VI REGULATION AND SUPERVISION OF FINANCIAL INSTITUTIONS

Sound regulatory and supervisory framework for banks and non-banking financial entities proved crucial in containing the impact of the contagion from the global financial crisis on the Indian financial system. Based on the lessons from the crisis and the emerging new international standards and best practices, further fine tuning of the Indian regulatory and supervisory structure would strengthen the financial stability framework, while ensuring that the financial system serves the needs of inclusive and high growth. During 2009-10, several steps were taken in that direction, including the enhanced focus on systemic stability issues and the release of the first Financial Stability Report, announcement of the timeframe for implementation of the advanced approaches to capital adequacy, implementation of the supervisory review and evaluation process under Pillar 2 of Basel II, progress on cross-border supervision and supervisory cooperation, prevention of frauds and strengthened surveillance system for the off-site monitoring based on online returns filing system. Critical financial soundness indicators (FSIs) and stress test results suggested that the financial system remains sound and resilient.

VI.1 The Reserve Bank's regulatory and supervisory architecture, as a key instrument to attain the goal of financial stability, assigns significant emphasis to soundness and resilience of banks and financial institutions, and its relevance and effectiveness was vindicated when the banks and financial institutions in India weathered the global financial crisis without any significant stress. Several specific aspects of the regulatory and supervisory architecture of the Reserve Bank helped in limiting the impact of the contagion on the Indian financial system. The calibrated approach to financial sector reforms, and limited exposure of the banking system to synthetic and complex structured products provided the most effective shield against the contagion effects of the financial crisis. Domestic regulatory policies, implemented even before the onset of the global crisis, emphasised the need for banks to maintain adequate capital and liquidity. Banks' exposures to sensitive sectors that are prone to potential boom-bust cycles, such as real estate and capital market, were contained. Regulations relating to CRR and SLR, which do not entirely fall in the category of prudential regulation, effectively provide cushion against liquidity risks. Certain aspects of regulatory guidelines for securitisation activities of banks especially the one disallowing upfront booking of profit on securitisation ensured that the perverse incentives in the securitisation process were contained unlike what was experienced in the advanced economies.

VI.2 In order to contain systemic risk, the Reserve Bank had restricted access to non-collateralised borrowing and lending in the money markets. To limit contagion risks arising out of inter-connectedness, limits were also imposed on inter-bank liabilities. Recognising the risks to the financial system from systemically important non-deposit taking non-banking entities (NBFCs-ND-SI), these institutions were also brought under the purview of prudential regulation. The Reserve Bank has adopted a gradual and well-calibrated approach towards introduction of new financial products. Unlike in advanced economies, at least one party to any transaction in the OTC derivative markets is required to be under the regulatory jurisdiction of the Reserve Bank. The institutional framework to ensure systemic stability was also in place in the form of a High Level Co-ordination Committee on Financial Markets (HLCCFM), besides the comprehensive self-assessment of India's financial sector that focused

on stability, resilience to stress and compliance with international standards and codes. Risk weights and provisioning requirements for certain categories of exposures such as commercial real estate, personal and consumer loans were varied counter-cyclically over the last five years, so as to ensure the flow of credit to these sectors consistent with the phases of economic cycles.

VI.3 All the above measures collectively contributed towards avoiding a financial crisis in domestic markets in the midst of a severe global crisis. During 2009-10, there have been several regulatory initiatives to develop the institutions and markets further and strengthen the financial stability framework based on lessons from the global crisis (Box VI.1).

Box VI.1
Global Crisis and Regulatory Lessons: India's Response so far

The limitations of regulatory regimes, especially in advanced countries, represent one of the primary causative factors behind the recent global financial crisis. These regimes resulted in undercapitalisation of banks and financial institutions, due to inadequate measurement of risks apart from imparting an element of procyclicality to their operations and leaving many deposit taking entities outside the remit of the regulation. As a result, not just the resilience of the financial sector was undermined but the financial sector also became more susceptible to the amplitudes of the financial cycle. In the post-crisis period, a roadmap is being laid out globally to strengthen the financial regulation and supervision. The Basel Committee has proposed both microprudential and macroprudential measures. The microprudential measures under consideration include raising the quality, quantity, consistency and transparency of the capital base, strengthening the risk coverage of the capital framework, introducing supplementary leverage ratio and global minimum liquidity standard. The macroprudential measures under consideration include countercyclical capital framework as well as more forward-looking provisioning, based on expected losses. IMF, Financial Stability Board (FSB), Committee on Global Financial System (CGFS) and Bank for International Settlements (BIS) have also been working on developing macroprudential frameworks, tools and indicators, including analytical approaches, to the assessment of Systemically Important Financial Institutions (SIFIs).

India's Response

The Indian financial system remained largely stable against the backdrop of global financial crisis, as the Indian banking system was profitable, well-capitalised and prudently regulated. On hindsight, it appears that various measures/proposals now being considered globally as a part of the regulatory reforms in response to the crisis were put into practice in India even before the crisis. These included stringent liquidity requirements, counter-cyclical prudential measures, not recognising many items in Tier I capital that are now being sought to be deducted internationally, recognising profits from sale of securitised assets to SPVs over the life of the securities issued, and not reckoning unrealised gains in earnings or in Tier I capital. The Reserve Bank, like other central banks, however, responded to both the crisis as well as regulatory lessons from the crisis.

Measures for Containing Financial Contagion

The Reserve Bank, apart from ensuring ample rupee and foreign exchange liquidity to ensure smooth functioning of credit and financial markets, also recalibrated various sector specific counter-cyclical regulatory measures involving risk weights and provisioning. It also gave regulatory guidance for restructuring of viable loan accounts for ensuring continued flow of credit to productive sectors of the economy with a view to arresting slowdown in growth. The regulatory measures aimed at furthering institutional and market development and strengthening resilience of the financial system included the following:

Institutional and Market Development Measures

Securitisation Market

Internationally, the post-global crisis reform of the securitisation market is based on the central idea that originators should retain a portion of each securitisation originated by them, as a mechanism to better align incentives and ensure more effective screening of loans. In addition, a minimum period of retention of loans prior to securitisation may also be considered desirable, to give comfort to the investors regarding due diligence carried out by the originator. Keeping in view the above objectives, the Reserve Bank has formulated draft guidelines regarding the minimum holding period and minimum retention requirement for securitisation and placed the same on Reserve Bank's website for public comments in April 2010.

Credit Default Swap(CDS)

An internal working group was set up to formulate operational guidelines for introduction of CDS. The draft report of the group has been placed on the Bank's website on August 4, 2010 for public comments.

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(...Concld.)

Holding Company Structure for Financial Conglomerates

In order to ensure orderly growth of financial conglomerates (FCs) in India, a Working Group has been constituted with representatives from the government, the Reserve Bank, the SEBI, the IRDA and the IBA to recommend a roadmap for the introduction of a holding company structure together with the required legislative amendment/framework.

Presence of Foreign Banks

With global financial markets exhibiting signs of improvement, drawing lessons from the crisis, the Reserve Bank is in the process of preparing a discussion paper on the mode of presence of foreign banks, through branch or wholly owned subsidiary (WOS) route, by September 2010.

Measures for Strengthening Resilience of the Financial System

Basel II Framework

The Basel Committee on Banking Supervision (BCBS) presented a comprehensive reform package in December 2009 to strengthen the global capital and liquidity regulations with the goal of promoting a more resilient banking sector. The Committee conducted a comprehensive Quantitative Impact Study (QIS) for two proposals: one, relating to raising the quality, consistency and transparency of the capital base, risk coverage, leverage ratio and procyclicality and the second, on measures for further elevating the resilience of internationally active banks to liquidity stress across the globe as well as increasing international harmonisation of liquidity risk supervision. Ten large Indian banks also participated in the QIS. The results show that Indian banks are not likely to be stressed significantly in meeting the requirements. Taking into account the results of the QIS, the comments received on the two proposals, the assessments of the economic impact over the transition and the long run economic benefits and costs, the Committee at its meeting in July 2010 reached a broad agreement on the overall design of the capital and liquidity reform package. In particular, this includes the definition of capital, the treatment of counterparty credit risk, the leverage ratio and the global liquidity standard. The calibration and phase-in arrangements are expected to be finalised shortly and the Committee has announced that it will issue the details of the capital and liquidity reforms by end-2010.

Provisioning Coverage

With a view to ensuring countercyclical provisioning in the banking system, the Reserve Bank has mandated that banks should augment their provisioning cushions consisting of specific provisions against NPAs as well as floating provisions, and ensure that their total Provisioning Coverage Ratio (PCR), including floating provisions, is not less than 70 per cent. Banks are required to adhere to this norm by end-September 2010.

SYSTEMIC STABILITY ASSESSMENT

VI.4 After the global crisis, internationally there has been a renewed focus on systemic stability assessment, with specific importance given to assessment of inter-connectedness among financial sector entities and the risks to the financial system from systemically important regulated as well as unregulated entities. To strengthen the systemic stability focus, the Reserve Bank instituted the Financial Stability Unit (FSU) in the Bank and the first Financial Stability Report (FSR) was released in March 2010. The remit of FSU includes conduct of macroprudential surveillance of the financial system on an ongoing basis. While the FSR will be published twice a year, more frequent assessments will be reported to the top management of the Bank.

VI.5 The system level stress tests for the period ended December 2009 suggested that the banking sector remained broadly healthy, with well capitalised banks, in terms of capital adequacy ratios, higher core capital and sustainable financial leverage. Stress tests for credit and market risk reveal banks' ability to withstand unexpected levels of stress. Banks are required to hold a minimum percentage of their NDTL in risk-free government and other approved securities, which to a large extent, helps in containing liquidity and solvency concerns. Stress test results indicated that the banking sector is comfortably resilient and, even in a worst case scenario, with all standard advances restructured during the downturn hypothetically becoming NPAs, the resultant stress would not be significant. While the resilience of the commercial banks to credit and interest rate shocks has improved over time, the liquidity scenario analysis shows some potential risk. The margins of banks might face pressure from the mark to market (MTM) impact on the investment portfolio, increased

provisioning requirement and calculation of interest on savings deposits on a daily basis from April 1, 2010. The asset liability management (ALM) analysis did not indicate any significant mismatches. The credit growth in recent times, however, has been mostly marked in sectors like infrastructure and commercial real estate, both of which require longer term funding. The resultant ALM mismatches would require careful monitoring on an ongoing basis.

VI.6 The analysis also suggested that the share of low cost current and savings account deposits in total deposits was high. However, over reliance on bulk deposits in certain institutions, which remain at elevated levels, could impact the cost and stability of the deposit base. Like the banking sector, the NBFC sector was also able to manage the fallout of the crisis without creating systemic issues. However, ALM mismatches, credit quality and the inter-connected flows between NBFCs and other financial sector entities would need to be closely monitored. Given the increasing significance of the non-banking financial sector, the supervisory regime for the NBFCs-ND-SI will need to be strengthened further for a more robust assessment of the underlying risks.

VI.7 An analysis of the recent period suggests that the SCBs continued to strengthen their capital cushion as both the CRAR and core CRAR recorded increase as at end-March 2010. Asset quality of SCBs, which was showing a distinct improvement since 2005, witnessed a marginal deterioration during 2009-10, mainly as a fallout of the impact of the global financial crisis on the Indian economy, notwithstanding the restructuring of standard advances (Chart VI.1).

VI.8 Income of SCBs from securities trading and forex operations declined substantially during 2009-10, thus partly offsetting the rise in the other operating income and hence, the growth of net profit of banks moderated somewhat. The ratio of liquid assets to total assets has been at the level of above 32 per cent for last several years. Return on assets (ROA) of SCBs, an indicator of efficiency with which banks deploy their assets, which had increased over last few years, recorded marginal decline during 2009-10 (Table VI.1).

VI.9 In the case of UCBs as well, the CRAR showed an improvement and both gross NPA as well as net NPA ratios declined. The deposit taking NBFCs further strengthened their capital base with rise in CRAR from 18.5 per cent to 22.2 per cent, though the gross NPA ratio deteriorated. In the case of NBFCs-ND-SI, the return on equity (RoE), which is an indicator of the efficiency with which capital is employed, declined, while RoA also declined.

VI.10 A high degree of heterogeneity in terms of deposits/asset base, areas of operation and nature of business characterise the urban co-operative banking sector in India. UCBs play an important role as financial intermediaries in urban and semi-urban areas catering to the needs of the non-

Chart VI.1: Soundness Indicators of SCBs

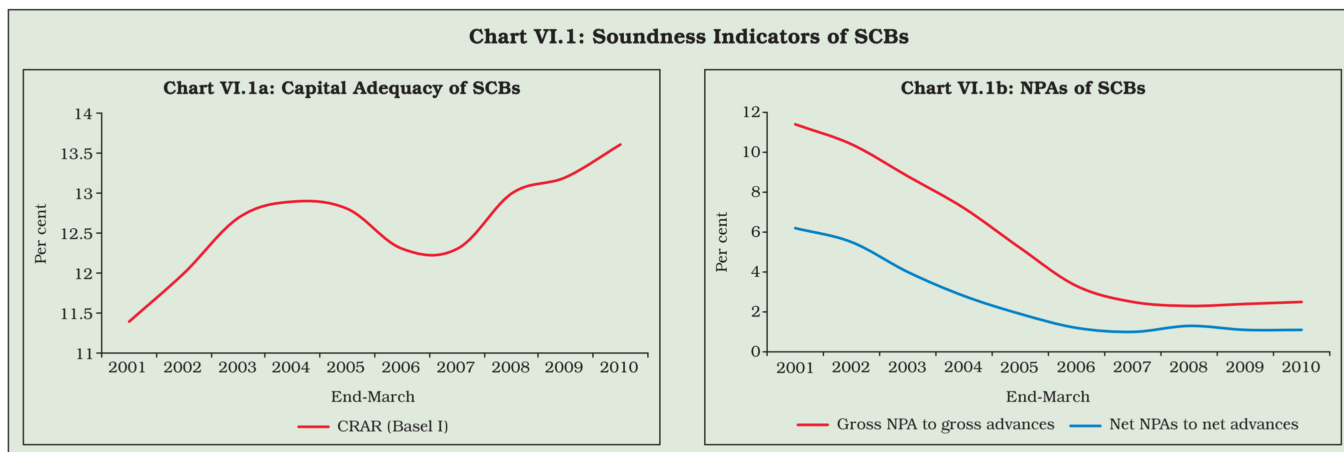

Table VI.1: Select Financial Indicators

(Per cent)

Item	End-March	Scheduled Commercial Banks	Scheduled Urban Co-operative Banks	All India Financial Institutions	Primary Dealers	NBFCs-Deposit taking	NBFCs-ND-SI
1	2	3	4	5	6	7	8
CRAR	2009	13.2 * 14.0 **	12.6	24.6	34.8	18.5	40.5
	2010	13.6 * 14.6 **	12.9	24.2	43.5	22.2	N.A.
Gross NPAs to Gross Advances	2009	2.4	11.5	0.3	..	1.0	2.5
	2010	2.5	9.2	0.2	..	2.0	N.A.
Net NPAs to Net Advances	2009	1.1	3.5	0.1	..	-	1.0
	2010	1.1	3.4	0.1	..	-	N.A.
Return on Total Assets #	2009	1.1	0.8	1.2	6.6	2.7	2.5
	2010	1.1	0.7	1.4	1.8	N.A	2.0
Return on Equity #	2009	14.5	N.A.	9.6	21.5	15.9	8.9
	2010	13.3	N.A.	7.5	6.8	N.A.	7.0
Efficiency (Cost/Income Ratio) #	2009	45.4	53.2	15.9	11.7	74.1	71.3
	2010	45.8	60.1	18.5	31.2	N.A.	73.5
Net Interest Margin (per cent) #	2009	2.7	N.A.	2.3	..	4.5	1.3
	2010	2.7	N.A.	2.3	..	N.A.	1.8

*: CRAR under Basel I. **: CRAR under Basel II. #: Pertain to financial year. N.A.: Not Available. .. : Not Applicable. -: Nil/Negligible.

Note: 1. Data for 2010 are unaudited and provisional, except for AIFIs.
2. Data for SCBs are inclusive of 4 LABs.
3. Data for SCBs cover domestic operations, except for CRAR.
4. For NBFC-D, data for 2010 pertain to period ended September 2009.
5. CRAR for UCBs excludes Madhupura Mercantile Co-op. Bank Ltd.

Source: 1. SCBs: Off-site supervisory returns.
2. UCBs: Off-site surveillance returns.
3. AIFIs: Audited OSMOS Returns received from AIFIs.

agricultural sector, particularly small borrowers. In the context of their role in the national economy, several initiatives are being taken by the Reserve Bank to help the sector to grow on sound lines. The impact of various measures can be assessed through the changing profile of the sector. The number of Grade III and Grade IV UCBs taken together, implying weakness/sickness in UCBs, declined from 39 per cent at end March 2005 to 20 per cent at end-March 2010.

VI.11 The economic slowdown led to deceleration in the growth of the balance sheet of the banking system. This could have a lagged effect on credit quality and profitability of banks. Asset quality could be impacted to some extent if there are slippages in some of the accounts which were restructured under a special dispensation introduced over a limited period to preserve the economic value of viable units affected by the downturn in 2008 and 2009. The 2009-10 annual inspection process reviewed the manner in which the restructuring guidelines were implemented by the banks to ensure that the preconditions and safeguards prescribed in this regard had been complied with by them. It was observed that though there were some deviations, these were not widespread and slippage in restructured accounts was not expected to be significant, especially in view of the recovery in the economy. As on March 31, 2010, the restructured standard advances constituted less than 3 per cent of the total gross advances of the banks. It is expected that the system level delinquency would not rise significantly in future because of the restructuring taken up during the economic downturn. Some borrowers could be affected due to adverse exchange rate movements. Banks would therefore also need to carefully assess the risks from unhedged foreign currency exposures of their corporate clients.

MAJOR DECISIONS TAKEN BY BOARD FOR FINANCIAL SUPERVISION

VI.12 The Board for Financial Supervision (BFS), constituted in November 1994, remains the main guiding force behind the Reserve Bank's supervisory and regulatory initiatives. The BFS held twelve meetings during the period July 2009 to June 2010. In these meetings, it considered, *inter alia*, the performance and the financial position of banks and financial institutions during 2008-09. It reviewed 96 inspection reports (28 reports of public sector banks, 22 of private sector banks, 24 of foreign banks, 4 of local area banks, 4 of financial institutions and 14 of local head offices of a public sector bank). During the period, the BFS also reviewed summaries of inspection reports pertaining to 20 scheduled UCBs and summaries of financial highlights pertaining to 43 scheduled UCBs classified in Grade I / II.

VI.13 As part of the endeavour to strengthen the effectiveness of the Supervisory Rating framework, the BFS approved a proposal relating to revision of Earnings Appraisal component of the rating model. This revision partially reduces the marks allotted to RoE (Return on Equity) component in the existing rating model to accommodate the RoA (Return on Assets) parameter. As directed by the BFS, the same has been implemented with effect from the inspection cycle of 2009-10.

VI.14 During 2009-10, the BFS also approved modification of the reporting format for the banks falling under the monthly monitoring mechanism to ensure a comprehensive oversight of their activities, operations and processes. The modified monitoring procedure has been accordingly implemented.

VI.15 In an effort to enhance transparency in the operations of banks by stipulating comprehensive disclosures in tune with the international best practices, the BFS approved a proposal to prescribe additional disclosure norms, as part of 'notes to accounts', in various areas of banks' operations.

VI.16 At the behest of BFS, the norms/criteria for identification of FCs owing to their presence in different financial market segments and the criteria for determining constituent entities of the FCs have been revised so that all groups which are systemically important and all entities over which the identified groups exercise 'control' are brought under the purview of the monitoring framework. With a view to gathering more qualitative information on the groups, the FC reporting format has been suitably revised.

VI.17 The BFS continued its efforts towards strengthening the mechanism for monitoring of frauds in banks and directed that the board / top management of the banks may be held accountable for non action / delayed action on frauds. The BFS felt that the top management is also required to follow up with the investigating agencies regarding the progress in the investigation. The BFS also directed that the efficacy and robustness of fraud risk management mechanism in banks should be looked into and specifically commented on in the annual financial inspection (AFI) reports.

VI.18 The BFS approved the special monitoring mechanism for banks identified as outliers on account of high concentration of frauds. It was decided that, in the initial stage, the monitoring may be implemented through an internal mechanism where the outlier banks may be identified and necessary action, including discussions with the top management of the bank, initiated without actually intimating the bank about its categorisation as an outlier bank. The monthly and quarterly discussions and AFI meetings will henceforth involve more focused discussions on frauds, especially where the banks fall in the outlier category.

VI.19 The BFS approved the proposals on the cross-border supervision and supervisory cooperation mechanism, which allow for signing of Memorandum of Understanding (MoU) with overseas regulators on supervisory cooperation and exchange of information with them, participation of Reserve Bank in supervisory colleges convened by overseas regulators and setting up of supervisory colleges by the Reserve Bank for large/complex Indian banks. The Reserve

Bank is finalising the MoU in consultation with the Government of India.

COMMERCIAL BANKS

Regulatory Initiatives

New Capital Adequacy Framework

VI.20 All commercial banks in India migrated to Basel II framework for maintaining regulatory capital in two stages (*i.e.* on March 31, 2008 and March 31, 2009), adopting the simpler approaches. In July 2009, the timeframe for implementation of the advanced approaches in India was laid down (Table VI.2). The extant guidelines for implementation of the Basel II framework in India were revised/enhanced in February 2010, as appropriate for banks using simpler standardised approaches, in line with the changes made by the Basel Committee on Banking Supervision (BCBS) to the Basel II framework in July 2009. The changes in Pillar 1 (minimum capital requirement) of the framework relating to standardised approaches are mainly aimed at increasing capital requirements for securitisation exposures, both in the banking book and trading book. The revised guidelines on Pillar 2 (Supervisory Review Process) are intended to assist the banks in better identifying and capturing firm-wide risks in their internal assessments of capital adequacy and managing them appropriately. The Pillar 3 (Market Discipline) revisions include more granular disclosure requirements for credit risk mitigations and securitised exposures.

VI.21 Detailed guidelines on The Standardised Approach (TSA) for calculation of capital charge for operational risk and Internal Models Approach (IMA) for measuring the capital charge for market risk were issued in March and April 2010, respectively.

Prudential Norms

Countercyclical Capital Adequacy and Provisioning Norms

VI.22 As part of the policy measures adopted to deal with the contagion from the global crisis, risk weights and provisioning prescriptions were relaxed in November 2008 as a countercyclical measure. In view of large increase in credit to the commercial real estate sector over the last one year and the extent of restructured advances in this sector, the provision required on standard asset in the commercial real estate sector was increased from 0.4 per cent to 1 per cent for building up cushion against likely deterioration in asset quality. Further, recognising the impact that temporary restructuring and slower growth might have on the credit quality of banks and taking into account the need to build up provisions when banks' earnings are good, banks were advised in December 2009 that their total provision coverage ratio, including floating provisions, should not be below 70 per cent by September 2010.

Modification to Prudential Norms for Projects under Implementation

VI.23 Asset classification guidelines applicable to projects under implementation were modified during the year so as to provide some flexibility in

Table VI.2: Timeframe for Implementation of Advanced Approaches in India

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

cases where completion of project, particularly the infrastructure projects, got delayed. The modifications were made within the restructuring framework thus ensuring that the modifications would not lead to dilution of prudential standards.

VI.24 An infrastructure project loan where the project is not able to commence operations on due date, can now continue to be classified as standard asset for a maximum period of four years (against two years allowed earlier) from the original date of commencement of commercial operations. Similarly, non-infrastructure project loans not being able to commence commercial operations on due date, can also continue to be classified as standard assets up to a maximum period of one year (against six months allowed earlier). These modifications are subject to certain conditions including a requirement for higher provision.

Modifications to Prudential Norms Governing Banks' Exposure to Infrastructure Sector

VI.25 With a view to providing incentive to SCBs for financing infrastructure, investment by them in the long-term bonds with a minimum residual maturity of seven years, issued by companies engaged in executing infrastructure projects is now allowed to be classified under held-to-maturity (HTM) category.

VI.26 Banks were permitted to treat annuities under build-operate-transfer (BOT) model in respect of road/highway projects and toll collection rights, where there are provisions to compensate the project sponsor if a certain level of traffic is not achieved, as tangible securities, subject to the condition that banks' right to receive annuities and toll collection rights is legally enforceable and irrevocable.

VI.27 Infrastructure loan accounts which are classified as sub-standard will attract a provisioning of 15 per cent instead of the current prescription of 20 per cent. To avail of this benefit of lower provisioning, banks should have in place an appropriate mechanism to escrow the cash flows and also have a clear and legal first claim on these cash flows.

VI.28 Risk weight for banks' exposures to infrastructure finance companies (NBFC-IFCs) would be linked to the ratings assigned to such companies by the rating agencies registered with the SEBI and accredited by the Reserve Bank. This will result in lower risk weight than hitherto for well rated NBFC-IFCs.

Definition of Commercial Real Estate Exposure (CRE)

VI.29 The definition of "Commercial Real Estate Exposure" (CRE) was rationalised to make it consistent with the definition of CRE given in the Basel II framework. An exposure should be classified as CRE, if the funding results in the creation/acquisition of real estate where the prospects for repayment, as also the prospect of recovery would depend primarily on the cash flows generated from such funded asset which is taken as security. Further, exposures will also be classified as CRE in certain cases where the exposure may not be directly linked to the creation or acquisition of CRE but the repayment would come from the cash flows generated by CRE.

IFRS Implementation in Indian Banks

VI.30 As part of the efforts to ensure convergence of the Indian Accounting Standards (IASs) with the International Financial Reporting Standards (IFRSs), the roadmap for banking companies and non-banking financial companies (NBFCs) has been finalised by the Ministry of Corporate Affairs in consultation with the Reserve Bank. As per the roadmap, all SCBs will convert their opening balance sheet on April 1, 2013 in compliance with the IFRS converged IASs. A Working Group has been constituted by the Reserve Bank to address implementation issues and facilitate formulation of operational guidelines in the context of convergence of IFRSs for the Indian banking system.

Working Group on Valuation Adjustments and Treatment for Illiquid Positions

VI.31 The Reserve Bank issued guidelines to banks in February 2010 consequent upon enhancements to Basel II framework announced by the BCBS in July 2009. These guidelines *inter alia* require banks to make specified valuation adjustments for various risks/costs in their portfolios including derivatives, which are subject to MTM requirement and also for illiquidity of these positions. These guidelines also permit banks to follow any recognised models/methods for computing the amount of valuation adjustment. In order to ensure that a consistent methodology is adopted by banks for the purpose, a Working Group has been constituted with members from the Reserve Bank, FIMMDA, IBA, FEDAI and a few banks to recommend an appropriate framework in this regard.

Compensation Practices

VI.32 In line with the steps taken by global community, particularly the initiatives taken by G-20 nations, the Reserve Bank has come out with draft guidelines for private sector banks and foreign banks with regard to sound compensation policy. These guidelines are largely based on Financial Stability Board's (FSB) principles on sound compensation practices. The guidelines cover effective governance of compensation, alignment of compensation with prudent risk-taking and disclosures for whole time directors (WTDs)/chief executive officers (CEOs), risk takers of banks as well as staff in the audit, compliance and risk management areas.

Base Rate System

VI.33 The BPLR system, introduced in 2003, fell short of its original objective of bringing transparency to lending rates as banks could lend below BPLR. Sub-BPLR lending was about 65.8 per cent in December 2009. From the viewpoint of policy makers, it was difficult to assess the transmission of policy rates of the Reserve Bank to lending rates of banks in the absence of transparency. In order to address this issue, the system of 'base rate' was introduced from July 01, 2010 as recommended by the Working Group on Benchmark Prime Lending Rate (Chairman: Shri Deepak Mohanty). The base rate will include all those elements of the lending rates that are common across all categories of borrowers. Banks are free to use any methodology for computation of base rate, provided it is consistent, and is made available for supervisory review. Banks determine their actual lending rates on loans and advances with reference to the base rate and by including such other customer and product specific charges, as considered appropriate. All categories of loans are to be priced only with reference to the base rate except the following: (a) DRI advances (b) loans to banks' own employees (c) loans to banks' depositors against their own deposits. Exemptions from the base rate have also been granted for eligible crop loans and export credit where interest subvention from GoI is available and also in the case of certain restructured loans for the purpose of viability of the borrowing unit. The base rate could also serve as the reference benchmark rate for floating rate loan products, apart from external market benchmark rates.

Know Your Customer /Anti-Money Laundering (AML) Measures

VI.34 A comprehensive evaluation of India's AML/ combating of financing of terrorism(CFT) regime was conducted by a joint team of assessors from Financial Action Task Force (FATF) and Asia Pacific Group (APG). With a view to ensuring compliance with the FATF standards, suitable amendments to Prevention of Money Laundering Act, 2002 and Prevention of Money Laundering Rules, 2005 as well as to the Unlawful Activities (Prevention) Act, 1967 were introduced by the Government of India. Accordingly, regulatory guidelines to banks/ financial institutions were issued by the Reserve Bank. As a result FATF has accorded full-

fledged membership to India, in its Plenary held in June 2010.

Branch Authorisation

VI.35 As recommended by the working group on branch authorisation, (Chairman: Shri P. Vijaya Bhaskar), the extant branch authorisation policy for domestic SCBs (other than RRBs) was liberalised. Accordingly, with effect from December 01, 2009, banks were permitted to open branches in Tier 3 to Tier 6 centres (with population up to 49,999 as per census 2001) without obtaining prior permission from the Reserve Bank. Banks were also permitted to open branches in rural, semi-urban and urban centres in North Eastern states and Sikkim without obtaining prior permission from the Reserve Bank. Banks are required to plan their branch expansion in such a manner that at least one-third of total number of branches opened in a financial year in Tier 3 to Tier 6 centres are in the under banked districts of under banked States.

VI.36 As regards opening of branches in Tier 1 and Tier 2 centres (centres with population of 50,000 and above), banks would continue to obtain prior authorisation from the Reserve Bank. For consideration of such proposals by the Reserve Bank, the banks' branch expansion record in Tier 3 to Tier 6 centres would be one of the criteria, apart from banks' performance on financial inclusion, priority sector lending and level of customer service.

Foreign Bank Entry

VI.37 During the year 2009-10, the Reserve Bank issued 6 approvals to foreign banks to open branches in India. As on April 30, 2010, 34 foreign banks were operating in India with 311 branches. Besides, 45 foreign banks were also operating in India through representative offices.

VI.38 A revision to the Reserve Bank's "Roadmap for Presence of Foreign Banks in India", released in February 2005, was due in April 2009. At that juncture, however, the global financial markets were in turmoil and there were uncertainties surrounding the financial strength of banks around the world. Accordingly, it was decided to review the roadmap once there was greater clarity regarding stability and recovery of the global financial system. While the conditions of global financial markets have been improving, various international fora have been engaged in setting out policy frameworks incorporating the lessons learnt from the crisis. Drawing lessons from the crisis, it has been decided to prepare a discussion paper on the mode of presence of foreign banks through branch or WOS route by September 2010.

New Bank License

VI.39 Subsequent to the Union Budget which mentioned licensing of new banks, it was announced in the Annual Policy for 2010-11, that a discussion paper marshalling the international practices, the Indian experience as also the extant ownership and governance guidelines on licensing of new banks would be placed on the Reserve Bank's website shortly for wider comments and feedback. Detailed discussions would be held with all stakeholders on the discussion paper and guidelines would be finalised based on the feedback. All applications received in this regard would be referred to an external expert group for examination and recommendations to the Reserve Bank for granting licenses. The discussion paper has been finalised and placed on the Bank's website on August 11, 2010.

Credit Information Companies

VI.40 Credit information companies maintain credit records of borrowers and make them available to lenders to assess a customer's credit history. This exchange of information on borrowers decreases default rates, reduces average interest rates, increases lending and also helps in deepening the credit markets. During the year, the Reserve Bank for the first time issued Certificates of Registration (CoRs) to two private credit information companies to commence business of credit information. The applications of two other

companies (one of which is an existing credit information company), to whom in-principle approval had already been granted, are under consideration for issue of CoRs.

Supervisory Initiatives

Implementation of the Supervisory Review and Evaluation Process

VI.41 In order to enable the Inspecting Officers (IOs) of the Reserve Bank to carry out Supervisory Review and Evaluation Process (SREP) under Pillar 2 of Basel II, as a part of the AFIs of banks, detailed guidance was prepared by an internal working group. SREP would seek to assess the risk profiles of various banks under a rating-driven framework.

Frauds Monitoring Mechanism

VI.42 The number and amount of frauds reported by banks exhibited some increase during the year (Table VI.3). The fraud monitoring mechanism in the Reserve Bank so far has been primarily based on criminal intention (*mens rea*) involving financial loss to the bank and undue gain to the perpetrators or fraudsters. As per an internal review, fraud will have to be defined in a non-legal manner without putting exclusive emphasis on *mens rea*, financial loss to the bank and undue gain to perpetrators. With the above altered definition in place, the supervisory focus could be placed on serious wrongdoings which are apparently not the outcome of simple negligence. Banks, however, will have to continue to take necessary legal action in respect of frauds as before.

Table VI.3: Frauds in Banking Sector

(Amount in Rupees crore)

Year	All frauds		Out of which large value frauds involving ₹1 crore and above	
	No.	Amount	No.	Amount
1	2	3	4	5
2005-06	13,914	1,381	194	1,094
2006-07	23,618	1,194	150	840
2007-08	21,247	1,059	177	659
2008-09	23,914	1,883	212	1,404
2009-10	24,797	2,017	225	1,524

VI.43 As per the extant instructions, fraud cases could not be closed by banks unless the cases pending with CBI / police / court were finally disposed off, which took several years and showed unrealistic data about frauds in banks. In order to address this issue, it was decided that banks could be allowed, for limited statistical purposes, to close fraud cases involving amount up to ₹25 lakh which are pending for more than three years from the date of filing of the first information report (FIR) or filing of charge sheet/challan/final report by CBI/ police in the court and trial by the court was in progress.

Off-site Monitoring and Surveillance Framework

VI.44 As part of the policy decision to receive off-site monitoring regulatory returns through a secured online returns filing system (ORFS), the existing periodic prudential off-site returns submitted by banks are being migrated to the ORFS in a phased manner. The benefits of ORFS include ease of compilation, speedy submission, monitoring, incorporating changes in the returns and maintenance of the system.

Customer Service

VI.45 During the year many important initiatives were taken by the Reserve Bank for improving customer service by banks. Banks were required to put in place a policy, duly approved by their board, for dealing with frequent dishonour of cheques of value of less than ₹1 crore. On inoperative accounts, the banks were advised that the savings account could be treated as inoperative only after two years from the date of the last credit entry of the interest on fixed deposit account. In respect of renewal of term deposit accounts frozen by enforcement authorities, banks were advised to grant option to the depositor to choose the term for renewal, failing which banks may renew the same for term equal to the original term. Banks were advised to display essential details about the local

level committees set up under the National Trust for the Welfare of Persons with Autism, Cerebral Palsy, Mental Retardation and Multiple Disabilities Act, 1999. A system of calculation of saving bank interest on daily product basis started with effect from April 1, 2010. In order to facilitate hassle free complaint redressal, the upgraded version of Complaint Tracking Software (CTS) package, which has several enhanced functions, went live from July 1, 2009.

VI.46 When instances of omissions and commissions by banks, which are detrimental to the interests of the customers, are noticed by the Reserve Bank, general directions to all banks are issued to protect customers. Such initiatives in 2009-10 included action against a bank regarding mode of calculation of interest rates on deposit accounts, direction to a bank to recalculate interest rate on all the housing loans as per terms of the agreements entered into with all the borrowers without their application for relief and direction to a bank to recredit insurance premium, which was debited from savings accounts without the concurrence of holders, under group insurance scheme. The Reserve Bank also issued instructions to the banks regarding disbursement of pension and arrears to the pensioners and compensation for delayed period in respect of payment of pension on receipt of complaint from one of the pensioners.

Outreach Activities Carried out by Banking Ombudsman

VI.47 With a view to creating more awareness about the Banking Ombudsman Scheme and its hassle free redressal mechanism, a number of focused initiatives were pursued during the year including interface with banks, organising awareness camps, participation in exhibitions and publicity through various media.

Code of Bank's Commitment to Customers

VI.48 The membership of Banking Codes and Standards Board of India (BCSBI) has grown from 67 banks in 2006 to 102 banks in 2010 and the membership of 16 more banks is in process. To keep pace with the growing expectations of customers, innovations in the banking system, ongoing market developments and the contemporary regulatory framework, BCSBI released the revised Code of Bank's Commitment to Customers in August 2009. The revised Code raises the existing standards of banking practices relating to customer service, brings about greater transparency and a more efficient grievance redressal system in banks.

URBAN CO-OPERATIVE BANKS

MoU Arrangements

VI.49 Since 2005 an effort is being made to address the problem of dual control of UCBs by signing of Memoranda of Understanding (MOUs) between the Reserve Bank and the respective state governments. The process of signing MoUs which was started in June 2005 was completed in February 2010, thus bringing all the UCBs in the country under the cover of MoUs. With the comfort of coordinated supervision, financially sound and well managed UCBs were permitted to expand their business by allowing them to open currency chests, sell units of mutual funds and insurance products, provide foreign exchange services, open new ATMs and convert extension counters into branches. Furthermore, UCBs were also considered for grant of license to open new branches.

Consolidation through Mergers

VI.50 With a view to encouraging and facilitating consolidation and emergence of strong entities as well as for providing an avenue for non-disruptive exit of weak/unviable entities in the co-operative banking sector, the Reserve Bank issued guidelines on merger/amalgamation for UCBs in February 2005. Pursuant to the issue of guidelines on merger of UCBs, the Reserve Bank received 143 proposals for mergers in respect of 124 banks. The Reserve Bank has issued no objection certificate (NOC) in 103 cases. Of these, 83 mergers became effective upon the issue of statutory orders by the Central

Registrar of Co-operative Societies (CRCS)/ Registrar of Co-operative Societies (RCS) concerned. Twenty five proposals for merger were rejected by the Reserve Bank, 6 proposals were withdrawn by the banks and the remaining 9 are under consideration. Out of the 83 banks for which orders of merger have been received from the RCS / CRCS, 52 had negative net worth.

Transfer of Assets and Liabilities of UCBs to Commercial Banks

VI.51 The Reserve Bank issued detailed guidelines on the scheme of transfer of assets and liabilities of UCBs (including branches) to commercial banks, as an additional option for resolution of weak banks, where proposals for amalgamation within the UCB sector were not forthcoming. The scheme ensures complete protection to depositors and DICGC support would be restricted to the amount provided under section 16(2) of the DICGC Act, 1961. The UCB concerned should have negative net worth as on March 31, 2007 or earlier and continue to have negative net worth as on the date of transfer.

Unlicensed UCBs

VI.52 Based on the revised guidelines issued by the BFS in August 2009, a review of existing unlicensed banks was made and since then 50 UCBs were granted banking licences. As on June 30, 2010, there are 6 unlicensed banks and review in respect of these banks will be completed shortly.

Rating Model for UCBs

VI.53 In order to bring about supervisory convergence between UCBs and commercial banks, the supervisory rating model for UCBs was revised and implemented from the inspection cycle beginning March 31, 2009. With the introduction of revised rating model, the gradation system of UCBs was dispensed with. The revised CAMELS rating model will be applicable to UCBs with deposits of ₹100 crore and above and a revised simplified version thereof would be applicable to UCBs with deposits of less than ₹100 crore. UCBs will be assigned a composite rating on a scale of A+ to D, based on the weighted average of the ratings of individual components.

RURAL CO-OPERATIVES

Progress of the Revival Package

VI.54 The implementation of the Government of India's "Revival Package for Short-term Rural Co-operative Credit Structure" is in progress. NABARD, the implementing agency, had released an amount of ₹7,988 crore, by end-June 2010, towards Government of India's share for recapitalisation of 49,779 Primary Agricultural Credit Societies (PACS) in 14 states, while the state governments had released ₹754 crore as their share. Sixteen states have so far amended their respective State Co-operative Societies Acts.

Licenses to StCBs/DCCBs

VI.55 The parameters for licensing of existing unlicensed State Co-operative Banks (StCBs) / District Central Co-Operative Banks (DCCBs) were relaxed in October 2009. Prior to October 2009, 14 StCBs (out of a total of 31) and 75 DCCBs (out of a total of 371) were licensed. After issuance of the relaxed parameters, another 8 StCBs and 125 DCCBs have been licensed, taking the total number of licensed StCBs and DCCBs to 22 and 200, respectively, as at end-June 2010.

Branch Licensing

VI.56 Guidelines were issued regarding branch licensing of StCBs in August 2009. Accordingly, proposals of StCBs, which have CRAR of at least 9 per cent, have not defaulted on CRR and SLR requirements, have net NPA to net advances ratio of less than 10 per cent and do not have any serious irregularity may be considered for branch licensing. Additionally, it is also required that the concerned state government should have signed the MoUs in connection with the Government of India's Revival

Package for short-term rural co-operative credit structure.

Strengthening of RRBs

VI.57 A Committee constituted by the Government of India (Chairman: Dr. K. C. Chakrabarty) to examine the financials of the RRBs and suggest a roadmap to bring the CRAR of RRBs to 9 per cent by March 2012 has recommended recapitalisation requirement of ₹2,200 crore for 40 of the 82 RRBs. The Committee has also recommended, *inter alia*, increase in the authorised capital of RRBs, allowing RRBs with higher net worth to access capital market in due course, improving governance, management structure and efficiency of RRBs. The recommendations of the Committee are under examination.

VI.58 In order to strengthen and consolidate RRBs, the Government of India in 2005 initiated the process of amalgamation of RRBs in a phased manner. Consequently, the total number of RRBs has reduced from 196 to 82 as on March 31, 2010.

VI.59 As per the status reports received from sponsor banks, 21 RRBs have migrated fully to core banking solutions (CBS) and implementation of CBS is in progress in the remaining RRBs.

VI.60 RRBs have been allowed to issue inter-bank participation certificates (IBPC) of a tenor of 180 days on risk-sharing basis to SCBs against their priority sector advances in excess of 60 per cent of their outstanding advances.

DEPOSIT INSURANCE AND CREDIT GUARANTEE CORPORATION OF INDIA

VI.61 Deposit insurance scheme at present covers all commercial banks, including Local Area Banks (LABs) and Regional Rural Banks (RRBs) in all the states and union territories. With the present limit of deposit insurance in India at ₹1 lakh, the number of fully protected accounts (12,670 lakh) as on March 31, 2010 constituted 89.0 per cent of the total number of accounts (14,239 lakh) as against the international benchmark of 80[1] per cent. Amount-wise, insured deposits at ₹23,69,483 crore constituted 55.3 per cent of assessable deposits at ₹42,82,966 crore against the international benchmark of 20 to 40 per cent. During the year 2009-10, the Corporation settled aggregate claims for ₹ 654.65 crore in respect of 82 Co-operative Banks (28 original claims and 54 supplementary claims) as compared with claims for ₹228.43 crore during the previous year.

NON-BANKING FINANCIAL COMPANIES

Applicability of NBFCs-ND-SI regulations

VI.62 A non-deposit taking NBFC with an asset size of ₹100 crore is classified as a systemically important entity. NBFCs have been advised that they may comply with the Reserve Bank's regulations issued to NBFCs-ND-SI from time to time, as and when they attain an asset size of ₹100 crore, irrespective of the date on which such size is attained and may continue to comply with the extant directions, even in case of reduction in the size of assets subsequently.

Acceptance of Deposits by Chit Fund Companies

VI.63 Chit fund companies, classified as miscellaneous non-banking companies (MNBCs), can accept deposits from the shareholders but have been prohibited from accepting deposits from public. Hence, they have been advised to repay public deposits on maturity.

Fit and Proper Criterion

VI.64 In view of some evidence of consolidation in the NBFC sector, it has been decided that any

1 Accepted as a rule of thumb at the First Annual Conference of the International Association of Deposit Insurance (IADI) in Basel, Switzerland in May 2002.

takeover/acquisition of shares of a deposit taking NBFC or merger/amalgamation of a deposit taking NBFC with another entity or any merger/amalgamation of an entity with a deposit taking NBFC that would give the acquirer/another entity control of the deposit taking NBFC, would require prior approval of the Reserve Bank. Further, it has also been decided to ensure that upon such merger/amalgamation, the general character of management complies with the 'fit and proper' criteria prescribed by the Reserve Bank.

Interest Rate Futures for NBFCs

VI.65 NBFCs have been allowed to participate as clients in the designated interest rate futures exchanges recognised by SEBI, subject to Reserve Bank/SEBI guidelines in the matter, for the purpose of hedging their underlying exposures.

New category of NBFC-Infrastructure Finance Companies

VI.66 Considering the critical role played by companies which provide credit to the infrastructure sector, it has been decided to introduce a fourth category of NBFCs *viz.* "Infrastructure Finance Companies" (IFCs). Companies that deploy a minimum of 75 per cent of total assets in infrastructure loans, have net owned funds of ₹300 crore or above, have minimum credit rating 'A' or equivalent; and CRAR of 15 per cent (with a minimum Tier I capital of 10 per cent) would be classified under this category and be allowed to exceed the extant credit concentration norms by lending to single/group borrowers by an additional 5 per cent of owned funds.

Submission of Statement of Interest Rate Sensitivity [NBS-ALM3]

VI.67 NBFCs-ND-SI have been advised to submit the return on Interest Rate Sensitivity (NBS-ALM3) within 20 days of the close of the half year to which it relates.

No Objection Certificate (NoC) for Overseas Investment by NBFCs

VI.68 As making any overseas investment without regulatory clearance is a violation of FEMA Act, NBFCs have been directed to obtain 'No Objection Certificate' (NoC) from the Reserve Bank before making such investments, overseas.

Finance for Housing Projects- Information Disclosure

VI.69 In order to ensure adequate disclosure NBFCs have been advised that the terms and conditions while granting finance to housing / development projects should stipulate that the borrower would disclose in the pamphlets / brochures /advertisements *etc.*, the name(s) of the entity to which the property is mortgaged and that they would provide 'no objection certificate' (NOC) / permission of the mortgagee entity for sale of flats / property, if required. Funds should not be released unless the borrower fulfils the above requirements.

Change in or Take Over of the Management of the Business of the Borrower by Securitisation Companies and Reconstruction Companies (Reserve Bank) Guidelines, 2010

VI.70 As announced in the Monetary Policy Statement for the year 2010-11 the Reserve Bank of India notified the guidelines on "Change in or Take Over of the Management of the Business of the Borrower by SCs/RCs, 2010" on April 21, 2010. These guidelines are aimed at proper management of the business of the borrower to enable the SCs/RCs to realise their dues from the borrowers, by effecting change in or takeover of the management of the business of the borrower and related matters.

The Securitisation Companies and Reconstruction Companies (Reserve Bank) Guidelines and Directions, 2003 – Amendments

VI.71 With a view to bringing transparency and market discipline in the functioning of SCs/RCs, additional disclosures related to assets realised

during the year, value of financial assets unresolved as at the end of the year, value of security receipts pending for redemption, *etc.*, have been prescribed. It is now mandatory for SCs/RCs to invest in and continue to hold a minimum of five per cent stake of the outstanding amount of the security receipts issued by them under each scheme and each class till the redemption of all the security receipts issued under a particular scheme.

NBFCs-ND-SI -applicability for exemption from concentration norms

VI.72 NBFCs-ND-SI also issue guarantees and devolvement of these guarantees may require access to public funds. Those NBFCs-ND-SI which do not access public funds either directly or indirectly or do not issue guarantees were advised to approach the Reserve Bank for exemption/ modification in the prescribed ceilings with regard to concentration of credit / investment norms.

Loan facilities to the physically / visually challenged

VI.73 In order to eliminate the possibility of discrimination on grounds of disability, NBFCs were advised not to discriminate in extending products or facilities to the physically/visually challenged applicants. All possible assistance may be rendered to these applicants for availing of the various business facilities.

VI.74 Going forward, the adoption of global best practices and the convergence of Indian accounting standards with IFRS would pose significant challenges to the financial sector. As new markets and products are developed or introduced, the risks emanating from such markets or products would need to be carefully assessed. The key underpinnings, while developing the markets or products, would be to ensure that one, the process of disintermediation away from banks is genuine and two, areas where both banks and NBFCs are involved, the risks are clearly and transparently captured within a prudential framework. Given the increasing significance of the non-banking financial sector, the supervisory regime of the sector will need to be strengthened for a more robust assessment of the underlying risks. The inter-connected flows between NBFCs and other financial sector entities also needs closer monitoring. The global changes in regulatory standards and practices, when applied to Indian conditions, could entail implications for flow of credit for higher and inclusive growth.