed. These charges are all inclusive, except service tax.

3.206 With cheque still being predominant medium of payment, the operations of paper based systems in a non-disruptive manner assumes critical importance. To ensure banks with sound financials have direct membership to the clearing house, the Reserve Bank has put in place norms/access criteria for membership to the clearing house.

3.207 In order to ensure uninterrupted functioning of the clearing houses at all times, a number of instructions have been issued to National Clearing Cells as a Business Continuity Planning (BCP) measure for clearing houses under their respective jurisdictions.

3.208 The delay in collection of foreign currency denominated cheques has been engaging the attention of the Reserve Bank for sometime. In order to bring about transparency, quicken the process of collection and to make available faster funds to the customers, the Reserve Bank has issued instructions to the banks which, *inter alia*, directed the banks to make the US Dollar (USD) cheque collection scheme (including its charges) transparent and as a part of its regular cheque collection policy. The Reserve Bank also advised banks to review their policy on an on-going basis and leverage on the US Check 21 facility for saving transit time and have a direct deposit mechanism with correspondent banks for early collection.

Electronic Payment Systems

3.209 The electronic payment systems comprise of the large value payment systems, *viz*., Real Time Gross Settlement (RTGS), systems operated by Clearing Corporation of India Ltd., (Government Securities Clearing, Foreign Exchange Clearing, and Collateralised Borrowing and Lending Obligation), and the retail payment systems, *viz*., National Electronic Clearing Services (NECS/ECS-Credit/Debit), National Electronic Funds Transfer (NEFT), and card based payment systems.

Large Value Electronic Payment System

Real Time Gross Settlement (RTGS)

3.210 The RTGS system has been operational since March 2004. The system which was operationalised with settlement of transactions relating to inter-bank payments was extended to customer transactions and from September 2006 the multilateral net settlements relating to clearings in Mumbai, including the systems operated by CCIL are settled in RTGS. With increasing number of bank branches participating in the RTGS (more than 60,000 as at end- September 2009) the RTGS timings was extended, both for customer as also interbank transactions by 30 minutes from January 10, 2009.

3.211 The development of corporate bond market in India lagged behind in comparison with other financial markets owing to many

structural problems. To facilitate settlement of Over the Counter (OTC) corporate bond transactions in RTGS system on delivery versus payment (DvP)-I basis, it was decided to allow the clearing houses of the exchanges to have a transitory pooling account facility with the Reserve Bank. The settlement of corporate bond transactions will be on a non-guaranteed basis and hence line of credit (LOC) support will not be provided, however, banks participating in the settlement would be eligible for intraday liquidity (IDL) support from the Bank.

Self Evaluation and Assessment by External Expert of the RTGS

3.212 To evaluate the RTGS system in India against the Core Principles for Systemically Important Payment Systems, a self evaluation was carried out and was published as part of the Report of the CFSA. According to this assessment, the RTGS system in India is fully compliant with the six Core Principles and broadly compliant with three Core Principles relating to management of credit and liquidity risk, operational reliability and efficiency. One Core Principle is not applicable to the RTGS system.

3.213 The Reserve Bank had also commissioned an external assessment of the RTGS system by a team of experts from the Swiss National Bank who submitted their report in April 2009. These experts viewed that the RTGS system in India is compliant with all the Core Principles, except the one on efficiency. This could not be assessed by the experts since the system was being offered free of charge to the participants. The recommendations made by the team for compliance with this Core Principle is to have a strategy and project business development over the next 5 to 10 years, to monitor the relationship with third-party vendors and ensure effective safeguards in order to retain full control over all aspects of the RTGS system, to have a cost-benefit-analysis, and appropriate pricing of payment services.

Retail Electronic Payment Systems

3.214 The retail payment system comprise of electronic clearing services (NECS/ECS-Credit/Debit), NEFT, card based payment systems including ATM network.

3.215 The growth of Electronic Clearing System (ECS) both debit and credit have been sustained during the year. The coverage of ECS has increased by five more centres and is now available at 75 centres. Settlement cycle has been reduced to T+1 from earlier T+3 across the country. To widen the geographical coverage of ECS beyond the existing ECS centres and to have a centralised processing capability, the National Electronic Clearing Service (NECS) was operationalised with effect from September 29, 2008. The NECS is a nationwide system leveraging on core banking solutions (CBS) of member banks. As at the end of September, 2009 as many as 114 banks with 30,780 branches participate in NECS.

3.216 The NEFT system was introduced in November 2005. The settlement timings for NEFT transactions have been enhanced by one and a half hour with effect from July 7, 2008. The NEFT is now available from 0900 hrs to 1700 hours on week days with settlement at 0900, 1100, 1200, 1300, 1500 and 1700 hours and the 3 settlements on Saturdays at 0900, 1100 and 1200 hours. 91 banks with over 61,000 branches are participating in NEFT as at end of September 2009.

3.217 To encourage the transactions in ECS/NECS/NEFT the processing charges for electronic payment products have been further waived up to March 31, 2010. The charges levied by banks to the customers have also been rationalised and for NEFT the maximum charges are Rs.5 and Rs.25 for transaction value upto Rs.1.00 lakh and above Rs.1.00 lakh, respectively.

3.218 To facilitate large Nepalese migrant workforce in India in sending money to their families/relatives in Nepal, a formal remittance system between India and Nepal, was introduced from May 15, 2008. Viewing the low volumes of the scheme the service charges were revised effective from February 9, 2009, with the maximum charge being Rs.75. Further, branches have been advised to create awareness about the scheme among the Nepalese migrants.

Card Based Payment Systems

3.219 Cash withdrawal from Automated Teller Machines (ATMs) of the banks was made free of charge with effect from April 1, 2009. The decision of making ATMs free for customers did not adversely impact the expansion of ATMs. Further, banks have been advised to reimburse to the customers, the amount wrongfully debited on account of failed ATM transactions within a maximum period of 12 days, from the date of receipt of customer complaint and effective from July 17, 2009, for any failure to re-credit the customer's account within the stipulated period, the bank shall pay compensation of Rs.100 per day, to the aggrieved customer.

3.220 Cash is still predominantly used for small value payments and thus the need for currency. Seeing the vast population as also the availability of ATMs *vis-à-vis* POS terminals the use of this infrastructure for permitting small value cash withdrawal for enhancing the customer convenience cash withdrawal facility at POS for all debit cards issued in India, up to Rs.1,000 per day has been permitted from July 22, 2009. The banks before introducing the facility will require prior regulatory approval from the Reserve Bank.

3.221 The use of credit/debit cards has been increasing for payment of goods and services as also cash withdrawals. In order to make the card based payments more safe, especially for transactions done on-line (card not present), the Reserve Bank reviewed various options to enhance the security of online card transactions. After extensive consultations with banks/card companies, a system of providing for additional authentication/validation based on information not visible on the cards for all on-line 'card not present' transactions has been implemented from August 1, 2009. A system of "Online Alerts" to the cardholder for all 'card not present' transactions of the value of Rs.5,000 and above has also been put in place.

New Initiatives

Issuance of Pre-Paid Payment Instruments

3.222 To ensure orderly development and operation of pre-paid payment instruments in the country, the Reserve Bank issued a set of guidelines in April 2009. The pre-paid payment instruments that are permitted to be issued in the country are broadly classified into Closed system payment instruments, Open system payment instruments and Semi-closed system payment instruments. The salient aspects of the guidelines are (i) banks and non-bank persons are permitted to issue pre-paid payment instruments in the country. While banks are permitted to issue all categories of these instruments, non-bank persons are permitted to issue only closed and semi-closed system payment instruments; (ii) the maximum value of any pre-paid payment instruments has been fixed at Rs.50,000/-; (iii) conditions have been stipulated on deployment of money collected by the issuer against issue of pre-paid payment instruments. Further, effective from August 14, 2009, "other persons" have also been permitted to issue mobile phone based semi-closed system pre-paid payment instruments for a maximum value of Rs.5,000. This will facilitate only purchase of goods and services, and person to person transfer of funds is not permitted. Three entities have been granted authorisation to issue prepaid payment instruments (Also see Box IX.2 'Pre-paid Payment Instruments in India' in RBI Annual Report 2008-09).

Mobile Banking Transactions

3.223 The expansion in the use and geographocal reach of mobile phones has created new opportunities for banks to use this mode for banking transactions and also provide an opportunity to extrend banking facilities to the hitherto excluded sections of the society. Reserve Bank has adopted Bank Led Model wherein the mobile phone banking is promoted through business correspondents of banks. The operative guidelines for banks on Mobile Banking Transactions in India were issued on October 8, 2008. Only banks who have received one time approval from the Reserve Bank are permitted to provide this facility to customers. Till June 30, 2009, 32 banks had been granted permission to operate Mobile Banking in India, of which 7 belonged to SBI and its associates, 12 to nationalised banks and 13 to private/ foreign banks. These guidelines were discussed in detail in the Report on Trend and Progress of Banking in India 2007-08**.**

National Payment Corporation of India

3.224 World over, Central Banks are distracting themselves from day to day operations of retail payment system. In alignment with this, the Reserve Bank encouraged the setting up of National Payment Corporation of India (NPCI) to act as an umbrella organisation for operating the various retail payment systems in India. NPCI has since become functional and is in the process of putting in place its Vision Document and road map. NPCI will be an authorised entity under the PSS Act and would, therefore, be subjected to regulation and supervision of the Reserve Bank.

Minimum Standards/Benchmark Indicators for Retail Payment Systems

3.225 The Reserve Bank has framed the Minimum Standards for Operational Efficiency of MICR Cheque Processing Centres as part of benchmarking retail payment systems in October 2007. The Bank has come out with a booklet in October 2008 covering i) Minimum Standards of Operational Efficiency (MSOE) for MICR Cheque Processing Centres; ii) MSOE for Magnetic Media Based Clearing System MMBCS (Automated) Clearing Houses; iii) Benchmark Indicators for Electronic Clearing Services; and iv) NEFT System - Benchmark Indicators for efficiency. The directions issued periodically and the implementation of the same for desired results is being assessed by way of calling for quarterly/half yearly Self Assessment Reports being submitted by the clearing houses to the Regional Office of the Reserve Bank under whose jurisdiction it falls. Periodic on-site visits are made by the officers of the Reserve Bank ROs.

Committee on Financial Sector Assessment

3.226 CFSA in its Report on assessment of the payment system and financial markets made observasions and suggestions which are provided in Box III.13.

12. Technological Developments

3.227 Technological innovation not only enables a broader reach for consumer banking and financial services, but also enhances the capacity for continued and inclusive growth. The efficient use of Information Technology (IT) has facilitated the movement from class banking to mass banking. Further, it has also enabled the banks in India to provide newer products as also alternate channels to the customers, aiming at vertical and horizontal expansion of their businesses. The Reserve Bank has been playing an important role in bringing about Technology based Banking which has resulted in large scale computerisation of the Banking Sector. The Financial Sector Technology (FST) Vision serves as a lighthouse for banks to make their own IT initiatives based on the broad approach envisioned by the Reserve Bank. The Reserve Bank continues to function as a business

Box III.13: Assessment of Payment Systems by CFSA

The CFSA made the following observations with regard to the payment system in India:

- High Value Clearing system which handles large values and settles on an unsecured deferred net settlement basis, could lead to financial vulnerability and recommended shifting of high value transaction to more secure electronic payment system like RTGS or NEFT.
- In MNSB settlement on 'all-or-none' basis, systemic risk can arise whenever there is a long chain of interdependent payments queuing up. Efficient liquidity management is of prime importance to banks in RTGS system.
- Establishing a mechanism to seamlessly link the depositories with the payment system through the clearing corporation/clearing agency to ensure DvP. CFSA observed a need for seamless link between Clearing Corporation and RTGS.
- CCIL being the only CCP catering to money, securities and foreign exchange markets and its expanding role over the years has been leading to concentration of risks on one entity. The inadequacy of risk management by CCIL can have system-wide implications, which could be more catastrophic than the decentralised systems. The concentration can also lead to 'moral hazard' problems if the central counterparty is considered 'too big to fail'.
- CFSA recommended spreading of settlements throughout the day against the end of the day settlement CCIL currently follows. It recommended on increasing of LoC by CCIL, net debit caps in the CBLO and Government securities segments, and considering back-to-back repo arrangement or limited purpose banking license so that it can access liquidity facility from the Reserve Bank.
- Since credit/debit card frauds are constantly evolving it is critical to stay abreast of the latest developments in this area to combat fraud effectively.
- Reserve Bank should engage with TRAI and DoT to educate them of the adverse impact any dilution in encryption standards could have on the entire e-commerce infrastructure and the need to balance between encryption standards and maintaining a supportive business environment.

facilitator for deployment of new products and services in payment and settlement systems including the Negotiated Dealing System (NDS) for Government Securities, the Real Time Gross Settlement (RTGS), National Electronic Funds Transfer (NEFT) and the Centralised Funds Management System (CFMS), apart from the Structured Financial Messaging System (SFMS) over the INFINET.

3.228 To provide scalability and high uptime availability of all critical payment system applications used by banks for their own transactions as well as those processed on behalf of their constituents, the Reserve Bank undertook a major initiative to operate these applications from its state-of-the-art Data Centres. The Systems at the Data Centres have been configured in such as manner that each centre functions as the backup to the other to ensure continuous availability of IT systems for its users in a safe and secure environment. Further, with large scale dependence on IT, the need to ensure uninterrupted availability of such systems attains utmost significance, especially in cases of failure due to any reason whatsoever. With a view to ensuring adequate provision for capacity and back-up, the Reserve Bank undertakes periodical Disaster Drill (DR) drills for its critical systems. The banks have also been independently taking up DR drills by using their Disaster Recovery Systems.

3.229 The secured web site of the Bank, which acts as a secured communication link between the Reserve Bank and Government Departments as well as other commercial banks continues to be used extensively and facilitated information dissemination.

3.230 A review of the achievements *vis-à-vis* the goals set in the FST Vision reveal the following: (i) enhanced network based operations, centralised processing of data by the migration to core banking systems by banks, integrating the CBS with common interbank applications, (ii) enhanced sharing of resources by banks for the ATMs as part of the National Financial Switch (NFS), (iii) more and more migration to electronic modes of payments, (iv) effective and failsafe business continuity plans (BCP) and initiation of periodical BCP exercises,

(v) Implementation of Information Systems (IS) Audit as an integral part of the controls and check measures, and (vi) improvement in management of outsourcing, especially with reference to vendor management.

3.231 The INdian FInancial NETwork (INFINET) functions as the backbone for transmission of inter-bank electronic information for systemic inter-bank payment systems of the Reserve Bank. A key trend in the connectivity space over the last year was the escalation of Multi Protocol Label Switching (MPLS) based VPN. The IDRBT, in the process of migrating the INFINET to the MPLS Technology, is working towards ensuring smooth migration of banks to MPLS in a phased manner. During the year, a number of the banks migrated to network based connectivity using the latest Multi Protocol Label Switching (MPLS) technology which is aimed at reducing costs for the users as also increase the ease of usage and provide better levels of availability (Box III.14). The INFINET MPLS is the communication backbone for the inter-bank applications like Real Time Gross Settlement (RTGS), National Electronic Funds Transfer (NEFT), Public Debt Office–Negotiated Dealing System (PDO-NDS), Centralised Public Accounts Department System (CPADS), and Automated Clearing House (ACH).

13. Legal Reforms

3.232 The legislative changes undertaken during 2008-09 are as follows:

3.233 The Payment and Settlement Systems Act, 2007 has come into force on notification in the official Gazette. The Act confers on the Reserve Bank regulatory and supervisory powers in respect of payment systems. Accordingly, the regulations, *viz.*, (i) Board for Regulation and Supervision of Payment and

Box III.14: Multi-Protocol Label Switching (MPLS)

Multi-Protocol Label Switching (MPLS), provides a mechanism for engineering network traffic patterns that is independent of routing tables. It is a combination of packet forwarding and label switching through a network, an integration of high speed layer 2 switching with layer 3 routing using label switching. MPLS adopts the usage of Virtual Private Networks (VPN) which enhances the security levels, thereby improving network based telecommunication. MPLS network is an improvement over the leased line network. The Leased line Network being a partial mesh network, is less scalable, and therefore, adding a new site to the network is difficult. Further, up-gradation of bandwidth is a time consuming and cumbersome process and packet switching is slower in a Leased Line Network as compared to the MPLS.

With the evolution of MPLS, VPNs are poised to herald a radical shift in the world of network computing. Another trend over the last year is that most enterprises are focused on creating highly agile and redundant networks, where MPLS VPN emerged as a trusted Wide Area Network (WAN) connectivity option. Moreover, it improves efficient use of resources and enhances performance of the network. MPLS also enables easy to implement Quality of Service and Class of Service based on application needs. The implementation of Internet Protocol Security (IPSec) tunnels (secure tunnels between which data is encrypted) between CPE (Customer Premises Equipment, *i.e.*, router) to CPE is relatively easy. IDRBT has taken up the project of implementing INFINET MPLS Architecture designed to provide high level redundancy.

INFINET MPLS improves the possibilities for Traffic Engineering and supports the delivery of services with Quality of Service (QoS) guarantees. Its salient features are: (i) Full Meshed communications at all locations (backbone), (ii) Two service providers to enable high speed fault tolerance, (iii) A VPN between two locations could be across service providers, all VPNs between CPEs will be encrypted, and (iv) Availability of QoS (Quality of Service) and TE (Traffic Engineering) on the last mile as well.

QoS is a capability of the network to provide resource assurance and service differentiation, where ‘service differentiation’ is the ability of the network to treat different applications in different ways, and ‘resource assurance’ is the ability of the network to provide appropriate service to fit the application requirements, such as bandwidth, packet loss, jitter and latency.

TE is the process of selecting and controlling the paths along which the data travels through a network in order to optimise network resource utilisation and traffic performance ensuring efficient and reliable network operations. The goal of TE is efficient and reliable network operation, optimisation of network resources, handling of link and node failures and Voice and Video delivery over data network with performance and QoS.

Settlement Systems Regulations, 2008; and (ii) Payment and Settlement Systems Regulations, 2008 have been framed by the Reserve Bank.

3.234 The State Bank of India (Subsidiary Banks Laws) Amendment Bill, 2009 was introduced in the Lok Sabha on February 24, 2009 for amending certain provisions in the State Bank of Hyderabad Act, 1956 and the State Bank of India (Subsidiary Banks) Act, 1959 dealing with approval of, or consultation with the Reserve Bank in the management and functioning of the subsidiary banks. The transfer of ownership of the State Bank from the Reserve Bank to the Central Government was carried out pursuant to the coming into force of the State Bank of India (Amendment) Act, 2007 (30 of 2007). Due to change in the ownership in the State Bank of India, consequential amendments were to be made in both the statutes. The Bill has, however, lapsed.

3.235 With regard to the legal infrastructure, the CFSA notes that though there have been improvements in legal infrastructure in the financial sector, the time taken for completion of liquidation proceedings is one of the highest in the world and the recovery rate one of the lowest. The operationalisation of the Companies Act (Second Amendment), 2002 will address the current problems relating to delays in completion of liquidation proceedings. The CFSA considers that a separate insolvency regime for banks and other categories of financial institutions is vital in the context of financial stability, as any inefficient handling of insolvency of such institutions could have a serious contagion effect and repercussions across the economic system that will destabilise economic activity.

14. Conclusion

3.236 In the wake of the global financial crisis, the policy initiatives during 2008-09 were mainly aimed at maintaining stability and ensuring liquidity in the banking system, while channelling adequate credit to the productive sectors of the economy without any interruptions. The issues received special attention from the Reserve Bank during the year included prudential regulation of off-balance sheet exposures of the banks, supervision of financial conglomerates and restructuring of advances of the banking system. Several modifications were also made to the Agricultural Debt Waiver and Debt Relief Scheme, 2008 to make the implementation of the Scheme easier. With a view to facilitating financial inclusion, the Reserve Bank gave priority to BC model, financial literacy, credit counselling and the LBS. An issue that deserves further attention from the Reserve Bank is the intensification of the financial inclusion process by encouraging the 'no-frill' account holders to actively operate their accounts. In the context of financial inclusion, strengthening the RRBs by applying capital adequacy norms and diversifying the business operations assume importance. Strengthening of the cooperative banking sector also received due attention from the Reserve Bank during the year owing to the importance of these institutions in the Indian financial landscape. The BOS was revised to make the banks more customer-friendly. Measures were also taken to reduce frauds in the banking system and to make ATMs user-friendly. RTGS was modified to make the electronic financial transactions more efficient. During the year, most of the banks have migrated to cost-saving MPLS technology.

3.237 To sum up, the Reserve Bank took pro-active policy decisions so as to contain the knock-on effects of the global financial turmoil on Indian banking and financial system. The assessment made by the CFSA also indicated that the Indian banks are sound and broadly compliant with the international norms.