X FINANCIAL REGULATION AND SUPERVISION

10.1 Recent international financial developments have underscored the critical role of the regulatory and supervisory function in ensuring the health and stability of the financial system. The impact of technological advancement, financial liberalisation and the degree of integration between domestic and international financial markets has rendered the conduct of oversight of the financial system a highly complex task. Regulatory and supervisory functions constitute a range of services to the community covering the establishment of specific rules of behaviour for participants in the financial system, monitoring the observance of the rules, and general supervision of the behaviour of financial entities. The rationale for financial regulation lies in the economic costs imposed on the society by financial market failure. The adverse consequences include threat to systemic stability, the potential for gridlocks due to adverse selection and moral hazard problems as well as undermining the substantial benefits which would otherwise accrue from correction of market imperfections, reduced transaction costs, and providing people with a financial system they can trust.

10.2 In India, progressive strengthening of the regulatory and supervisory framework has been a key element of financial sector reforms. There has been significant progress in achieving international best practices in banking regulation and supervision. Within the process of convergence with best practices, fine-tuning is undertaken keeping in view the country-specific circumstances. The process of refining the crucial functions of regulation and supervision of the financial system in India gathered further momentum in 2002-03 in the context of dramatic shifts in the macroeconomic and financial environment. The focus of policy initiatives during the year was on streamlining banking operations, upgrading risk management systems, enhancing the level of compliance by banks with the Accounting Standards and operationalising consolidated accounting practices. A major development in the evolving institutional infrastructure for financial regulation was the enactment of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002 which is expected to improve the recovery of non-performing loans. Policies for regulation and oversight of the financial system were guided by the objectives of increasing operational efficacy of monetary policy, redefining the regulatory role of the Reserve Bank, strengthening prudential norms and developing the technological and institutional infrastructure.

THE BOARD FOR FINANCIAL SUPERVISION (BFS)

10.3 The Board for Financial Supervision (BFS), formed in November 1994 under the aegis of the Reserve Bank, is responsible for an integrated system of supervision of banks, financial institutions (FIs) and non-banking financial companies (NBFCs) regulated by the Reserve Bank. The Board functions as a Committee of the Central Board of the Reserve Bank with Governor as Chairman, a Deputy Governor as Vice Chairman, and other Deputy Governors and four Directors of the Central Board as members.

10.4 During 2002-03 (July-June), the BFS held 11 meetings. It reviewed the performance of regulated financial entities on the basis of 101 Inspection reports of banks/FIs. Of these reports, 73 (26 public sector banks (PSBs), 20 private sector banks, 17 foreign banks, eight FIs, one local area bank and a consolidated report on Local Head Offices of the State Bank of India) related to the position on March 31, 2002 while other reports pertained to earlier or later periods. A major thrust of the supervisory review process is to ensure that the summary of the inspection reports of all the banks is placed before the BFS at least once during the period of 12 months ending March 31 every year. The Board also reviewed the monitoring of bank frauds, house-keeping in PSBs, including reconciliation of entries in inter-branch accounts, inter-bank accounts (including *Nostro* accounts) and balancing of the books of accounts. The performance of Primary Dealers (PDs) as a group was reviewed by the BFS. Besides delineating the course of action to be pursued in respect of institution-specific supervisory concerns, the BFS provided guidance on several regulatory and supervisory policy decisions. The Board also reviewed the overall position of overseas operations of Indian banks as on March 31, 2002 based on portfolio inspection of the records available at head offices of the banks in India.

10.5 A comprehensive review of the Indian banking system in respect of domestic operations based on quarterly data reported by banks in 2002-03 and half-yearly reports on Macro-Prudential Indicators (MPIs), highlighting the linkages among institutions, markets and sectors of the economy, was placed before the BFS. At the initiative of the BFS, studies were also conducted on the impact on capital adequacy of converting excess SLR holdings into loan assets, capital market exposures of banks and the differences in the provisioning norms being followed by Indian banks and those applicable to banks in the US under their Generally Accepted Accounting Principles (GAAP). Another important study conducted under the direction of the BFS was the analysis of slippages of NPA accounts from sub-standard to doubtful/loss category (Box X.1).

10.6 Keeping in view the emerging supervisory concerns, six banks in the old private sector group and five banks in the new private sector group were placed under monthly monitoring. Under this system, certain key financial parameters of the banks like capital to risk-weighted assets ratio (CRAR), exposure to sensitive sectors, managerial problems and promoters' share holdings are analysed at the end of each month to monitor the progress made by them. Supervisory concerns in respect of these banks identified through the analysis of key financial parameters were placed before the BFS every month for its consideration and for providing guidance. This exercise has resulted in an improvement in the performance of most of these banks. The scope of monthly monitoring is being expanded to include the progress in recovery of NPAs.

10.7 In the area of fraud monitoring and prevention, information on background, *modus operandi*, causes and actions taken by the banks and the Reserve Bank in respect of frauds of Rs.1 crore and above and the follow-up of 39 large value frauds (Rs.10 crore and above) reported by banks and FIs during 1996 to 2000 were submitted to the BFS on a quarterly basis during the year.

10.8 Corporate governance is becoming crucial for banks and FIs to promote effective risk management and financial stability. The banks' Board of Directors and their committees bear the primary responsibility of providing adequate checks and balances, introducing proper systems and procedures for risk containment, evolving early warning systems and ensuring prompt corrective action. The report of the Consultative Group of Directors of Banks/FIs (Chairman: Dr. A S Ganguly) on Corporate Governance was examined by the BFS and based on the recommendations, actions to be taken by public and private sector banks were grouped separately and advised to the banks in June 2002 (Box X.2).

10.9 The Sub-Committee (Audit), set up by the BFS to review the policies governing audit, held two meetings during the year and examined the recommendations of the Committee on Computer Audit. Their report was forwarded to banks for implementation. The Sub-Committee (Audit) also examined suggestions made by the Central Vigilance Commission on the need to strengthen the internal

Box X.1

Guidelines for Preventing Slippage of NPA Accounts

At the behest of the BFS, a study was conducted on slippage of non-performing accounts from sub-standard to doubtful/loss categories. A suggested framework of recommendations, prepared on the basis of the study, was circulated among banks for feedback and comments. Based on the response to these draft recommendations, the final recommendations for preventing slippage of NPA accounts were forwarded to banks in September 2002. A system of early recognition with timely and adequate intervention was suggested.

In this context, it was also suggested that banks may introduce a new asset category called "Special Mention Accounts" between 'Standard' and 'Sub-standard' for their own internal monitoring and follow-up, in line with international best practices but keeping in view the local requirements. An asset may be transferred to this category once the earliest signs of sickness/ irregularities are noticed. This would help banks to look at accounts with potential problems in a focused manner right from the onset of the problem, so that monitoring and remedial actions can be more effective. Banks which already have a designated asset category on the lines of 'special mention assets' may continue the same on the basis of their internal norms.

Special mention assets would not require provisioning, as they are not classified as NPAs. Their main purpose is to alert management to the possibility of such an account turning bad, thus triggering preventive action well in time. These guidelines are aimed at providing a common minimum framework to tackle the problem of slippage of NPAs and it is expected that banks will work out their strategic responses in keeping with the broad thrust of the guidelines.

Box X.2

Current Issues in Corporate Governance

As part of the on going financial sector reforms, the Boards of banks and FIs have been given greater autonomy to lay down guidelines and procedures to enhance transparency and disclosure, to contain risk and for asset-liability management. The Consultative Group of Directors of Banks and Financial Institutions (Chairman: Dr. A. S. Ganguly), set up by the Reserve Bank, reviewed these aspects and recommended measures to make the supervisory role of the Boards of banks and FIs more effective. These recommendations have been benchmarked against international best practices as enunciated by the Basel Committee on Banking Supervision. In June 2002, a list of actions to be undertaken by banks was indicated to banks. These included due diligence procedures for appointment of directors on the boards of private sector banks, and role and responsibilities of independent/non-executive directors.

The Securities and Exchange Board of India (SEBI) had constituted a Committee on Corporate Governance. Their recommendations were forwarded to the Reserve Bank with a request to consider issuing appropriate guidelines to banks with a view to harmonising the existing requirements with the SEBI Committee requirements. Banks which have issued shares to the public and are listed on stock exchanges were advised to form committees to look into redressal of shareholders' complaints and to provide un-audited financial results on half yearly basis to their shareholders with summary of significant developments. It was observed that the procedures in regard to appointment and removal of external auditors are more stringent in banks than those recommended by the SEBI Committee.

The Joint Parliamentary Committee (JPC) on Stock Market Scam and Matters Related Thereto observed that it is imperative for the banks to follow strategies and techniques basic to the tenets of sound corporate governance. These are capable and experienced directors, efficient management, coherent strategy and business plan, and clear lines of responsibility and accountability. The JPC also endorsed the recommendations of the Advisory Group on Banking Supervision (Chairman: Shri M. S. Verma) submitted in May 2001 and desired that the same be implemented expeditiously. Banks have to attach priority to strengthen their Management Information System (MIS) and internal control mechanisms to comply with these requirements.

Other corporate governance measures to be taken by banks relate to strengthening of the risk management framework, review of connected lending and constitution of various committees in conformity with corporate governance standards. They are also required to develop mechanisms to ensure percolation of their strategic objectives and corporate values throughout the organisation.

The Reserve Bank has set up an Internal Working Group to examine Auditing and Corporate Governance Issues in Banks. The Internal Working Group would consider issues addressed by the Sarbanes-Oxley (SOX) Act, 2002 of the US and the Reports of the Committee on Corporate Audit and Governance (Chairman: Naresh Chandra), the Consultative Group of Directors of Banks/Financial Institutions (Chairman: Dr. A.S. Ganguly), the Advisory Group on Banking Supervision (Chairman: M.S. Verma), the Advisory Group on Accounting and Auditing (Chairman: Y.H. Malegam), and the Advisory Group on Corporate Governance (Chairman: Dr. R.H. Patil).

The Internal Working Group would explore the possibility of setting up of an Advisory Group in the Reserve Bank. The Advisory Group would advise the Reserve Bank on a regular basis the measures to improve quality control, ethics, independence and other standards relating to the preparation of audit reports of banks; and, pass judgement and comments on the quality and sufficiency of systems.

audit system of banks and the recommendations of the Working Group constituted to review the eligibility norms for empanelment of audit firms as statutory auditors and other audit related issues.

SCHEDULED COMMERCIAL BANKS

Prudential Norms

Income Recognition/Asset Classification

10.10 Banks were advised in May 2002 that they should not recognise income on accrual basis in respect of (a) the projects where financial closure had been achieved and formally documented, (b) projects sanctioned before 1997 with original project cost of Rs.100 crore or more where financial closure was not formally documented and (c) projects sanctioned before 1997 with original project cost of less than Rs.100 crore where financial closure was not formally documented. In February 2003, banks were advised to recognise income on accrual basis in respect of these three categories of projects under implementation which are classified as 'standard'.

Provisioning Norms

10.11 In the recent period, there has been a concerted endeavour to converge to the best international practices in provisioning (Table 10.1). Banks are required to make 100 per cent provision for the net debit position in their inter-branch accounts in respect of unreconciled entries outstanding for more than six months, with effect from the year ending March 31, 2004, as against the existing period of one year.

Table 10.1: Regulatory Framework

Variable	1992-93	2000-01	2001-02	2002-03
1	2	3	4	5
Capital to Risk-weighted Assets Ratio (per cent)				
Domestic banks with international business	4	9	9	9
Foreign banks	8	9	9	9
Non-performing assets (period overdue)				
Sub-standard assets	4 Q	2 Q	180 days	180 days #
Doubtful assets (period for which remained sub-standard)	24 M	18 M	18 M	18 M @
Provisioning Requirements (per cent)				
Standard assets	-	0.25	0.25	0.25
Sub-standard assets	10	10	10	10
Doubtful assets (unsecured portion)	100	100	100	100
Loss assets	100	100	100	100

\# 90 days from March 31, 2004.
@ 12 months from March 31, 2005.
Q Quarters; M Months.

10.12 Banks are required to make provisions, with effect from the year ended March 31, 2003, on the net funded country exposures on a graded scale ranging from 0.25 to 100 per cent, depending upon the risk categories prescribed in the country risk management (CRM) guidelines. They are also required to disclose, as a part of the 'Notes on Accounts' to the balance sheet as on March 31 each year, their category-wise country risk exposures and the extent of aggregate provisions held against them. With a view to reducing the level of long pending entries outstanding in the Clearing Adjustment Accounts, banks were allowed, as a one-time measure, to net off entries representing clearing differences receivable against entries representing clearing differences payable upto Rs. 500 each which are outstanding for more than three years. Banks were also advised to write-off aggregate net debit position of clearing differences.

Investments by Banks

10.13 With a view to building up of adequate reserves to guard against any possible reversal of the interest rate environment in future due to unexpected developments, banks were advised to build up an Investment Fluctuation Reserve (IFR) of a minimum of five per cent and a maximum of 10 per cent of the investment held in the Available for Sale (AFS) and Held for Trading (HFT) categories of the investment portfolio within a period of five years commencing from the year ended March 31, 2002. In order to give a further impetus to banks, IFR would continue to be treated as Tier II capital but would not be subject to the ceiling of 1.25 per cent of the total risk-weighted assets. For compliance with the capital adequacy norms, however, Tier II capital including IFR would be considered up to a maximum of 100 per cent of total Tier I capital, effective March 31, 2003 onwards.

Guidelines on Infrastructure Financing

10.14 In view of the critical importance of the infrastructure sector, revised guidelines on financing of infrastructure projects were issued in February 2003. Accordingly, any credit facility in whatever form extended by lenders (*i.e.,* banks, FIs or NBFCs) to an infrastructure facility as broadly defined in the guidelines would be treated as 'infrastructure lending'. Furthermore, credit exposure to a single borrower and to borrowers belonging to a group may exceed the prudential exposure norm of 15 per cent and 40 per cent, respectively, of the bank's capital funds by an additional five and 10 percentage points (*i.e.,* up to 20 per cent and 50 per cent, respectively), provided the additional credit exposure is on account of infrastructure lending. Banks may assign a concessional risk weight of 50 per cent, for capital adequacy purposes, on investment in securitised paper pertaining to an infrastructure facility, subject to compliance with certain conditions specified in the revised guidelines.

Norms for Foreign Banks

10.15 Effective March 31, 2002, foreign banks were brought on par with Indian banks for the purpose of computing prudential credit exposure ceiling by redefining 'capital funds' as defined under capital adequacy standards. Since some foreign banks' exposures exceeded the revised prudential exposure limits, specific relaxation was allowed in respect of merger/acquisition of different borrowing companies. The excess exposure may be continued with till March 31, 2004. Similarly, excess exposure on existing fund and non-fund based facilities such as term loans, investments in bonds/debentures and performance guarantees may continue till their expiry/maturity. Foreign banks are not allowed to assume fresh exposure to single/group borrowers beyond the prudential credit exposure limits. The requests of the banks for meeting priority sector lending target breaching prescribed exposure norms will be approved on a case-to-case basis.

NPA Management of Banks

One-Time Settlement/Compromise Schemes

10.16 Subsequent to the introduction of the SARFAESI Act, 2002, the Reserve Bank issued fresh guidelines for one-time settlement scheme in January 2003 for compromise settlement of chronic NPAs up to Rs.10 crore in PSBs. These guidelines cover: (a) all NPAs in all sectors, irrespective of the nature of business, which have become doubtful or loss assets as on March 31, 2000 with outstanding balance of Rs.10 crore and below on the cut-off date; (b) NPAs classified as sub-standard as on March 31, 2000, which have subsequently become 'doubtful' or 'loss' assets; and (c) cases in which the banks have initiated action under the SARFAESI Act, 2002 and also cases pending before Courts/Debt Recovery Tribunals (DRTs)/Board for Industrial and Financial Reconstruction (BIFR), subject to consent decree being obtained from the Courts/DRTs/BIFR. The last date for receipt of applications from borrowers under the scheme is September 30, 2003.

10.17 Guidelines for the special One-Time Settlement (OTS) scheme for loans up to Rs.50,000 to small and marginal farmers by PSBs were operative up to December 31, 2002. They were extended up to March 2003 in view of requests received from banks and the drought/flood situation in various parts of the country.

Lok Adalats

10.18 The Reserve Bank issued guidelines to commercial banks and FIs to enable them to make increasing use of *Lok Adalats*. They were advised to participate in the *Lok Adalats* convened by various DRTs/DRATs for resolving cases involving Rs.10 lakh and above to reduce the stock of NPAs.

Debt Recovery Tribunals

10.19 The Debt Recovery Tribunal (Procedure) Rules 2003 were amended substantially regarding application fee and plural remedies for better administration of the Recovery of Debts due to Banks and Financial Institutions Act, 2002. The passage of the SARFAESI Act, 2002 has provided the necessary impetus for banks and FIs to hasten the recovery of the dues (Box X.3).

Box X.3

The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002

The Government enacted t*he Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002,* which provides, *inter alia*, for enforcement of security interest for realisation of dues without the intervention of courts or tribunals. The Government has also notified the Security Interest (Enforcement) Rules, 2002 to enable secured creditors to authorise their officials to enforce the securities and recover the dues from the borrowers. PSBs and FIs have been advised to take action under the Act and report compliance to the Reserve Bank.

Since the Act provides for sale of financial assets by banks/FIs to securitisation companies (SCs)/reconstruction companies (RCs), guidelines have been issued to ensure that the process of asset reconstruction proceeds on sound lines. These guidelines, *inter-alia*, prescribe the financial assets which can be sold to SCs/RCs by banks/FIs, procedure for such sales (including valuation and pricing aspects), prudential norms for the sale transactions (*viz.*, provisioning/valuation norms, capital adequacy norms and exposure norms) and related disclosures required to be made in the Notes on Accounts to balance sheets.

The IFCI, along with other banking and FIs, incorporated an asset reconstruction company called 'Asset Care Enterprise Ltd.' (ACE) in June 2002 with an authorised capital of Rs.20 crore. IFCI Ltd. contributed a major share in ACE Ltd. (Rs.2.45 crore or 49.0 per cent of the initial paid-up capital of Rs.5.00 crore), followed by Punjab National Bank (26.0 per cent), Tourism Finance Corporation of India (14.2 per cent), Life Insurance Corporation of India (10.0 per cent) and Madhya Pradesh Consultancy Organisation (0.8 per cent). The Company has already applied to the Reserve Bank seeking necessary registration as an asset reconstruction company. More recently, the IDBI, the ICICI Bank, the SBI and few other banks have jointly promoted the Asset Reconstruction Company (India) Ltd. (ARCIL) with an initial authorised capital of Rs.20 crore and paid-up capital of Rs.10 crore. The three major sponsors, *viz.*, IDBI, ICICI Bank and SBI, will hold 24.5 per cent each of the share capital in ARCIL. The balance 26.5 per cent shareholding would be from small private sector banks. Similar asset reconstruction/management companies are also being proposed by other institutions/banks. IDBI has already proposed to transfer some NPAs to ARCIL.

The SARFAESI Act has served as an important tool for banks and FIs in the recovery of the dues. Under the Act, PSBs issued 32,043 notices for an outstanding amount of Rs.11,447 crore till end-May 2003. The total recoveries by PSBs till end-May 2003 aggregated Rs.436 crore from 8,676 cases. Nine FIs under the regulatory and supervisory domain of the Reserve Bank served notices in respect of 182 companies involving aggregate outstanding dues of Rs.9,046 crore as at end February 2003. The total recoveries by FIs till end-February 2003 aggregated Rs.25.2 crore.

Credit Information on Defaulters and Role of Credit Information Bureau

10.20 In order to alert the banks and FIs and put them on guard against defaulters to other lending institutions, recent efforts of the Reserve Bank have focussed on developing a credit information bureau in the country (Table 10.2). The information on defaulting non-suit filed doubtful and loss accounts of Rs.1 crore and above is disseminated on half-yearly basis (March 31 and September 30) while that on suit-filed accounts is published as on March 31 every year and is updated on quarterly basis. The defaulters' list of non-suit filed accounts has been disseminated as on March 31, 2002 to banks and FIs for their confidential use. The list of suit-filed accounts as on March 31, 2002 was published in electronic form and placed on the Reserve Bank website followed by quarterly updates up to September 30, 2002. The wilful defaulters' list (suit-filed accounts) of Rs.25 lakh and above as on March 31, 2002 was published in electronic form and also placed on the Reserve Bank's website. The wilful defaulter's list (containing suit-filed and non-suit filed accounts) for the quarter ended June 30, 2002 was given to banks/FIs for their confidential use and the list of suit-filed accounts has been placed on the Reserve Bank's website.

Risk Management

Bank Financing of Equities and Investment in Shares

10.21 During 2002-03, banks were required to review their risk management systems pertaining to capital market exposures and exposures to stock broking entities/market makers. The review would assess the efficiency of the risk management systems in place in the bank, the extent of compliance with the guidelines issued and would identify the gaps in compliance for initiating appropriate steps.

Guidelines on Country Risk Management (CRM)

10.22 With a view to moving forward in complying with the *Core Principles for Effective Banking Supervision,* guidelines on country risk management and provisioning thereof were issued to banks requiring:

- formulation of well-documented and clearly defined Country Risk Management (CRM) policies by banks;
- identification, measurement, monitoring and controlling of country exposure risks and specifying responsibility and accountability of the various levels;

Table 10.2 : Recent Initiatives on Credit Information on Defaulters

Year	Measure
1	2
1999	Working Group (Chairman: Shri N.H. Siddiqui) set up in June to explore the possibility of setting up Credit Information Bureau (CIB) in India; submitted its Report in November.
2000	Credit Information Bureau of India Limited (CIBIL) set up in August for collecting, processing and sharing credit information on borrowers.
2001	Working Group (Chairman: Shri S.R.Iyer) set up in December to examine the possibility of the CIB performing the role of collecting and disseminating information on suit-filed accounts and the list of defaulters; submitted its Report in January 2002.
2002	Banks and FIs advised in June to submit periodic data on suit-filed accounts of Rs.1 crore and above till December 2002 and suit filed accounts of wilful defaults of Rs.25 lakh and above till the quarter ending December 2002 to the Reserve Bank as well as to CIBIL and thereafter to CIBIL only.
	To broad-base credit information/data with CIBIL, banks and FIs advised on October 1 to furnish information in respect of suit-filed accounts between Rs.1 lakh and Rs.1 crore from the period ended March 2002 in a phased manner to CIBIL only.
	Periodic data relating to non-suit filed accounts for defaulter lists to continue to be submitted to the Reserve Bank only as hitherto.
	Banks and FIs advised on October 1 to obtain consent of borrowers and their guarantors for disclosure of their names in case of default, and submit progress returns thereon to CIBIL.
2003	In view of the constraints expressed by banks in adhering to the time schedule for obtaining the consent clause, revised schedule advised in February for obtaining the consent clause and submission of returns to CIBIL by September 2004 and December 2004, respectively.

- institution of contingency plans and clear exit strategies to be activated at times of crisis; and,
- rigorous application of the 'Know Your Customer' (KYC) principle in international activities which should not be compromised by availability of collateral or shortening of maturities.

Guidance Notes on Management of Credit and Market Risk

10.23 As a step towards enhancing and fine-tuning the existing risk management practices in banks, draft Guidance Notes on Credit Risk Management and Market Risk Management were issued and placed on the website for wider discussion. These Guidance Notes were based on the recommendations of two Working Groups constituted by the Reserve Bank drawing experts from select banks and FIs. In the light of the feedback received, revised Guidance Notes were issued to banks for upgrading their risk management systems. These notes have kept in view banks' own requirements, dictated by the size and complexity of business, risk philosophy, market perception and the expected level of capital. In recent years, the management of operational risk has also assumed importance (Box X.4).

Supervisory Initiatives

Off-site Monitoring and Surveillance

10.24 Off-site monitoring and surveillance (OSMOS) function was established in 1995 with the primary objective of analysing the financial position of banks in between on-site inspections. A comprehensive OSMOS became fully operational in 1997. Since then, the scope and coverage of the off-site returns have been enhanced significantly. In view of the recent initiatives on consolidated supervision, country risk management and risk-based supervision, certain additional data needed to be collected through the off-site returns. Accordingly, an upgraded OSMOS system, including new returns as well as enhancing the coverage of the existing ones, has been implemented from the quarter ended June 2003.

Consolidated Supervision

10.25 Guidelines on consolidated supervision were issued to banks for implementation with effect from the year ended March 2003 (Box X.5). Banks were advised to ensure strict compliance commencing from the year ended March 31, 2003. This would enable the Reserve Bank in adhering to the *Core Principles for Effective Banking Supervision.*

Box X.4

Management of Operational Risk

The operational risk faced by banks has increased manifold, *inter alia,* due to an expansion in the size of their operations and increased exposure to various sectors and activities. Operational risk arises out of deficiencies in internal systems and controls, systems failures and non-adherence to prescribed procedures. Its management has gained importance because of the scale of losses that banks have suffered on account of deficiencies in internal controls. Banks, particularly those operating in international markets, are beginning to apply the same quality of management attention to operational risk as to well developed areas of credit and market risks. Some of these banks have already developed operational risk rating matrices, similar to bond credit rating.

Internal control (segregation of duties, clear management reporting lines and operating procedure) and internal audit are the primary means to mitigate operational risk. Internationally, as well as in India, banks have not been able to evolve any scientific method for quantifying operational risk. This may be due to lack of historical data.

The Reserve Bank's guidelines on "Risk Management Systems in Banks" provide simple benchmarks based on business activity such as gross revenue, fee income and operating costs in the absence of any sophisticated models. Under the New Capital Accord, banks would be required to earmark capital for operational risk. In its comments on "A New Capital Adequacy Framework" released in April 2000, the Reserve Bank noted that banks should devote the necessary resources to quantify the level of operational risks and incorporate them into the assessment of their overall capital adequacy. Banks would be required to focus more closely upon their internal control systems, particularly towards clearing of backlog in balancing of books and inter branch and *nostro* accounts reconciliation.

The New Capital Accord provides a range of options of increasing sophistication for providing explicit capital for operational risk. These evolutionary approaches have built-in incentives to encourage banks to continuously improve their risk management and measurement capabilities and undertake more accurate assessment of regulatory capital.

Box X.5

Guidelines for Consolidated Accounting to Facilitate Consolidated Supervision

In the recent period, there has been an increased focus on empowering supervisors to undertake consolidated supervision of bank groups. Moreover, the *Core Principles for Effective Banking Supervision* issued by the Basel Committee on Banking Supervision (BCBS) have underscored this requirement as an independent principle. Accordingly, the Reserve Bank set up a multi-disciplinary Working Group in November 2000 (Chairman: Shri Vipin Malik) to examine the feasibility of introducing consolidated accounting and other quantitative methods to facilitate consolidated supervision.

On the basis of the recommendations of the Working Group, the components of consolidated supervision to be implemented by the Reserve Bank include Consolidated Financial Statements (CFSs) for public disclosure and Consolidated Prudential Reports (CPRs) for supervisory assessment of risks which may be transmitted to banks or other supervised entities by other Group members. Moreover, there would be application of certain prudential regulations like capital adequacy and large exposures/risk concentration on group basis. Initially, consolidated supervision has been mandated for all groups where the controlling entity is a bank. In due course, banks in mixed conglomerates would be brought under consolidated supervision where (i) the parents may be non-financial entities, (ii) the parents may be financial entities falling under the jurisdiction of other regulators like Insurance Regulatory and Development Authority (IRDA) or SEBI or, (iii) the supervised institution may not constitute a substantial or significant part of the group.

10.26 All banks under the purview of consolidated supervision of the Reserve Bank, whether listed or unlisted, were advised to prepare and disclose consolidated financial statements (CFSs) from the financial year commencing from April 1, 2002 in addition to their single financial statements. The CFSs are required to be prepared in accordance with the Accounting Standards 21, 23 and 27 prescribed by the Institute of Chartered Accountants of India (ICAI). Banks coming under the purview of consolidated supervision would also need to prepare consolidated prudential reports (CPRs) in addition to CFSs. CPRs were initially introduced on half-yearly basis from March 31, 2003 as part of the off-site reporting system on the lines of the existing DSB returns for banks. The banks should prepare the CPR adopting the same principles as laid down in Accounting Standards 21, 23 and 27. The CPR should contain information and accounts of related entities which carry on activities of banking or financial nature and should not include group companies engaged in insurance or non-financial activities. Prudential norms/limits similar to those as applicable to banks are prescribed for compliance by the consolidated bank.

Prompt Corrective Action (PCA)

10.27 The scheme of prompt corrective action (PCA) was developed for pre-emptive adjustments by troubled banks to early signs of financial vulnerability (Table 10.3). The scheme is in operation, initially for a period of one year from December 2002. Continuation or otherwise of the PCA framework as well as modification in the trigger levels or actions to be taken will be reviewed in December 2003.

Risk Based Supervision

10.28 To ensure a smooth transition to Risk Based Supervision (RBS) and to facilitate the requisite preparation, commercial banks were involved in a consultative process to identify the support required by them in this regard. The Risk Profile Template (RPT) has been tried by banks for undertaking self-assessment of risks and found suitable. Training of

Table 10.3 : Prompt Corrective Action

Year	Measure
1	2
1999	A draft note on Prompt Corrective Action (PCA) was prepared and forwarded to select banks for their views.
2000	A Discussion Paper on PCA was released by the Reserve Bank in July to envisage the possibility of introducing such a system for India based on the following three trigger points - CRAR, net NPA to net advances ratio and return on assets.
2001	The Scheme was sent to the Government of India in April for their views before implementation.
2002	The Scheme was back tested on a few select banks in July.
2002	The Scheme was circulated among banks in December, advising them to take steps to avoid coming under the purview of PCA.

commercial bank officers as well as the Reserve Bank supervisory staff at the training colleges of the Reserve Bank has made considerable progress. On-location and dedicated programmes on risk based supervision and risk management have also been conducted for banks. The RBS Manual has been prepared for use by the Reserve Bank supervisory staff. The pilot run of risk-based supervision of select banks was initiated during the quarter April-June 2003.

10.29 The financial turmoil during the second half of the 1990s in Asia and subsequently in several emerging economies provoked much reflection on ways to strengthen the global financial system. As part of its surveillance work, the International Monetary Fund (IMF) assesses financial system soundness in its member countries through the preparation of Financial System Stability Assessments (FSSA). Several national and international institutions have also initiated or intensified monitoring work. Towards this objective, several countries, including India, have undertaken efforts towards developing macro-prudential indicators (MPIs) for monitoring the health of the financial system (Box X.6).

Supervisory Rating of Banks

10.30 Some changes were made to the system of rating banks under CAMELS/CALCS models keeping in view the importance of frauds monitoring and prevention. Compliance in the area of fraud monitoring and prevention would carry more weight while rating banks.

Other Structural and Regulatory Measures

Fair Practices Code for Lenders

10.31 Guidelines in regard to Fair Practices Code for Lenders were framed and the banks/all-India FIs

Box X.6

Macro-Prudential Indicators (MPIs): Salient Features

The ability to monitor financial sector soundness presupposes the existence of valid indicators of the health and stability of financial systems. These macro-prudential indicators (MPIs) matter for several reasons. They allow assessments to be based on objective measures of financial soundness. Publicly available MPIs enhance disclosure of key financial information to the markets. Moreover, MPIs adhering to internationally agreed standards facilitate monitoring of the financial system at the global level, especially in view of the magnitude and mobility of international capital, and the risk of contagion of financial crises. MPIs, in essence, comprise both aggregated micro-prudential indicators of the health of individual financial institutions and macroeconomic variables associated with financial system soundness. Financial crises often occur when both types of indicators point to vulnerabilities.

In the Indian context, the mid-term Review of Monetary and Credit Policy of October 2000 indicated that a half-yearly financial stability review using MPIs would be prepared. Accordingly, a pilot review of MPIs was prepared for the half-year ended March 2000, followed by regular half-yearly reviews from September 2000 onwards for internal circulation. The scope and coverage of MPIs were enhanced in the review for the half-year ended March 2002. The salient features of the review for the half-year ended March 2003 are given below:

- Top five banks accounted for almost 43 per cent of the assets of the banking system.
- Growth in regulatory capital outstripped the growth in risk-weighted assets.
- Combined CRAR of the banking system increased to 12.8 per cent as at end-March 2003 from 12.0 per cent as at end-March 2002.
- Investment in SLR securities exhibited high growth.
- Gross non-performing loans (NPL) declined by 1.6 per cent. Due to high provisioning, net NPLs declined by 9.8 per cent.
- For the first time, ratio of gross NPL to gross advances of the banking system declined below 10.0 per cent and ratio of net NPL to net advances below 5.0 per cent.
- Credit utilisation ratio (*i.e.,* ratio of balances outstanding to limits sanctioned) by large industrial borrowers (Rs.10 crore and above) went up from 56.0 per cent at end-March 2002 to 63.1 per cent at end-March 2003, reversing the recent declining trend.
- Return on equity, at over 18 per cent, turned out to be the highest in the last six years. Return on assets stood at over 1.0 per cent for the system as a whole.
- Profits from treasury operations represented one of the key sources of income for the banking system, accounting for almost one-third of total operating profits.
- The banking system's short-term assets were in excess of short-term liabilities (with asset to liability ratio at 107.5 per cent).
- For the banking system as a whole, the degree of credit concentration (in terms of credit extended to top 20 corporates as percentage of total credit) declined from 33.4 per cent as at end-March 2002 to 30.0 per cent as at end-March 2003.

have been advised to adopt these guidelines (Box X.7). The Fair Practices Code, duly approved by their Board of Directors, should be put in place in respect of all lending prospectively not later than August 1, 2003. Banks and FIs have the freedom of enhancing the scope of the guidelines without sacrificing the spirit underlying them. The Board of Directors should also lay down the appropriate grievance redressal mechanisms within the organisation to resolve disputes arising in this regard. A periodical review of the compliance of the Fair Practices Code and the functioning of the grievances redressal mechanism may be submitted to the Board at regular intervals.

Setting up of New Private Sector Banks

10.32 M/s. Kotak Mahindra Finance Ltd., a non-banking finance company, which was granted a licence for banking business in February 2003, commenced operations with effect from March 22, 2003 (Table 10.4).

Box X.7

Lenders' Liability Laws – Fair Practices Code for Lenders

In August 2002, the Government of India had constituted a Working Group to study Lenders Liabilities Laws of the USA and their full implications on the borrowers, lenders, regulators and other stakeholders. The Group, which was also advised to consider provisions and experience of other countries, submitted its report in October 2002. Salient features of the guidelines on Fair Practices Code for Lenders issued to banks are as follows:

Applications for Loans and their Processing

Loan application forms in respect of priority sector advances up to Rs.2 lakh should include information such as fees/charges payable for processing and pre-payment options so that a meaningful comparison with that of other banks can be made and informed decision can be taken by a borrower. Banks and FIs should devise a system of giving acknowledgement for receipt of all loan applications. The time frame within which loan applications up to Rs.2 lakh will be disposed of should also be indicated in acknowledgement of such applications. Additional details/documents, if required, should be intimated to the borrowers immediately. In the case of rejection of loan applications of small borrowers seeking loans up to Rs.2 lakh, the main reason(s) for rejection should be conveyed in writing, within stipulated time.

Loan Appraisal and Terms/Conditions

Lenders should ensure that there is proper assessment of credit application by borrowers. Margin and security stipulation should not be used as a substitute for due diligence on credit worthiness of the borrower. Terms and conditions and other caveats governing credit facilities given by banks/FIs arrived at after negotiation should be recorded in writing and duly certified. A copy of the loan agreement along with all enclosures quoted in the loan agreement should be furnished to the borrower. As far as possible, the loan agreement should clearly stipulate credit facilities that are solely at the discretion of lenders such as drawings beyond the sanctioned limits, honouring cheques issued for the purpose other than specifically agreed to in the credit sanction and disallowing drawal on a borrowal account on its classification as a non-performing asset or on account of non-compliance with the terms of sanction. It should also be specifically stated that the lender does not have an obligation to meet further requirements of the borrowers on account of growth in business without a proper review of credit limits.

Lenders should ensure timely disbursement of loans sanctioned in conformity with the terms and conditions governing such sanction; give notice of any change in the terms and conditions including interest rates and service charges; and, ensure that changes in interest rates and charges are effected only prospectively.

Post-disbursement Supervision

Post-disbursement supervision by lenders, particularly in respect of loans up to Rs.2 lakh, should be constructive with a view to taking care of any "lender-related" genuine difficulty that the borrower may face. Before taking a decision to recall / accelerate payment or performance under the agreement or seeking additional securities, lenders should give notice to borrowers, as specified in the loan agreement, or a reasonable period if no such condition exists in the loan agreement. Lenders should release all securities on receiving payment of loan or realisation of loan subject to any legitimate right or *lien* for any other claim lenders may have against borrowers. If such right of set-off is to be exercised, borrowers shall be given notice with full particulars about the remaining claims and the documents under which lenders are entitled to retain the securities till the relevant claim is settled/paid.

In addition, lenders should refrain from interference in the affairs of the borrowers except for what is provided in the terms and conditions of the loan sanction documents (unless new information, not earlier disclosed by the borrower, has come to the notice of the lender). For recovery of loans, the lenders should not resort to undue harassment, *viz.*, persistently bothering the borrowers at odd hours or use coercion. Consent or objection to a request for transfer of borrowal account, either from the borrower or from a bank/FI, should be conveyed within 21 days from the date of receipt of request.

Table 10.4 : Recent Initiatives on New Private Sector Banks

Year	Measure
1	2
1998	Committee established to review licensing policy.
2001	Revised guidelines for entry of new banks in the private sector issued in January.
	High-level Advisory Committee (Chairman: Dr. I.G.Patel) established to scrutinise *prima facie* eligibility.
	Two applicants - Shri Ashok Kapur and two other banking professionals with *Rabobank* Netherlands and M/s. Kotak Mahindra Finance Ltd., a non-banking finance company – recommended for eligibility in June.
2002	In-principle approval issued to these two applicants in February, valid for one year.
2003	M/s. Kotak Mahindra Finance Ltd. commenced operations on March 22 and included in the Second Schedule to the Reserve Bank of India Act, 1934 with effect from April 12.
	The other applicants with *Rabobank* Netherlands have been granted extension of time till November to complete all necessary formalities and to commence banking operations.

Off-shore Banking Units

10.33 The Government of India introduced Special Economic Zones (SEZs) with a view to providing an internationally competitive and a hassle-free environment for export production. For the first time, Offshore Banking Units (OBUs) were permitted to be set up in SEZs. These units would be virtually foreign branches of Indian banks but located in India. These OBUs, *inter alia,* would be exempted from cash reserve requirements and would be able to provide finance to SEZ units and SEZ developers at international rates of interest (Box X.8).

Measurement of Credit Exposure of Derivative Products

10.34 The exposure of banks by way of non-funded credit limits was hitherto capped at 50 per cent of such limits or outstandings, whichever is higher. The exposure to derivative products such as Forward

Box X.8

Setting up of Off-shore Banking Units

The salient features of the Scheme for setting up of OBUs in SEZs are:

- All banks operating in India, authorised to deal in foreign exchange, are eligible to set up OBUs, with a preference for banks having overseas branches and experience of running OBUs. Each of the eligible banks would be permitted to establish one OBU in one SEZ which would essentially carry on wholesale banking operations.
- Banks would be required to obtain prior permission of the Reserve Bank for opening an OBU in a SEZ under Section 23 (1)(a) of the Banking Regulation Act, 1949. The parent bank's application for branch licence should itself state that it proposes to conduct business at the OBU branch in foreign currency only. The OBUs would operate and maintain their balance sheet only in foreign currency. They would not be allowed to deal in Indian rupees except for having a special rupee account out of convertible funds to meet their day to day requirements. These branches would be prohibited from participating in domestic call, notice, term and other money markets and payment systems.
- Since OBUs would be branches of Indian banks, no separate assigned capital for such branches would be required. With a view to enabling them to start their operations, however, the parent bank would be required to provide a minimum of US $ 10 million to its OBU.
- The Reserve Bank would grant exemption from cash reserve ratio (CRR) requirements to the parent bank with reference to its OBU branch. Banks are, however, required to maintain SLR in respect of their OBU branches; requests for exemption, if any, will be considered for a specified period.
- The sources for raising foreign currency funds would be only external. Funds can be raised from resident sources to the extent such residents are permitted under the existing exchange control regulations to invest in/maintain foreign currency accounts abroad. Deployment of funds would be restricted to lending to units located in SEZs and SEZ developers. Foreign currency requirements of corporates in the domestic area can also be met by the OBUs. If funds are lent to residents in the Domestic Tariff Area (DTA), existing exchange control regulations would apply to the beneficiaries in DTA. OBUs may be allowed to invest their surplus funds outside India under the investment policy framed for this purpose by the Board of Directors of the bank concerned.
- All prudential norms applicable to overseas branches of Indian banks would apply to the OBUs. The OBUs would be required to follow the best international

(Contd....)

(Concld....)

practice of 90 days payment delinquency norm for income recognition, asset classification and provisioning. The OBUs may follow the credit risk management policy and exposure limits set out by their parent banks, duly approved by their Boards. Separate open position limits for each currency will have to be prescribed by the banks' Boards.

- The OBUs would be required to scrupulously follow "Know Your Customer (KYC)" and other anti-money laundering instructions issued by the Reserve Bank. To ensure strict compliance with anti-money laundering instructions, OBUs are prohibited from undertaking cash transactions and transactions with individuals.
- The OBUs would be required to maintain separate *nostro* accounts with correspondent banks, which would be distinct from *nostro* accounts maintained by other branches of the same bank.
- The loans and advances of OBUs would not be reckoned as net bank credit for computing priority sector lending obligations.
- Deposits of OBUs will not be covered by deposit insurance.

Rate Agreements (FRAs) and Interest Rate Swaps (IRS) was captured by applying the conversion factors to notional principal amounts as per the original exposure method. Effective April 1, 2003 in addition to reckoning non-fund based limits at 100 per cent, banks have to include forward contracts in foreign exchange and other derivative products at their replacement cost value in determining individual/group borrower exposure. Following the Basel Committee on Banking Supervision's paper on *International Convergence of Capital Measurement and Capital Standards,* 1988, banks have been encouraged to follow the Current Exposure Method which is an accurate method of measuring credit exposure in a derivative product.

Accounting Standards

10.35 The Reserve Bank has been continuously making efforts to ensure convergence of its supervisory norms and practices with the international best practices. In regard to accounting standards issued by the Institute of Chartered Accountants of India (ICAI), banks in India are generally complying with most of these standards (Box X.9).

Box X.9
Accounting Standards for Compliance by Banks

A Working Group was constituted under the Chairmanship of Shri N.D. Gupta, former President of the ICAI, to recommend steps to eliminate/reduce gaps in compliance by banks with the accounting standards (AS) issued by the ICAI. The Working Group examined compliance by banks with the AS 1 to 22, which were already in force for the accounting period commencing from April 1, 2001, as also AS 23 to 28 which were to come into force for subsequent periods. The Group observed that banks in India are generally complying with most of the accounting standards except the following eight accounting standards, leading to qualification in the financial statements:

Accounting Standard	Pertaining to
5	Net Profit or Loss for the period, prior period items and changes in accounting policies
9	Revenue recognition
11	Accounting for the effects of changes in foreign exchange rates
15	Accounting for retirement benefits in the financial statements of employers
17	Segment reporting
18	Related party disclosures
21	Consolidated financial statements
22	Accounting for taxes on income

The Statutory Central Auditors' observations in the Auditors' Reports attached to the balance sheets on banks' non-compliance with some of the AS could affect the confidence of users of the financial statements in the integrity of the published results. Accordingly, the Group made recommendations for compliance by banks with the AS. Detailed guidelines on the basis of the Group's recommendations have been issued by the Reserve Bank. The Working Group did not make any recommendation on AS 11 (Accounting for effects of changes in foreign exchange rates) as the ICAI was in the process of revising it. The ICAI has been requested to furnish appropriate clarifications on the accounting standards in line with the Working Group's recommendations. With the issue of the guidelines and adoption of the prescribed procedures, there should normally be no need for any Statutory Auditor for qualifying the financial statements of banks for non-compliance with the AS. Thus, it is essential that both banks and the Statutory Central Auditors adopt the prescribed guidelines and procedures. Whenever specific difference of opinion arises among the auditors, the Statutory Central Auditors would take a final view and persisting differences, if any, can be sorted out with prior consultation with the Reserve Bank, if necessary.

Underwriting by Merchant Banking Subsidiaries of Commercial Banks

10.36 Banks/subsidiaries were, hitherto, required to ensure that the funded and non-funded commitments (including investments and devolvement on account of underwriting and other commitments like stand-by facilities) relating to a single legal person or entity did not exceed 25 per cent of the net owned funds of the bank/subsidiary which was subsequently reduced to 15 per cent. Banks were also required to ensure that the commitments under a single underwriting obligation did not exceed 15 per cent of an issue. With a view to providing a level-playing field to the merchant banking subsidiaries of banks, it was decided that the existing ceiling on underwriting commitments would not be applicable to merchant banking subsidiaries of banks. These subsidiaries, regulated by the SEBI, would consequently be governed by the norms on the various aspects of the underwriting exercise taken up by them. The prudential exposure ceiling on underwriting and similar commitments of banks would, however, remain unchanged and continue to be reckoned within the norms prescribed by the Reserve Bank on overall borrower/issue size limits.

Advances to Self Help Groups (SHGs) against Group Guarantee

10.37 Unsecured advances given by banks to SHGs against group guarantees would be excluded for the purpose of computation of the prudential norms on unsecured guarantees and advances (*i.e.*, 20 per cent of banks' outstanding unsecured guarantees together with total of outstanding unsecured advances should not exceed 15 per cent of total outstanding advances).

Insurance Business by Banks

10.38 According to the existing guidelines for entry of banks into insurance business, banks were not allowed to undertake referral business through their network of branches. Under the referral arrangement, banks provide physical infrastructure within their select branch premises to insurance companies for selling their insurance products to the banks' customers with adequate disclosure and transparency and, in turn, earn referral fees on the basis of premia collected. Banks have now been permitted to enter into referral arrangements with insurance companies, subject to certain conditions to protect the interests of their customers.

Discounting/Rediscounting of Bills by Banks

10.39 After considering the recommendations of the Working Group on Discounting of Bills by Banks (Chairman: Shri K.R. Ramamoorthy), revised guidelines were issued to banks (Box X.10).

Bank Finance for PSU Disinvestment Programme of Government of India

10.40 Banks were advised in August 2002 that if the shares of the disinvested PSU, against which bank finance is proposed to be extended, are illiquid due to lock-in period/restrictive clauses, the successful bidder to whom the bank proposes to extend finance, should obtain necessary approval from the Government of India and other regulatory agencies exempting such equity holdings from these restrictions. On a review, banks have been allowed to extend finance to the successful bidders - even though the shares of the disinvested company acquired/to be acquired by the successful bidder are subjected to a lock-in period/other such restrictions which affect their liquidity - subject to fulfilment of the specified

Box X.10

Revised Guidelines on Discounting of Bills

- Banks may sanction working capital limits as also bills limits to borrowers after proper appraisal of their credit needs and in accordance with the loan policy as approved by their Board of Directors.
- Banks are required to open letters of credit (LCs) and purchase/discount/ negotiate bills under LCs only in respect of genuine commercial and trade transactions of their borrower constituents who have been sanctioned regular credit facilities by them.
- For the purpose of credit exposure, bills purchased/ discounted/negotiated under LCs or otherwise would be reckoned as exposure on the bank's borrower constituent. Accordingly, the exposure should attract a risk-weight appropriate to the borrower constituent (*viz.,* 100 per cent for firms, individuals, corporates) for capital adequacy purposes.
- Banks have been permitted to exercise their commercial judgment in discounting of bills of services sector. Banks would need to ensure that actual services are rendered and accommodation bills are not discounted. Services sector bills should not be eligible for rediscounting.

conditions. The concerned bank must make a proper appraisal and exercise due caution about credit worthiness of the borrower and the financial viability of the proposal.

10.41 Banks are precluded from financing investments of NBFCs in other companies and inter-corporate loans/deposits to/ in other companies. On review, banks were advised that special purpose vehicles (SPVs) satisfying the following conditions would not be treated as investment companies and, therefore, would not be considered as NBFCs, and hence would be eligible for bank finance for PSU disinvestments of Government provided they: (a) function as SPVs with not less than 90 per cent of their total assets as investment in securities held for the purpose of holding the ownership stake; (b) do not trade in these securities except for block sale; and, (c) do not undertake any other financial activities.

Trading in Government Securities on Stock Exchanges

10.42 With a view to encouraging wider participation of all classes of investors, including retail investors in Government securities, trading of the dated Government of India securities was allowed through a nation wide anonymous, order-driven, screen-based trading system in the stock exchanges in the same manner in which trading takes place in equities. This facility would be available in addition to the present Negotiated Dealing System (NDS) of the Reserve Bank. Accordingly, effective January 16, 2003, trading of dated Government of India securities in dematerialised form is being allowed on automated order driven system of the National Stock Exchange (NSE), The Stock Exchange, Mumbai (BSE) and Over the Counter Exchange of India (OTCEI). The scheme will subsequently be extended to the Government of India Treasury Bills and State Government securities.

10.43 In view of familiarity with the systems, processes and procedures, it was decided to adopt the equity trading model for trading of Government securities on the exchanges. As in the case of equities, banks as institutional investors can undertake transactions only on the basis of giving and taking delivery of securities. Besides, they were directed to obtain specific approval from their Board to enable them to trade in the Stock Exchanges and frame and implement a suitable policy to ensure that operations in securities on the above stock exchanges are conducted in accordance with the norms laid down by the Reserve Bank/SEBI and the respective stock exchanges.

Interest Rates on Advances

10.44 Banks had been advised to switchover to a system of charging interest on advances at monthly rests, effective April 1, 2002, to facilitate adoption of 90 days norms for recognition of loan impairment from the year ending March 31, 2004. They were given the option to compound interest at monthly rests effective either from April 1, 2002 or July 1, 2002 or April 1, 2003. With effect from July 1, 2002, banks were supposed to ensure that the effective rate does not go up merely on account of the switchover to the system of charging/ compounding interest at monthly rests and increase the burden on the borrowers. Interest at monthly rests shall be applied to all running accounts *(e.g.* Cash Credit, Overdraft, Export Packing Credit Accounts), all new and existing term loans and other loans of longer/fixed tenor but not to agricultural advances.

Empanelment of Audit Firms as Statutory Auditors

10.45 In order to review the norms for empanelment of audit firms for their appointment as statutory auditors as well as the number of audit firms that were allotted to each PSB, a Working Group consisting of representatives from select PSBs, IBA, ICAI, Government of India, Comptroller and Auditor General of India and the Reserve Bank was constituted in December 2001. The Working Group's recommendations have been accepted by the Sub-Committee (Audit) of the BFS and will be made applicable from 2004-05 (Box X.11).

Guidelines for Uniform Accounting for Repo/ Reverse Repo Transactions

10.46 A review of the accounting practices for repo/ reverse repo transactions revealed divergences among market players. Accordingly, uniform accounting guidelines for repo/reverse repo transactions were finalised, in consultation with Fixed Income Money Market and Derivatives Association (FIMMDA), and were applicable from the financial year 2003-04. On implementation of the guidelines, market participants may undertake repos from any of the three categories of investments, *viz.,* Available for Sale (AFS), Held for Trading (HFT) and Held to Maturity (HTM). The legal character of repo under the current law as outright purchase and outright sale transactions is kept intact. The buyer of the securities under the reverse repo transactions can reckon the approved securities acquired for the purpose of SLR during the period and mark to market the securities as per the investment classification of the security. In case of entities not

Box X.11
Empanelment of Audit Firms

The major recommendations of the Working Group for eligible audit firms are:

- minimum seven full-time chartered accountants with the firm (as against six) of which five should be full-time partners, each with a minimum continuous association of 15, 10, 5, 5 and 1 years with the firm.
- a professional staff of 18 (as against 15).
- a minimum standing of 15 years (as against 10 years).
- a minimum statutory bank/branch audit experience of 15 years (as against 8 years).
- at least one partner or paid chartered accountant with CISA/ISA or any other equivalent qualification.

A team of 4, 5 or 6 audit firms may be allotted to each PSB based on its assets and liabilities of the previous year, *i.e.,* up to Rs.50,000 crore, above Rs.50,000 crore and up to Rs.1 lakh crore, and above Rs.1 lakh crore, respectively (as against allotting a team of 5 and 6 audit firms to banks with a deposit base up to Rs.10,000 crore and above Rs.10,000 crore, respectively).

Available vacancies every year are to be filled in the ratio of 8:2 (as against 9:1 earlier) among experienced and new audit firms. The system of carrying over the names of unallotted experienced audit firms and giving them a preference in allotment in the following year may be discontinued.

following any investment valuation norms, the valuation of securities acquired under reverse repo transactions will be in accordance with the valuation norms followed by them in respect of securities of similar nature. Securities sold under repo and purchased under reverse repo are to be disclosed by banks in the "Notes on Accounts" to the balance sheet. The guidelines would not, for the present, apply to repo/reverse repo transactions under the Liquidity Adjustment Facility (LAF) with the Reserve Bank.

'Know Your Customer' - Identification of Depositors

10.47 'Know Your Customer' (KYC) guidelines relating to identification of depositors were issued on August 16, 2002. Banks have to put in place systems and procedures to control financial frauds, identify money laundering and suspicious activities, and for scrutiny/monitoring of large value cash transactions. They have also been advised to be vigilant while opening accounts for new customers to prevent misuse of the banking system for perpetration of frauds. Taking into account recent developments, both domestic and international, the extant instructions on KYC norms and cash transactions were reinforced with a view to safeguarding banks from being unwittingly used for the transfer or deposit of funds derived from criminal activity (both in respect of deposit and borrowal accounts), or for financing of terrorism.

Operational Developments

Amalgamation/Merger of Banks

10.48 In view of the erosion of the net worth of the Nedungadi Bank Ltd., the Reserve Bank notified the draft scheme of its amalgamation with Punjab National Bank on November 13, 2002. The Scheme of Amalgamation came into force on February 1, 2003.

10.49 Under the Scheme of Amalgamation and in terms of Section 44A of the Banking Regulation Act, 1949, the Indian branches of Standard Chartered Grindlays Bank Ltd. (SCGB) were merged with the Indian branches of Standard Chartered Bank (SCB). Accordingly, SCGB was descheduled in August 2002 in terms of Clause (b) of sub-Section (6) of section 42 of the Reserve Bank of India Act, 1934.

Indian Banks' Operations Abroad

10.50 During 2002-03 (July-June), the number of Indian banks with overseas operations remained at nine; of these, eight banks are in the public sector and one bank is in the private sector. With the closure of one branch of the State Bank of India in the USA, the total number of overseas branches of the nine Indian banks was reduced to 93. The number of Representative Offices of Indian banks abroad increased to 17 with the opening of Representative Offices in London and New York by ICICI Bank Ltd., in Dubai by HDFC Bank Ltd. and in Shenzen (China) and Ho Chi Minh City (Vietnam) by Bank of India. On the other hand, the State Bank of India closed down its Representative offices in Ho Chi Minh City (Vietnam), Sao Paulo (Brazil) and Jakarta (Indonesia).

Foreign Banks' Operations in India

10.51 At present, there are 36 foreign banks operating in India with 206 branches. Approval for opening 17 additional branches in India was given to existing foreign banks under the branch expansion programme for 2002-03. Out of this, eight branches have been opened up to June 2003. The foreign banks also have 26 Representative Offices in India. Four banks, *viz.,* Commerzbank, Dresdner Bank AG, KBC Bank and The Siam Commercial Bank P.C.L. have wound up their banking operations in India. The Overseas-Chinese Banking Corporation Ltd. and the Toronto Dominion Bank are also in the process of closing down their Indian operations.

Scheduled Commercial Banks' Performance

10.52 Scheduled commercial banks (SCBs) improved their profitability in 2002-03. Net profits (as a ratio of total assets) increased from 0.8 per cent during 2001-02 to 1.0 per cent during 2002-03, largely due to higher non-interest income and lower interest expenses. Non-interest income increased from 1.6 per cent of total assets in 2001-02 to 1.9 per cent in 2002-03 on account of treasury operations. Reflecting the soft interest rate environment, interest income as well as interest expenses (both as a ratio to total assets) moderated during the year to 8.4 per cent and 5.6 per cent, respectively. The reduction in the interest expenses ratio (around 22 basis points) was relatively sharper than that on the income side (around four basis points) suggesting that decline in lending rates was not commensurate with that in deposit rates. Banks were able to contain their operating expenses at 2.3 per cent of their total assets (Table 10.5).

10.53 The improvement in performance indicators was widespread across banks, with 70 banks (out of a total of 93) registering an increase in their net profits ratio. None of the public sector banks recorded an increase in their interest expenses ratio (Table 10.6).

Table 10.5: Operational Results of Scheduled Commercial Banks : Key Ratios

(Per cent)

Ratio to Total Assets	2002-03	2001-02
1	2	3
Earnings before Provisions and Taxes (EBPT)	2.42	1.98
Profits after Tax (PAT)	1.03	0.75
Total Income	10.29	10.03
Interest Income	8.39	8.43
Non-interest Income	1.90	1.60
Total Expenditure	7.86	8.05
Interest Expenses	5.59	5.81
Operating Expenses	2.27	2.23
Provisions and Contingencies	1.39	1.23

Note: Data are provisional and relate to domestic operations only.

10.54 At the end of March 2003, almost all SCBs (92 out of a total of 93) complied with the regulatory requirement of CRAR of nine per cent. The number of banks with CRAR in excess of 15 per cent increased to 36 at end-March 2003 from 30 at end-March 2002, mainly on account of foreign banks (Table 10.7).

10.55 There was a further improvement in the NPAs position of banks, both in relation to assets and advances (Table 10.8). This reflected, *inter alia,* recent initiatives at improving recovery. Group-wise, foreign banks had the lowest NPA ratios, followed by the State Bank group.

10.56 The number of banks with net NPAs (as a proportion of net advances) above 10 per cent fell from 23 during 2001-02 to 12 during 2002-03 (Table 10.9).

Table 10.6: Operational Results of Scheduled Commercial Banks during 2002-03

(Number of Banks Showing Increase in Ratios during the Year)

Ratio to Total Assets	Public Sector Banks		Private Sector Banks		Foreign Banks	All Banks
	SBI Group	Nationalised Banks	Old	New		
1	2	3	4	5	6	7
Earnings before Provisions and Taxes (EBPT)	7	19	10	6	12	54
Profits after Tax (PAT)	7	17	16	7	23	70
Total Income	1	5	2	5	12	25
Interest Income	–	1	1	4	12	18
Non-interest Income	6	13	7	7	13	46
Total Expenditure	–	1	–	3	13	17
Interest Expenses	–	–	–	3	11	14
Operating Expenses	2	7	10	8	23	50
Provisions and Contingencies	6	15	8	5	10	44

Note : Data are provisional and relate to domestic operations only.

Table 10.7: Capital to Risk-weighted Asset Ratio (CRAR) of SCBs: end-March 2003

(Frequency Distribution)

CRAR	Public Sector Banks		Private Sector Banks		Foreign Banks	All Banks
	SBI Group	Natio-nalised Banks	Old	New		
1	2	3	4	5	6	7
Negative	–	–	–	–	–	–
	(–)	(–)	(2)	(–)	(1)	(3)
Between	–	–	–	1	–	1
0 and 9 per cent	(–)	(2)	(–)	(–)	(–)	(2)
Between	–	1	3	2	–	6
9 and 10 per cent	(–)	(2)	(2)	(2)	(3)	(9)
Between	8	16	13	5	8	50
10 and 15 per cent	(8)	(14)	(12)	(6)	(13)	(53)
15 per cent and	–	2	5	1	28	36
above	(–)	(1)	(7)	(–)	(22)	(30)
Total	**8**	**19**	**21**	**9**	**36**	**93**
	(8)	**(19)**	**(23)**	**(8)**	**(39)**	**(97)**

Note : Data are provisional.
Figures in brackets relate to position as at end-March 2002.

Table 10.9: Net NPLs to Net Advances of SCBs

(Frequency Distribution)

	Public Sector Banks		Private Sector Banks		Foreign Banks
	SBI Group	Nation-alised Banks	Old	New	
1	2	3	4	5	6
1996-97					
Up to 10%	5	12	22	9	36
Above 10% and up to 20%	3	6	3	–	1
Above 20%	–	1	–	–	2
2000-01					
Up to 10%	8	14	16	8	31
Above 10% and up to 20%	–	5	4	–	6
Above 20%	–	–	3	–	5
2001-02					
Up to 10%	8	16	17	8	25
Above 10% and up to 20%	–	3	3	–	5
Above 20%	–	–	3	–	9
2002-03 P					
Up to 10%	8	18	19	8	28
Above 10% and up to 20%	–	1	1	–	4
Above 20%	–	–	1	1	4

P Provisional.

CO-OPERATIVE BANKING

10.57 Co-operative credit institutions occupy an important position in the financial system in terms of reach, volume of operations and objectives. The co-operative credit system can be broadly classified into urban co-operative and rural co-operative banks. The rural co-operatives play a pivotal role in the rural credit delivery system, whereas the urban co-operative banks aim at mobilising savings from the middle-and low-income groups and purvey credit towards the weaker sections. UCBs and rural co-operative credit banks are supervised by the Reserve Bank and the NABARD, respectively. Both are regulated by State Governments in regard to certain types of functions; in addition, multi-state UCBs are regulated by the Union Government.

Policy Initiatives

10.58 Since 2001-02, the Reserve Bank has undertaken a series of measures directed towards strengthening the financial position of the UCBs, such as applying capital adequacy standards, prescribing an asset-liability management framework, enhancing the proportion of holding of Government and other approved securities for the purpose of SLR, restriction on bank finance against the security of corporate shares and debentures. During 2002-03, these efforts were reinforced.

Table 10.8: Non-Performing Assets (NPAs) of SCBs: end-March 2003

(Per cent)

	Public Sector Banks		Private Sector Banks		Foreign Banks	All Banks
	SBI Group	Nationalised Banks	Old	New		
1	2	3	4	5	6	7
Ratio of NPAs to Total Assets						
Gross NPAs to Total Assets	3.6	4.7	4.4	5.1	2.5	4.2
	(4.5)	(5.3)	(5.3)	(5.1)	(2.5)	(4.8)
Net NPAs to Total Assets	1.4	2.2	2.6	2.3	0.8	1.9
	(2.1)	(2.8)	(3.3)	(2.1)	(0.8)	(2.4)
Ratio of NPAs to Advances						
Gross NPAs to Gross Advances	9.2	10.1	9.1	10.2	5.3	9.5
	(11.8)	(11.5)	(11.3)	(11.0)	(5.6)	(11.0)
Net NPAs to Net Advances	3.9	5.1	5.7	4.8	1.7	4.5
	(5.7)	(6.4)	(7.5)	(4.8)	(1.9)	(5.8)

Note : Data are provisional and relate to domestic operations only.
Figures in brackets relate to position as at end-March 2002.

Strengthening the Co-operative Credit System

10.59 UCBs were advised in June 2002 that all purchase/sale transactions in Government securities should necessarily be through their SGL account with the Reserve Bank or through a Constituent SGL account with the designated agencies or in a dematerialised account with the depositories. UCBs were warned against dealing with brokers as counter-parties and advised to have their transactions in Government securities subjected to concurrent audit every quarter by chartered accountants and to confirm that the investments as reported by the bank were, in fact, owned and held by the bank. In line with the international best practice, it was decided to reduce the period of default for reckoning an advance as 'non-performing' from the existing 180 days to 90 days with effect from March 31, 2004.

10.60 With a view to strengthening the management system of UCBs, new urban banks are required to have at least two Directors with requisite professional qualifications or adequate experience in banking. This requirement was extended to existing UCBs as well. UCBs were earlier advised that all types of loans and advances granted by them to their Directors and their specified relatives and to concerns in which the directors or their relatives are interested should not, in the aggregate, exceed 10 per cent of the demand and time liabilities (DTL) of the bank. This limit was initially reduced to five per cent effective December 2002. A complete ban is to be imposed on such advances effective October 1, 2003.

10.61 Fully/partially computerised UCBs were advised to introduce an electronic data processing (EDP) audit system. All UCBs are required to have an audit committee of the Board for overseeing and providing directions to internal audit/inspection machinery of the UCB. The Audit Committees are also required to examine and follow up the observations and suggestions made in the inspection reports of the Reserve Bank and Statutory Audit reports.

10.62 Based on the recommendations of the Joint Parliamentary Committee (JPC) which enquired into the irregularities in capital market transactions, UCBs were advised that

- they have to take action for removing the deficiencies pointed out in the Reserve Bank inspection reports within a maximum period of four months from the date of the inspection report, and provide a certificate to that effect, failing which penalty will be imposed for non-compliance;
- the Audit Committee of the Board of Directors of UCBs should review the internal audit/statutory audit reports and the Reserve Bank's inspection reports and monitor action taken; and
- UCBs should appoint concurrent auditors.

Supervisory Initiatives

10.63 To strengthen the system of supervision on UCBs, the Reserve Bank introduced a system of Off-Site surveillance on scheduled UCBs on March 31, 2001. Furthermore, the system of classifying UCBs as 'weak' was also modified with effect from March 31, 2002. A new system of grading based on their level of CRAR, level of net NPAs, record of losses and compliance with liquidity requirements was introduced. A system of supervisory rating for UCBs under the CAMELS model has been instituted. This rating system will initially be introduced for the scheduled UCBs commencing from the year ending March 31, 2003. A simplified rating system is also being introduced for non-scheduled UCBs with effect from March 31, 2004.

Disclosures in Balance Sheet

10.64 In order to impart greater transparency in the balance sheet and profit and loss accounts, UCBs with deposits of Rs.100 crore or more were advised to disclose the following information as 'Notes on Accounts' to their balance sheet, effective from the year ending March 31, 2003: (a) CRAR, (b) movement of CRAR, (c) investment (book value, face value and market value), (d) advances against real estate, construction business and housing, (e) advances against shares and debentures, (f) advances (both fund-based and non-fund based) to directors, their relatives, companies/firms in which they are interested in, (g) average cost of deposits, (h) NPAs (gross and net), (i) movement in NPAs, (j) profitability (interest income to working funds, non-interest income to working funds, operating profit to working funds, return on assets, business per employee and profit per employee), (k) provisions made towards NPAs and depreciation in investments, (l) movement in provisions towards NPAs, depreciation in investments and standard assets, and (m) foreign currency assets and liabilities.

Balance Sheet Indicators of Urban Co-operative Banks

10.65 As on March 31, 2003, there were 2,104 UCBs, inclusive of 89 salary earners' banks. Around 79 per cent of these UCBs are located in five States, *viz.,* Andhra Pradesh, Gujarat, Karnataka, Maharashtra and Tamil Nadu. During the period 2002-03 (April-March), four UCBs, *viz.,* Solapur Janata Sahakari Bank Ltd., Solapur, Bharati Sahakari Bank Ltd., Pune, Thane Bharat Sahakari Bank Ltd., Thane and Zoroastrian Co-operative Bank Ltd., Mumbai were included in the Second Schedule to the Reserve Bank of India Act, 1934. At end-March 2003, the total number of scheduled UCBs was 56, spread over the six states, *i.e.,* Andhra Pradesh, Goa, Gujarat, Karnataka, Maharashtra and Uttar Pradesh.

10.66 Deposits and advances of scheduled UCBs increased marginally during the year, and their growth was significantly lower than that of the commercial banking system. This could be attributed to risk aversion of depositors in view of problems faced by a few large UCBs in the recent past. A positive aspect of the performance of the UCBs was a reduction in net NPAs, both in absolute terms as well as a proportion to net advances, reflecting the recent supervisory initiatives (Table 10.10).

Table 10.10 : Key Financial Indicators of Scheduled UCBs

(Amount in Rupees crore)

Category	end-March 2003*	end-March 2002	Variation (Per cent)
1	2	3	4
Number of UCBs	56	52	
Paid-up share capital	627	545	15.0
Reserves	2,195	1,931	13.7
Deposits	36,380	35,215	3.3
Loans and advances	23,943	23,308	2.7
Investments in Government and other approved securities	10,487	8,630	21.5
Gross NPAs	7,378	6,968	5.9
Gross NPAs to total loans and advances (per cent)	30.8	29.9	0.9
Net NPAs	2,465	2,979	- 17.3
Net NPAs to net loans and advances (per cent)	10.3	12.8	- 2.5

* Data as at end-March 2003 are unaudited and provisional.

FINANCIAL INSTITUTIONS

10.67 During 2002-03, the main focus of policy initiatives of the Reserve Bank for select all-India financial institutions[1] (FIs) was on imparting operational flexibility, strengthening the prudential regulatory and supervisory framework, and improving accounting and auditing standards. The Government undertook restructuring packages for some of the FIs, taking into account their financial performance, rising NPAs, adverse market conditions for raising resources, and challenges posed by commercial banks under a competitive environment.

Prudential Norms

Capital Adequacy

10.68 In line with the international practice and the norms applied for banks, the risk weight assigned to housing loans extended by FIs to individuals against the mortgage of residential housing properties was reduced from 100 per cent to 50 per cent. Investments by the FIs in the Mortgage Backed Securities (MBS) carry a risk weight of 50 per cent (in addition to the 2.5 per cent risk weight for market risk) provided that the assets underlying the MBS are the residential loan assets of the housing finance companies which are recognised and supervised by the National Housing Bank and satisfy the terms and conditions listed separately by the Reserve Bank. The loans granted by FIs against the security of commercial real estate would continue to attract 100 per cent risk weight. If the assets underlying the MBS also include commercial properties, then investment by FIs in such MBS would attract 100 per cent risk weight. The risk weights for the housing loans granted by the FIs to their own employees would, however, remain unchanged at 20 per cent for loans fully covered by superannuation benefits and mortgages of flats/ houses. Loans extended by FIs against the guarantee of a bank attract a risk weight of 20 per cent in computation of CRAR of the lending FI. The remaining amount of loan, if any, would normally attract 100 per cent risk weight.

Exposure Norms

10.69 For the purpose of exposure norms, the entire loan transaction of an FI should be reckoned as an

[1] The all-India financial institutions include Industrial Development Bank of India (IDBI), IFCI Ltd., Industrial Investment Bank of India Ltd. (IIBI), Tourism Finance Corporation of India Ltd. (TFCI), Infrastructure Development Finance Company Ltd. (IDFC), Export-Import Bank of India (Exim Bank), National Bank for Agriculture and Rural Development (NABARD), National Housing Bank (NHB) and Small Industries Development Bank of India (SIDBI).

exposure on the borrowing entity and not on the bank guaranteeing the loan so as to correctly reflect the degree of credit concentration. Before commencement of disbursement, the exposure would be either the sanctioned limit or the extent up to which the FI has entered into commitment with the borrowing entity in terms of the agreement. After commencement of disbursement, the exposure would be the aggregate of the outstanding amount plus the undisbursed or undrawn commitment.

10.70 The norms relating to credit exposures were modified and, as in the case of banks, the FIs are required to (i) reckon non-fund based exposures at 100 per cent value and (ii) include forward contracts in foreign exchange and other foreign exchange derivative products at their replacement cost in determining the individual/group borrower exposures. FIs were encouraged to switch to the Current Exposure Method for determining individual/group borrower exposures.

Asset Classification

10.71 As per the existing norms, the asset classification of the projects under implementation falling under Category II (time overrun for projects with original project cost of Rs.100 crore or more) is required to be decided with reference to the 'deemed date of completion'. Provisions held by FIs in respect of such accounts should not be reversed even in cases where certain accounts might become eligible for upgradation to the 'standard' category as per the deemed date of completion of the Category II projects.

Connected Lending

10.72 Occurrences of "connected lending" by FIs has been engaging the attention of the Reserve Bank. Guidelines were, therefore, issued to FIs in this regard, relating to credit facilities to the Directors; non-fund facilities on behalf of the Directors; loans and advances to relatives of the FIs' Directors or to the Directors of other FIs/banks and their relatives; loans and advances to officers of FIs or to their relatives; time-frame for recovery of loans; effect of non-recovery within the stipulated time; remission of the liabilities of the borrowers; interpretation of the transactions; non-participation of the interested Directors in the proceedings; and award of contracts by the FIs.

Classification and Valuation of Investments

10.73 Clarifications in regard to equity investments issued as a part of project finance proposal were provided. The preference shares acquired by conversion of loans/debentures in the nature of advance could be viewed as loan equivalent. In cases where there was no loan outstanding against a borrower company which had issued the shares, the record of dividend receipt on the preference shares should be examined to determine the asset classification of the preference shares, as per record of recovery. If the dividend on preference shares is not received within 180 days from the date of closing of annual accounts of the issuing company, the shares should be treated as NPA and provided for accordingly. As regards non-project related and redeemable preference shares which are eligible to be kept in the HTM category within the 25 per cent ceiling, these could be valued at acquisition cost/amortised cost, subject to provisioning for permanent diminution, if any, in value for which payment of dividend would also be a relevant factor. The investments in the units of closed-ended schemes of mutual funds could be included in the HTM category only if such units are not listed on the Stock Exchange. Units of closed-ended schemes of mutual funds, if listed on the Stock Exchange, should be placed in the AFS or HFT category.

10.74 As regards valuation of equity in the nature of advance in AFS category, the equity shares should be considered to be in the nature of advances if these equity shares were issued as part of a proposal for project finance. In cases where no loan against the company issuing the shares is outstanding, the equity shares in the nature of advance, should be valued at market price, if listed and quoted, provided the latest market quotation was not more than 30 days old as on the date of valuation. The market price in such cases should not be based on a solitary or small value transaction but on price observed in a reasonable volume transaction, between two independent parties in an arms-length relationship. “Thinly traded shares” should be valued as per the extant norms. The unquoted equity shares or where current quotations are not available, should be valued at “break up” value (without considering revaluation reserves, if any) derived from the company’s latest balance sheet. In case, the latest balance sheet is not available, the shares should be valued at Re. 1 per company. For the purpose of deriving break up value, the balance sheet used should not be older than one year (21 months in respect of companies, which close their accounts on dates other than 31 March) from the date of valuation.

Supervisory Measures

Consolidated Accounting and Supervision

10.75 Drawing from the recommendations of the Working Group on Consolidated Accounting (Chairman: Shri Vipin Malik), final guidelines were issued to FIs, which prescribed the group-wide prudential norms for capital adequacy, large exposures and liquidity gaps for the FIs to be implemented effective April 1, 2003 (July 1, 2003 in the case of NHB). FIs were also advised to build up requisite MIS to enable development of the database. Accordingly, FIs with subsidiaries have initiated steps towards consolidated accounting. Listed FIs have already commenced preparation/publishing Consolidated Annual Accounts as a part of their Annual Report, as mandated by the Accounting Standard 21 of ICAI, effective from the financial year 2001-02. The Reserve Bank’s guidelines seek to make such publication mandatory even by non-listed FIs from April 1, 2003 onwards.

Supervisory Rating System for the FIs

10.76 A supervisory rating model was introduced with effect from the annual financial inspections conducted with reference to the position as on March 31, 2002 (June 30, 2002 in the case of the National Housing Bank). The Model is based on CAMELS components. The basic purpose of assigning supervisory ratings is to provide a summary measure of the performance and health of the financial institution concerned for requisite supervisory intervention.

Other Regulatory and Structural Measures

Rotation of Auditors

10.77 In view of instances of appointment of auditors for long periods, FIs were advised to ensure rotation of the partner of the audit firm conducting audit, if the firm continues for more than four years.

Computer Audit

10.78 Pursuant to the directions of the Audit Sub-Committee of the BFS, a "Committee on Computer Audit" was constituted in October 2001 with members from the Reserve Bank, ICAI and select commercial banks. The mandate of the Committee was to draw up a standardised checklist for conducting computer audit to enable the banks to ensure that requisite controls are applied by their computerised branches and the auditors verify them and report thereon. The Committee's recommendations, which have been accepted by the BFS, classified the possible areas of audit interest in the Information System (IS) environment into 15 broad categories and has prepared 'standardised checklists' under each category to facilitate the conduct of computer audit. The issues elaborated in the checklists would give a fair idea about areas that need to be controlled. These checklists would be in the nature of guidelines and FIs would be free to develop more elaborate checklists to conduct IS Audit suitable to the IT environment in which they operate.

Transactions in Dematerialised Form

10.79 FIs were required to fully comply with the Reserve Bank's instructions to necessarily hold their investments in Government securities portfolio in either SGL (with the Reserve Bank) or Constituents’ Subsidiary General Ledger (CSGL) or in a dematerialised account with depositories. Only one CSGL or dematerialised account can be opened by any such entity. In case the CSGL accounts are opened with a scheduled commercial bank or state co-operative bank, the account holder has to open a designated funds account (for all CSGL related transactions) with the same bank. In case a CSGL account is opened with any of the non-banking institutions, the particulars of the designated funds account (with a bank) should be intimated to that institution. The entities maintaining the CSGL/ designated funds accounts will be required to ensure availability of clear funds in the designated funds accounts for purchases and sufficient securities in the CSGL account for sales before putting through the transactions. No further transactions by a regulated entity should be undertaken in physical form with any broker with immediate effect. A specific timeframe has been separately indicated for each category of regulated entities to comply with these guidelines.

Review of Operations

On-site Inspection

10.80 The Reserve Bank continued to undertake annual on-site inspection of nine FIs. During 2002-03, the supervisory process for all nine FIs with reference to their position as on March 31, 2002 and June 30, 2002 in the case of NHB was initiated and completed, including submission of reviews to the BFS.

Off-site Surveillance System

10.81 A Prudential Supervisory Reporting System (PSRS) for ongoing off-site supervision, introduced in July 1999 as part of the integrated supervisory strategy, has been rechristened as FID-OSMOS. The FIs are required to submit off-site returns using the software input module provided to them for this purpose. A review of the performance of the FIs based on the off-site returns submitted by them is presented to the BFS on a quarterly basis.

Capital to Risk-weighted Assets Ratio (CRAR)

10.82 All FIs, except IFCI Ltd. and IIBI Ltd., had a CRAR much above the norm of nine per cent as at end-March 2003. The IFCI's erosion of capital reflects asset liability mismatches arising out of bunching of repayments as also the requirement for meeting heavy provisioning due to high NPAs and consecutive financial losses. Furthermore, raising of resources in a cost-effective manner had become difficult due to downgrading of IFCI by the rating agencies. In order to mitigate this problem and augment its capital, a capital restructuring package was initiated by the Government. In the case of IIBI, accumulation of high NPAs and provisioning thereof, coupled with the problem of declining profitability explains its low CRAR (Table 10.11).

Table 10.11 : CRAR and Net NPA of Select FIs (end-March 2003)

Financial institution	CRAR (Per cent)	Net NPA (Rupees crore)	Net NPA to net loans (Per cent)
1	2	3	4
Term-Lending Institutions (TLIs)			
IDBI	18.7	7,157	15.8
IFCI	-2.9	5,983	34.8
EXIM Bank	26.9	184	2.2
IIBI	3.5	819	40.3
TFCI	20.8	152	20.5
IDFC	57.1	3	0.1
All TLIs	**15.9**	**14,298**	**18.8**
Refinancing Institutions (RFIs)			
NABARD	41.6	1	0.0
NHB	22.3	0	0.0
SIDBI	43.9	473	3.8
All RFIs	**39.3**	**474**	**0.7**
All FIs	**22.3**	**14,772**	**10.6**

Source : Respective FIs.

Non-Performing Assets

10.83 The net NPAs of all-India FIs increased during 2002-03 due to slow economic recovery, sectoral bottlenecks and adverse domestic/ international market conditions (Table 10.11). IDFC Ltd., NHB and NABARD continued to maintain nil or negligible NPAs.

Restructuring of Liabilities of IDBI and IFCI Ltd.

10.84 The Union Government has initiated restructuring of two FIs, *viz.,* IDBI and IFCI Ltd. As part of the restructuring exercise, PSBs and FIs who had exposures to the IDBI were assured about the payment of contracted interest rates up to original maturity by the Government. The IDBI, in turn, was given an assurance by the Government that it will meet the difference between the originally contracted interest rate and the agreed interest rate of eight per cent by the banks and FIs till the original maturity period. Besides, all PSU banks and FIs agreed to rollover their investments in IDBI bonds for a further similar period of maturity at the prevailing interest rate during the time of rollover. The characteristics of bonds, *viz.,* SLR/ Non-SLR will remain unchanged. As part of the corporatising exercise, the Industrial Development Bank (Transfer of Undertaking and Repeal) Bill, 2002 was introduced in the Lok Sabha on December 4, 2002 which seeks to convert IDBI into a banking company. The Bill also seeks SLR exemption for a period of five years from the appointed day. The Bill was referred to the Standing Committee on Finance, which recommended exemptions from banking regulations such as SLR and CRR for five years and certain tax exemptions for the newly converted banking company. The Cabinet approved the amendments to the Bill on August 11, 2003 to incorporate provisions in the Bill to ensure that the new banking company also continues to be a development bank which will provide term lending to large, medium and small industries.

10.85 As part of the restructuring package in respect of liabilities of IFCI Ltd., the Government decided to take over all Government-guaranteed SLR bonds and retail borrowings of investors below Rs.1 lakh. Furthermore, the Government decided to service the loans from Asian Development Bank (ADB) and KfW. The package includes conversion of 20 year zero-coupon operationally convertible debentures/bonds worth Rs.1,811 crore into quasi-equity instruments, and conversion of preference capital into 20 year maturity at a coupon rate of 0.10 per cent per annum. Besides, the Life Insurance Corporation of India and the State

Bank of India - the major institutional shareholders in IFCI Ltd. - have agreed to reinvest Rs.200 crore each for 20 years at the coupon rate of six per cent per annum. Similarly, the IDBI has also agreed to reinvest Rs.100 crore on similar terms and conditions.

Corporate Debt Restructuring (CDR) Mechanism

10.86 The Corporate Debt Restructuring (CDR) mechanism became operational from March 2002 with the execution of the Inter-Creditor Agreement (ICA) on February 25, 2002 by 47 institutions/banks. Sixty-one institutions comprising all-India FIs (12), PSBs (27) and private sector banks (22) have signed the ICA. The UTI (among FIs), seven private sector banks (small in operation) and 41 foreign banks are yet to sign. During 2002-03, the CDR Standing Forum met two times, the Core Group five times and the Empowered Group 16 times. Of the 71 applications received (four from 2001-02), the CDR Cell referred all the cases to the Empowered Group within the stipulated time of 30 days. The Empowered Group approved final schemes in respect of 41 cases in which aggregate assistance by financial system amounted to Rs.38,638 crore; 18 cases were rejected and the remaining 12 cases are being processed (Box X.12).

NON-BANKING FINANCIAL COMPANIES

Registration of NBFCs

10.87 At end-June 2003, a total of 37,859 applications were received by the Reserve Bank for grant of Certificate of Registration (CoR). Of these, approval was granted to 13,863 applications, including 725 applications of companies authorised to accept/hold public deposits.

Policy Initiatives

Regulation of Non-Banking Financial Companies

10.88 Keeping in view the soft interest rate regime, the maximum rate of interest that NBFCs (including *Nidhi* companies and Chit Fund companies) can pay on their public deposits was reduced from 12.5 per cent to 11.0 per cent per annum with effect from March 4, 2003. The minimum rate of return payable by the residuary non-banking companies (RNBCs) to their depositors was also revised downwards (Table 10.12).

Box X.12

Corporate Debt Restructuring

Based on the experience in other countries like the U.K., Thailand and Korea, a Corporate Debt Restructuring (CDR) system was evolved in India. Detailed guidelines were issued in August 2001 for implementation by banks and FIs. The objective of the CDR framework is to facilitate a timely and transparent mechanism for restructuring the corporate debts of viable entities facing financial difficulties, outside the purview of BIFR, DRT and other legal proceedings. In particular, the framework aims at preserving viable corporates that are affected by certain internal and external factors and minimise the losses to the creditors and other stakeholders through an orderly and coordinated restructuring programme.

Pursuant to the announcement in the Union Budget 2002-03, a High-Level Group was constituted under the Chairmanship of Shri Vepa Kamesam, Deputy Governor, Reserve Bank with representatives from banks, FIs and industry to suggest measures to make the operations of the CDR mechanism more efficient. Based on the recommendations made by the High-Level Group and in consultation with Government of India, a revised CDR scheme was finalised and issued to banks for implementation with following salient features:

- It will cover only multiple banking accounts/ syndication/consortium accounts with outstanding exposure of Rs.20 crore and above.
- It will be a voluntary system based on Debtor-Creditor Agreement (DCA) and Inter-Creditor Agreement (ICA).
- In no case, requests of any corporate indulging in wilful default, fraud or misfeasance, even in a single bank, will be considered for restructuring.
- CDR will have a three-tier structure consisting of the CDR Standing Forum and its Core Group (the policy making body), CDR Empowered Group (the functional group deciding on the restructuring of the cases referred to CDR mechanism) and the CDR Cell (the secretariat to the CDR system).
- Under the earlier guidelines issued in August 2001, accounts classified as 'standard' and 'sub-standard' in the books of the lenders were eligible for restructuring under the CDR mechanism. The revised scheme provides for restructuring of accounts which are classified as 'doubtful' in the books of the lenders.
- One of the important elements of the DCA between the debtor and the creditors would be 'stand-still' agreement binding for 90 days, or 180 days by both sides. Under this clause, both the debtor and

(Contd....)

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creditor(s) shall agree to a legally binding 'stand-still' whereby both the parties commit themselves not to take recourse to any legal action during the 'stand-still' period. This would be necessary for enabling the CDR System to undertake the necessary debt restructuring exercise without any outside intervention, judicial or otherwise. During pendency of the case with the CDR system, the usual asset classification norms would continue to apply. The process of reclassification of an asset should not stop merely because the case is referred to the CDR Cell. If restructuring under the CDR system takes place, the asset classification status should be restored to the position which existed when the reference to the Cell was made.

- The revised guidelines provide exit options for lenders who do not wish to commit additional financing or wish to sell their existing share.
- The CDR Empowered Group shall have the right to convert a portion of the restructured amount into equity while deciding the restructuring package.

Of the 71 applications received by the CDR system since inception, final schemes have been approved in 41 cases involving Rs.38,638 crore. Almost 62 per cent of the amount approved pertains to units in the iron and steel industry (Table).

Table : Cases Referred and Approved under the CDR Mechanism

(Cumulative Position up to June 30, 2003)

(Rupees crore)

Industry	Cases Referred to CDR		Cases Approved under the CDR Mechanism	
	No. of Units	Amount involved	No. of Units	Amount involved
1	2	3	4	5
1. Textile	15	2,165	8	1,539
2. Petrochemicals/ Chemicals	9	5,669	6	4,064
3. Iron and Steel	8	28,001	6	23,861
4. Paper	4	216	3	175
5. Infrastructure	1	236	1	236
6. Non-ferrous Metals	5	967	1	119
7. Cement	2	1,962	2	1,962
8. Ceramic	3	203	3	203
9. Sugar	7	1,482	3	985
10. Power	5	3,612	2	2,966
11. Electronics/Electrical	1	583	–	–
12. Engineering	3	188	2	155
13. Rubber	1	113	1	113
14. Glass	1	27	1	27
15. Fertilisers	2	2,510	1	2,206
16. Hotels	1	27	1	27
17. Others	3	5,775	–	–
Total	**71**	**53,736**	**41**	**38,638**
Memo				
Cases Rejected	18	7,252		
Cases Pending	12	7,846		

Asset Liability Management (ALM)

10.89 The ALM guidelines, issued in June 2001, are applicable to NBFCs (engaged in and classified as equipment leasing, hire purchase finance, loan, investment and residuary non-banking companies) meeting the criteria of asset base of Rs.100 crore (whether accepting/holding public deposits or not) or holding public deposits of Rs.20 crore or more (irrespective of their asset size) as per their audited balance sheet as of March 31, 2001. The Chit Fund and *Nidhi* Companies have been kept out of the purview of these guidelines. The guidelines became fully operational on March 31, 2002. A system of half-yearly reporting was put in place beginning with the position as on September 30, 2002 for only those NBFCs which hold public deposits.

Table 10.12 : Minimum Interest Rates on NBFC Deposits

(Per cent per annum)

Type of Deposit Schemes	Rate of return before April 1, 2003	Rate of return effective April 1, 2003
1	2	3
Daily deposit scheme	4	3.5
Deposits received in lump sum or at monthly/ longer intervals	6	5

Transactions in Government Securities

10.90 The facility of holding Government securities in physical form was withdrawn. As in the case of FIs, all NBFCs were advised to invariably hold their investments in Government securities either in Constituents' Subsidiary General Ledger Account (CSGL) or in a dematerialised account with depositories. The NBFCs were prohibited from undertaking Government securities transaction/s in physical form with any broker.

Exposure of NBFCs to the Capital Market

10.91 NBFCs holding public deposits of Rs.50 crore and above and RNBCs with aggregate liabilities to depositors of Rs.50 crore and above as on March 31, 2002 or thereafter were directed to furnish information relating to their exposure to the capital market, at quarterly intervals, within one month of the close of the quarter.

Exemptions

10.92 Venture capital fund companies holding Certificate of Registration (CoR) from the SEBI have been exempted from the provisions of Sections 45-IA (obtaining CoR), 45-IB (maintenance of liquid assets) and 45-IC (creation of reserve fund) of the Reserve Bank of India Act, 1934 as also from the directions of the Reserve Bank on acceptance of public deposit and prudential norms for NBFCs, provided they are not accepting/holding public deposits. The stock broking companies, which are not holding public deposits as defined under the Reserve Bank regulations and registered with the SEBI, have also been similarly exempted.

Investment by RNBCs in UTI

10.93 Keeping in view the bifurcation of UTI as a result of which the mutual fund activities of UTI have come under the purview of SEBI (Mutual Funds) Regulations, 1996 the facility provided to RNBCs to invest in UTI units up to the entire sub-limit of 10 per cent of the aggregate liabilities to the depositors was withdrawn. Investment by RNBCs in the mutual funds including UTI will continue to be within the ceiling of 10 per cent of the aggregate liability and subject to the sub-ceiling of two per cent of such liabilities for any one mutual fund.

Permission to NBFCs for Entry into Insurance Business

10.94 Consequent upon issue of final guidelines for entry of NBFCs into insurance business in June 2000, the Reserve Bank permitted five NBFCs to participate in insurance business on risk-sharing basis. Two NBFCs were granted permission to undertake both life and general insurance business while the other three NBFCs were permitted to undertake only life insurance business with risk participation. One company was permitted to engage both in insurance agency business as well as to make strategic investment in equity of an insurance company up to 10 per cent of its owned fund. Four companies were granted permission to conduct only insurance agency business, while two others were permitted to make only strategic investment in the equity of an insurance company.

Other Initiatives

10.95 The Reserve Bank undertook several measures for the benefit of depositors:

- Pursuing with State Governments for enactment of legislation for protection of interest of depositors in financial establishments.
- Undertaking extensive publicity campaign using the print and electronic media to educate the depositors.
- Conducting training programmes for personnel/ executives of NBFCs in order to familiarise them with the objectives, genesis and focus of the Reserve Bank regulations.
- Conducting seminars for the civil and police personnel of the State Governments.
- Conducting training programmes/seminars for the auditors, in association with the ICAI, to familiarise them with the directions and regulations of the Reserve Bank as applicable to the NBFCs as also the directions applicable to statutory auditors of the NBFCs.
- Holding meetings with the top Civil and Police officials of the State Governments and also other regulators like the Registrar of Companies and Department of Company Affairs of the Central Government wherein issues of common concern are discussed.

Inspection of NBFCs

10.96 During the period 2002-03 (April-March), a total of 934 (292 deposit taking companies and 642 non-deposit taking companies) registered NBFCs were inspected. In addition to the inspections, the Reserve Bank also conducted 1,722 snap scrutiny exercises.

Performance Indicators

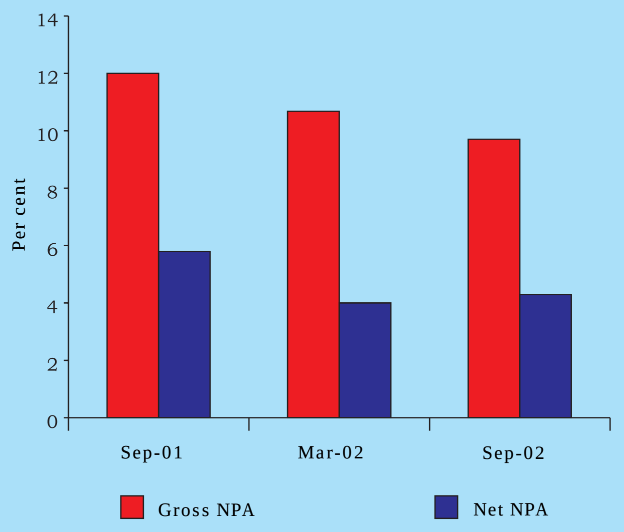
Capital Adequacy

10.97 The norms relating to capital adequacy have been made applicable to NBFCs accepting or holding public deposits with effect from March 31, 1998. At the end of September 2002, almost 94 per cent of the NBFCs reported a CRAR equal to or in excess of the stipulated minimum of 12 per cent with as many as 74 per cent reporting a CRAR above 30 per cent (Table 10.13).

Table 10.13 : Capital to Risk-weighted Assets Ratio (CRAR) of NBFCs

CRAR	Number of NBFCs		
	September 2002	March 2002	September 2001
1	2	3	4
Less than 12%	37	43	53
12% and less than 30%	120	131	131
30% and above	439	489	491
Memo:			
Total Reporting NBFCs	**596**	**663**	**675**

Chart X.1 : NBFCs Non-Performing Assets to Credit Exposure



Non-Performing Assets

10.98 The gross and net NPAs of reporting companies have been showing a declining trend. The gross NPAs, which formed 12.0 per cent of the credit exposure in September 2001, came down to 9.7 per cent in September 2002. Over the same period, the net NPAs came down from 5.8 per cent to 4.3 per cent of credit exposure (Chart X.1).

Outlook

10.99 Over the medium-term, the conduct of financial regulation and surveillance in India would progress from micro-regulation to macro-management, supported by a tightening of prudential norms and improvements in the functioning of the financial markets. A clearer definition of the regulatory role of the Reserve Bank is emerging within the broader debate on the conflict of interest between ownership and regulation. Co-operative banking is being sensitised to the changing context of financial regulation through enhanced standards of disclosure and governance, and a disentangling of the existing regulatory overlap.

10.100 The supervisory strategy of the Board for Financial Supervision would increasingly blend on-site inspection, off-site surveillance, enhanced role of external auditors and strengthening of corporate governance. Banks need to prepare for switching fully to risk-based supervision by 2003 by identifying information gaps in the compilation of risk profiles and training of personnel. The supervisory follow-up process will then involve a monitorable action plan including remedial actions and timely corrective steps.

10.101 Banks are being encouraged to improve the reliability and robustness of their risk management, management information and supervisory reporting systems. A scheme of prompt corrective action based on early warning triggers is evolving as a supervisory tool and would increasingly be adapted to country-specific circumstances. In addition to macro-prudential indicators of financial vulnerability being reviewed in India, financial soundness indicators have been proposed as early warning signals. The Reserve Bank and the Government have initiated a wide range of legal reforms to enable the regulatory and supervisory regime to keep pace with advancements in information and communication technology.