# V FINANCIAL REGULATION AND SUPERVISION

V.1 The Reserve Bank undertook various measures during 2005-06 to strengthen the financial sector with a view to maintaining financial stability. Various policy initiatives during 2005-06 were guided by the need to prepare the commercial banks for implementation of Basel II. In view of the enlarged capital requirements under Basel II, banks were permitted to raise capital through new instruments. In order to provide a benchmark for banks to establish a scientific operational risk management framework, a guidance note was issued to banks. In the context of sharp growth in bank credit to a few sectors, prudential measures were tightened for the specific sectors to safeguard the health of the banking system. Concomitantly, the Reserve Bank laid an increasing emphasis on financial inclusion to provide the financial services to vast segments of the population. Apart from scheduled commercial banks, which are the dominant players in the financial sector, initiatives to strengthen other segments of the banking system were intensified. In the case of regional rural banks, the focus was on amalgamations for improving the efficiency of their operations. In regard to urban cooperatives banks, memoranda of understanding have been signed between the Reserve Bank and a few State Governments to overcome, to an extent, the problem of dual control. In the case of non-banking financial companies, the reporting system for large non-deposit taking companies was strengthened to facilitate macro-level assessment.

V.2 These regulatory and supervisory policy initiatives of the Reserve Bank during the year 2005-06 are presented in this Chapter. It reviews the policy measures to strengthen the financial sector in the light of the implementation of Basel II from March 2007. Efforts for greater financial inclusion and steps to improve customer service measures by the Reserve Bank are also covered in this Chapter. Finally, this Chapter provides an assessment of the banking sector in terms of macro-prudential indicators.

## REGULATORY FRAMEWORK FOR THE INDIAN FINANCIAL SYSTEM

V.3 The Reserve Bank continued to exercise its supervisory role over the financial system encompassing commercial and urban cooperative banks (UCBs), financial institutions, non-banking financial companies (NBFCs) and primary dealers (PDs) through the Board for Financial Supervision (BFS). As on March 31, 2006, there were 89 scheduled commercial banks [excluding regional rural banks (RRBs)], 133 RRBs, 1,864 UCBs, 8 development finance institutions (DFIs), 13,049 NBFCs (of which 434 NBFCs are permitted to accept/ hold public deposits) and 17 PDs. The BFS, constituted as a Committee of the Central Board of the Reserve Bank since November 1994, is headed by the Governor with a Deputy Governor as Vice Chairperson and other Deputy Governors and four Directors of the Central Board as members. The BFS provides direction on a continuing basis on regulatory polices and supervisory practices. In respect of State and district central co-operative banks, and regional rural banks, while the Reserve Bank is the regulator, the supervision is vested with the National Bank for Agriculture and Rural Development (NABARD). Insurance companies and mutual funds are regulated by the Insurance Regulatory and Development Authority (IRDA) and the Securities and Exchange Board of India (SEBI), respectively. A coordinated approach to supervision is ensured through a High-Level Coordination Committee on Financial Markets with the Governor of the Reserve Bank, as Chairman, and the chiefs of SEBI, IRDA and Pension Fund Regulatory and Development Authority (PFRDA), and the Secretary, Economic Affairs, Ministry of Finance, Government of India as the members.

V.4 During the year (July 2005 - June 2006), the BFS held 13 meetings and examined 57 inspection reports. The findings of on-site inspection of the Clearing Corporation of India Ltd. and the follow up actions taken were also reviewed by the BFS. Besides delineating the course of action to be pursued in respect of institution-specific supervisory concerns, the Board provided guidance on several regulatory and supervisory policy decisions.

V.5 As a result of the continued oversight by the BFS, there has been considerable overall improvement in the banking system particularly in housekeeping, internal controls and quality of assets in banks. During 2005-06, the Board focused its

attention on a number of issues. First, the Board stressed the importance of good corporate governance in financial institutions. It was decided that banks that have governance concerns because of dominant ownership or other reasons should be kept under close monitoring. The Board, therefore, emphasised the desirability of diversified ownership in banks, 'fit and proper' status of important shareholders, directors, CEO and the need for a minimum capital/net worth criteria. In case of public sector banks, the Government of India was requested to set up a new 'Board' on the lines of Public Sector Enterprises Board, for recommending to the Government the appointment of CMDs and EDs and directors. It was also suggested to the Government to extend the 'fit and proper status' guidelines prescribed for private sector banks to the public sector banks, with a view to attaining higher standards of 'corporate governance'.

V.6 Second, the Board's concern for continuity of a healthy and vibrant financial sector and a robust regulatory and supervisory regime translated into issue of several important guidelines during the year. Guidelines on credit cards were issued in November 2005 covering issues such as unsolicited cards and disclosure of various charges including interest charged on an annualised basis. Guidelines were also issued laying down the process for mergers, determination of swap ratios and disclosures. Furthermore, guidelines for purchase/sale of non-performing financial assets by banks, including valuation and pricing aspects and prudential norms were finalised. Draft guidelines on outsourcing of services by banks were placed on the Reserve Banks website inviting feedback/suggestions for issue of final instructions.

V.7 Finally, since the financial sector in India has become increasingly complex due to the proliferation of financial groups, the Reserve Bank in consultation with SEBI and IRDA has identified certain groups as financial conglomerates and also put in place an oversight framework for their monitoring. The financial conglomerate monitoring system envisages submission and analysis of quarterly returns on intra-group transactions and exposures, exposures to various segments of financial markets and information on cross-share holding/commonality of back office arrangements by the conglomerates to their principal regulators. The oversight framework was further strengthened with the launch of half-yearly discussion meetings in 2005-06 with the conglomerates attended by all the regulators.

## REGULATORY AND SUPERVISORY INITIATIVES

### Commercial Banks

V.8 As at end-March 2006, there were 89 scheduled commercial banks (excluding RRBs) comprising 28 public sector banks, 28 private banks, 29 foreign banks and four local area banks.

*Strengthening Prudential Norms*

V.9 The Committee on Banking Sector Reforms (Chairman: Shri M. Narasimham) had recommended that, as a prudential measure, a general provision of one per cent of standard assets would be appropriate and this should be implemented in a phased manner. To maintain asset quality in the light of high credit growth during 2005-06, provisioning requirements were tightened in two stages. In November 2005, the provisioning requirement on standard assets, with the exception of direct advances to agricultural and small and medium enterprise (SME) sectors, was raised from 0.25 per cent to 0.40 per cent of the funded outstanding on global loan portfolio basis. In May 2006, the provisioning requirement on standard advances in specific sectors, *i.e.*, personal loans, loans and advances qualifying as capital market exposures, residential housing loans beyond Rs.20 lakh and commercial real estate loans was raised from 0.40 per cent to 1.0 per cent. As hitherto, these provisions would be eligible for inclusion in Tier II capital for capital adequacy purposes up to the permitted extent.

V.10 In order to provide banks additional options for raising capital funds for smooth transition to Basel II, banks were allowed to augment their capital funds by issue of additional instruments (Box V.1).

V.11 Risk weights were tightened during the year for some sensitive sectors. In view of the sharp growth in bank credit to commercial real estate, the risk weight on banks' exposure to the commercial real estate was increased from 100 per cent to 125 per cent in July 2005 and further to 150 per cent in April 2006. Furthermore, banks have been advised that while appraising loan proposals involving real estate, they should ensure that the borrowers have obtained prior permission from government/local governments/ other statutory authorities for the project, wherever required. In order that the loan approval process is not hampered on account of this, while the proposals could be sanctioned in the normal course, the disbursements should be made only after the borrower has obtained the requisite clearances from the government authorities (Box V.2).

## Box V.1
## Enhancement of Capital Raising Options for Capital Adequacy Purposes

With the transition to the new capital adequacy framework (Basel II) scheduled for March 2007, banks would need to further shore up their capital funds to meet the requirements under the revised framework. Under Basel II, the capital requirements are not only more sensitive to the level of credit risk but also apply to operational risks. Thus, banks would need to raise additional capital on account of market risk, Basel II requirements, and to support the expansion of their balance sheets.

While equity is the purest form of capital, the Basel prescriptions recognise other instruments as eligible for inclusion as capital for capital adequacy purposes. The instruments that are generally recognised as capital have various features of equity built into them which take them closer to equity in substance and give the regulator the comfort that these will be available to absorb losses, when required. At the same time, the features of debt present in these instruments - like maturity, call option and coupon - help the issuer to raise capital funds through these instruments at a cost lower than that of equity. The advantages with these instruments are that these are non-dilutive and cost effective.

Taking into account these considerations, the Reserve Bank, in January 2006, allowed Indian banks to augment their capital funds by issue of the following additional instruments: (a) innovative perpetual debt instruments (IPDI) eligible for inclusion as Tier I capital; (b) debt capital instruments eligible for inclusion as Upper Tier II capital; (c) perpetual non-cumulative preference shares eligible for inclusion as Tier I capital subject to laws in force from time to time; and (d) redeemable cumulative preference shares eligible for inclusion as Tier II capital subject to laws in force from time to time.

The basic features/minimum regulatory requirements in respect of IPDI for inclusion as Tier I and debt capital instruments eligible for inclusion as Tier II capital are as under :

| Feature | Innovative Perpetual Debt Instruments | Debt Capital Instruments |
|---|---|---|
| Limits | Shall not exceed 15 per cent of total Tier I capital | Shall not exceed 100 per cent of Tier I capital along with other components of Tier II capital. |
| Maturity | Perpetual | Minimum 15 years |
| Put option | Not available | |
| Call option | Available after ten years with the approval of the Reserve Bank. | |
| Step up option | Available only once during the life of the instrument, in conjunction with the call option, after lapse of ten years from the date of issue. The step-up shall not be more than 100 basis points. | |
| Loss absorption | Interest due will not be payable and will be non-cumulative if CRAR is/will be less than minimum prescribed. | Interest due and principal on redemption will be deferred, but would be cumulative for interest, if CRAR is/ will be less than the minimum prescribed. |
| | Banks may be allowed to pay with the prior approval of the Reserve Bank when the payment of interest will result in net loss/ increase net loss provided CRAR remains above the regulatory norm. | |
| Seniority of claim | Superior to the claims of investors in equity shares; and<br>Subordinate to the claims of all other creditors. | Superior to the claims of investors in equity shares and in instruments eligible for inclusion in Tier I capital; and<br>Subordinate to the claims of all other creditors |
| Discount for the purpose of capital adequacy | Not subjected to progressive discount. | Progressive discount at 20 per cent per year in the last five years before maturity. |
| FII/NRI Investment | Investment in these instruments by FIIs and NRIs shall be within an overall limit of 49% and 24% of the issue, respectively, subject to the investment by each FII not exceeding 10 % of the issue and investment by each NRI not exceeding 5% of the issue.<br>Investment by FIIs shall be outside the limit for investment in corporate debt instruments *i.e.*, US $ 1.5 billion | Investment by FIIs in Upper Tier II Instruments raised in Indian Rupees shall be outside the limit for investment in corporate debt instruments i.e, US $ 1.5 billion. However, investment by FIIs in these instruments will be subject to a separate ceiling of US $ 500 million. NRIs shall be eligible to invest in these instruments as per existing policy. |
| Issue of these instruments in foreign currency. | Not more than 49% of the eligible amount can be issued in foreign currency. | The total amount of Upper Tier II Instruments issued in foreign currency shall not exceed 25% of the unimpaired Tier I capital. This limit will be distinct from other limits in foreign currency borrowings by authorised dealers. |
| CRR/SLR requirements | Will not attract CRR/SLR requirements. | Will attract CRR/SLR requirements. |

Foreign banks in India are allowed to raise Head Office borrowings in foreign currency for inclusion in Tier I capital and in upper Tier II capital subject to the same terms and conditions as above. Detailed guidelines regarding perpetual non-cumulative preference shares eligible for inclusion as Tier I capital and redeemable cumulative preference shares eligible for inclusion as Tier II capital will be issued separately as appropriate in due course.

### Box V.2
### Banks' Exposure to Real Estate Sector - Risk Management and Checks

Given the volatile nature of real estate prices, central banks across the world treat exposures to real estate as a sensitive sector. The concern stems from the adverse consequences on banks' balance sheets in the event of a meltdown in the prices of such assets. Large flow of bank funds to the real estate sector runs the risk of fuelling prices further.

Banks/financial institutions, therefore, need to develop proper risk management systems, as part of their overall strategy, before undertaking any exposure to this sector. It is advisable that banks have a Board mandated policy in respect of their real estate exposures. The policy may include, among other things, permissible exposure limits, collaterals to be considered, margins to be kept, sanctioning authority/level and sector to be financed. The actual limits/margins may vary from bank to bank depending upon the individual bank's portfolio size, risk appetite and risk containing abilities. While a bank may specify an overall internal limit for this sector as a whole, it should also specify sub-limits for each individual sub-sectors of the real estate sector. The risk management system should specifically address the price risk involved in this sector. For ensuring these, banks need to develop effective Management Information System (MIS) to have accurate and timely data on their actual exposure and also a proper monitoring mechanism to ensure that the policy stipulations are being followed by field level functionaries and that their actual exposures, overall as well as segment-wise, are within the stipulated limits.

As part of its regulatory responsibilities, the Reserve Bank has been collecting and analysing data on the banks' exposures to this sector under its off-site monitoring mechanism. In view of the sharp increase in growth of such advances in recent period, banks have been advised to have a proper risk management system in place to contain the risks involved. Banks have also been advised to put in place a system for ensuring proper checking and documentation of related papers before sanctioning/ disbursing of such loans. Owing to the perceived risks involved in this sector, 'risk weights' for real estate advances have been increased.

V.12 With effect from July 26, 2005, the risk weight for credit risk on certain capital market exposures was increased from 100 percent to 125 percent. Capital market exposures subject to higher risk weights included: (i) direct investment by a bank in equity shares, convertible bonds and debentures and units of equity oriented mutual funds; (ii) advances against shares to individuals for investment in equity shares [including Initial Public Offerings (IPOs)/ Employee Stock Option Plans (ESOPs)], bonds and debentures and units of equity oriented mutual funds; and (iii) secured and unsecured advances to stock brokers and guarantees issued on behalf of stock brokers and market makers.

V.13 Venture capital funds (VCFs) play an important role in encouraging entrepreneurship. While significance of venture capital activities and need for banks' involvement in financing venture capital funds is well recognised, there is also a need to address the relatively higher risks inherent in such exposures. In the absence of adequate public disclosures with regard to performance/asset quality of VCFs, prudence demands treatment of exposures to VCFs as 'high risk'. Accordingly, in May 2006, it was decided that a bank's total exposure to venture capital funds will form a part of its capital market exposure and banks are, therefore, required to assign a higher risk weight of 150 per cent to these exposures.

V.14 The Basel Committee on Banking Supervision (BCBS) had issued the 'Amendment to the Capital Accord to Incorporate Market Risks' containing comprehensive guidelines to provide explicit capital charge for market risks in 1998. Pending adoption and prescription of these guidelines for banks in India, the Reserve Bank had as an initial step advised banks to: i) assign an additional risk weight of 2.5 per cent on the entire investment portfolio; ii) assign a risk weight of 100 per cent on the open position limits on foreign exchange and gold; and iii) build up Investment Fluctuation Reserve (IFR) up to a minimum of five per cent of the investments held in Held for Trading (HFT) and Available for Sale (AFS) categories in the investment portfolio. With a view to ensuring smooth transition to Basel II norms, banks were advised in 2004 to maintain capital charge for market risk in a phased manner over a two year period: i) in respect of securities included in the HFT category, open gold position limit, open foreign exchange position limit, trading positions in derivatives and derivatives entered into for hedging trading book exposures by March 31, 2005, and ii) in respect of securities included in the AFS category by March 31, 2006. Banks were advised in October 2005 that they may treat the entire balance held in IFR as Tier I capital, provided they have maintained capital of at least 9 per cent of the risk weighted assets for both credit risk and capital charge for market risk as prescribed above. For this purpose, banks may have to transfer the balance in the IFR

'below the line' in the Profit and Loss Appropriation Account to Statutory Reserve, General Reserve or balance of Profit & Loss Account. In the event that the provisions created on account of depreciation in the AFS or HFT categories are found to be in excess of the required amount in any year, the excess should be credited to the Profit and Loss account and an equivalent amount (net of taxes, if any and net of transfer to statutory reserves as applicable to such excess provision) should be appropriated to an Investment Reserve Account in Schedule 2 – "Reserves & Surplus" under the head "Revenue and other Reserves" and would be eligible for inclusion under Tier II within the overall ceiling of 1.25 per cent of total risk weighted assets prescribed for General Provisions/ Loss Reserves.

V.15 In partial modification of the guidelines dated March 15, 2005 on compliance with Accounting Standard (AS) 11 (dealing with the effects of changes in foreign exchange rates), the threshold limits relating to recording the foreign currency transactions at the date of the transaction were revised and banks were advised that:

(i) the weekly average closing rate of the preceding week would not be considered for approximating the actual rate at the date of the transaction if the difference between (a) the weekly average closing rate of the preceding week and (b) the exchange rate prevailing at the date of the transaction is more than three and a half percent of (b);

(ii) in respect of non-integral foreign operations, the quarterly average closing rate would not be considered for approximating the actual rate at the date of the transaction, if the difference between (a) the quarterly average closing rate and (b) the exchange rate prevailing at the date of the transaction is more than seven percent of (b).

Banks were, however, encouraged to equip themselves to record the foreign currency transactions of Indian branches as well as integral foreign operations and translate the income as well as expense items of non-integral foreign operations at the exchange rate prevailing on the date of the transaction.

V.16 The market for securitisation of standard assets has grown significantly in recent years. In order to ensure orderly development of the market, the Reserve Bank had issued draft guidelines on securitisation of standard assets in April 2005. Based on the feedback, the draft guidelines were suitably modified and the final guidelines on securitisation of standard assets as applicable to banks, financial institutions and non-banking financial companies were issued. The final guidelines applicable from February 1, 2006 include, *inter alia*, the criteria for 'true sale', the criteria that should be met by the SPV to enable the originator to avail off-balance sheet treatment for the assets securitised, policies on provision of credit enhancement/liquidity/underwriting facilities and services, prudential norms for investment in securities issued by SPV, and accounting treatment of the securitisation transactions and disclosures. As regards criteria for true sale, the guidelines, *inter alia*, indicate that (i) the sale should result in immediate legal separation of the originator from the assets that are sold to the new owner *viz.*, the SPV; the assets should stand completely isolated from the originator after its transfer to the SPV, *i.e.*, put beyond the originator's as well as their creditors' reach, even in the event of bankruptcy of the originator; (ii) the originator should effectively transfer all risks/rewards and rights/obligations pertaining to the asset and shall not hold any beneficial interest in the asset after its sale to the SPV and the SPV shall have no recourse to the originator for any expenses or losses except those specifically permitted under these guidelines; and (iii) the securities issued by the SPV shall not have any put options. The securities may have a call option to address the pre-payment risk on the underlying assets.

V.17 Globally, banks are increasingly relying on outsourcing as a means of reducing costs as well as accessing external expertise. At the same time, outsourcing is associated with certain risks, *viz.*, strategic risk, reputation risk, compliance risk, operational risk, exit strategy risk, counterparty risk, country risk, contractual risk, access risk concentration and systemic risk. The failure to manage these risks could lead to financial losses/reputational risk for the bank and systemic risks within the banking system. It is, therefore, imperative for the banks outsourcing their activities to ensure effective management of these risks. In view of this, the Reserve Bank in December 2005 released draft guidelines for outsourcing of financial services by banks.

V.18 In terms of the Rules notified by the Government under the Prevention of Money Laundering Act (PMLA) 2002, a Financial Intelligence Unit-India (FIU-IND) has been set up to collect, compile, collate and analyse the cash and suspicious transactions reported by banks and financial institutions. The Reserve Bank has advised banks that Cash Transaction Report (CTR) for each month should

be submitted to FIU-IND by 15th of the succeeding month, and the Suspicious Transaction Report (STR) should be furnished within 7 days of arriving at a conclusion that any transaction, whether cash or non-cash, is of suspicious nature. Cash transactions of Rs.10 lakh and above or a series of integrally connected transactions aggregate of which, in a month, exceed Rs.10 lakh are to be reported in CTR. Individual cash transactions below Rs.50,000 have been excluded from the purview of reporting to FIU-IND. Banks have been advised to report all other cash transactions where forged or counterfeit bank notes have been used and any forgery of a valuable security has taken place.

*Resolution of Non-Performing Loans*

V.19 In order to increase the options available to banks for resolving their non-performing assets (NPAs) and to develop a healthy secondary market for NPAs, where securitisation companies and reconstruction companies are not involved, the guidelines on sale/purchase of NPAs were formulated and forwarded to banks / FIs / NBFCs in July 2005. Banks were advised to place the guidelines before their boards and take appropriate steps for their implementation.

V.20 Under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002, commercial banks have issued 1,33,665 notices by end-March 2006 involving an outstanding amount of Rs.41,053 crore. Of this, banks have recovered an amount of Rs.7,296 crore in respect of 72,178 cases. Furthermore, an amount of Rs.4,410 crore has been received through 35,090 compromise proposals. The Act provides, *inter alia*, for enforcement of security interest for realisation of dues without intervention of courts or tribunals.

V.21 The Recovery of Debts due to Banks and Financial Institutions Act, 1993 provides for the establishment of tribunals for expeditious adjudication and recovery of debts due to banks and financial institutions. The amendments made in 2000 and 2003 to the above Act and the Rules framed thereunder have strengthened the functioning of Debts Recovery Tribunals (DRTs). Out of 71,399 cases involving Rs.1,11,293 crore filed with DRTs by the banks, 36,803 cases involving Rs.42,792 crore have been adjudicated by end-March 2006. The amount recovered so far through the adjudicated cases is Rs.14,992 crore.

V.22 The Reserve Bank has issued guidelines to commercial banks and financial institutions to enable them to make increasing use of the forum of *Lok Adalats*. By end-March 2006, commercial banks have filed 8,16,068 cases with *Lok Adalats* involving an amount of Rs.4,263 crore. The number of cases decided was 3,07,189 involving an amount of Rs.1,574 crore. The recoveries effected in 2,40,819 cases stood at Rs.649 crore.

V.23 A Special Group was constituted in September 2004 with Smt. Shyamala Gopinath, Deputy Governor, Reserve Bank to undertake a review of the Corporate Debt Restructuring System. The Special Group suggested certain changes/improvements in the existing scheme for enhancing its scope and making it more efficient. Based on the recommendations made by the Special Group and feedback on the revised draft guidelines, final guidelines on Corporate Debt Restructuring mechanism were furnished to all commercial banks/FIs (excluding RRBs) in November 2005. Key features of the revised guidelines are: (i) extension of the scheme to entities with outstanding exposure of Rs.10 crore or more; (ii) requirement of support of 60 per cent of creditors by number in addition to the support of 75 per cent of creditors by value to make the decision making more equitable; (iii) linking the restoration of asset classification prevailing on the date of reference to the CDR Cell to implementation of the CDR package within four months from the date of approval of the package; (iv) restricting the regulatory concession in asset classification and provisioning to the first restructuring where the package also has to meet norms relating to turnaround period and minimum sacrifice and funds infusion by promoters; and (v) pro-rata sharing of additional finance requirement by both term lenders and working capital lenders.

V.24 In order to improve flow of credit to SMEs, detailed guidelines were issued to banks to ensure restructuring of debt of all eligible SMEs at terms, which are, at least, as favourable as the existing corporate debt restructuring mechanism. The guidelines include: (i) definition of SMEs; (ii) eligibility criteria; (iii) viability criteria; (iv) prudential norms for restructured accounts; (v) additional finance; (vii) upgradation of restructured accounts; (viii) asset classification status; and (ix) repeated restructuring.

V.25 The guidelines relating to one-time settlement scheme for recovery of NPAs below Rs.10 crore for SME accounts issued to public sector banks were extended to FIs in November 2005.

*Financial Inclusion*

V.26 In view of the extant banking practices that tend to exclude, rather than attract, vast sections of population, the Reserve Bank urged banks to review their existing banking practices to align them with the objective of financial inclusion. With a view to achieving the objective of greater financial inclusion, all banks were advised in November 2005 to make available a basic banking 'no-frills' account either with 'nil' or very low minimum balances as well as charges that would make such accounts accessible to vast sections of population (Box V.3).

V.27 With the objective of ensuring greater financial inclusion and increasing the outreach of the banking sector, banks have been allowed to use the services of Non-Governmental Organisations (NGOs)/Self Help Groups (SHGs), Micro Finance Institutions (MFIs) and other civil society organisations as intermediaries in providing financial and banking services through the use of business facilitator and correspondent models. Since engagement of intermediaries as business facilitators/correspondents involves significant reputational, legal and operational risks, banks were advised to give due consideration to such risks. Banks were also advised to constitute

**Box V.3**

**Financial Inclusion**

Over the last decade, there has been expansion, competition and diversification of ownership of banks leading to both enhanced efficiency and systemic resilience. However, there are legitimate concerns in regard to the banking practices that tend to exclude rather than attract vast sections of population, in particular, pensioners, self-employed and those employed in unorganised sector. While commercial considerations are no doubt important, the banks have been bestowed with several privileges, especially of mobilising public deposits on a highly leveraged basis and consequently they should be obliged to provide banking services to all segments of the population on equitable basis. Regulation and supervision by the Reserve Bank enables banks to access funds from a wider investor base while access to the payment and settlement systems provides efficient payments and funds transfer services. All these services, which are in the nature of public good, involve significant costs and are made available only to banks to ensure availability of banking and payment services to the entire population without discrimination. It is, therefore, inappropriate to ignore the mandate relating to depositors' interests. The socio-economic profile for a typical depositor who seeks safe avenues for his savings deserves special attention relative to other stakeholders in the banks.

The Reserve Bank in its Annual Policy Statement for 2005-06, therefore, emphasised that banks should empower the depositors by providing wider access and better quality of banking services. Furthermore, banks were advised in August 2005 to ensure that customers belonging to poor sections of the society are not kept away from banking system, on account of difficulties in meeting the KYC requirements for opening bank account. The KYC procedure for opening accounts was simplified further for persons who intend to keep balances not exceeding Rs.50,000/- in all their accounts taken together and the total credit in all the accounts taken together is not expected to exceed Rs.1,00,000/- in a year. The customer is allowed to exceed the threshold limit only after the full compliance with the KYC norms.

The Reserve Bank reiterated the concerns of financial inclusion in its Mid-term Review of Annual Policy Statement for 2005-06. All banks were advised in November 2005 to make available a basic banking 'no-frills' account either with 'nil' or very low minimum balances as well as charges that would make such accounts accessible to vast sections of population. The nature and number of transactions in such accounts could be restricted, but made known to the customer in advance in a transparent manner. All banks were also advised to give wide publicity to the facility of such a 'no-frills' account including on their web sites indicating the facilities and charges in a transparent manner.

Furthermore, banks were advised in December 2005 to make available all printed material used by retail customers such as account opening forms, pay-in-slips and passbooks in trilingual form, *i.e.*, English, Hindi and the concerned regional language. Banks were also advised to provide a simplified general credit card (GCC) facility without insistence on collateral or purpose, with a revolving credit limit up to Rs.25,000 based on cash flow of the household to enable hassle-free access to credit to rural households. Fifty per cent of credit outstanding under GCC could be included by banks under indirect finance to agriculture. A simplified mechanism for one-time settlement (OTS) of loans with principal amount up to Rs.25,000 which have become doubtful and loss assets as on September 30, 2005 was suggested for adoption. In case of loans granted under Government-sponsored schemes, banks were advised to frame separate guidelines following a State-specific approach to be evolved by the State Level Bankers' Committee (SLBC). Banks have been specifically advised that borrowers with loans settled under the OTS scheme will be eligible to re-access the formal financial system for fresh credit. Banks were advised to give effect to these measures at all branches for achieving greater financial inclusion.

grievance redressal machinery within the bank for redressing complaints about services rendered by business facilitators and correspondents. Since the objective is to extend savings and loan facilities to the underprivileged and unbanked population, banks were advised to adopt a flexible approach within the parameters of guidelines issued on Know Your Customer (KYC) from time to time. Special initiatives have been taken to improve the provision of financial services in the North-Eastern region (Box V.4)

*Towards More Deregulation*

V.28 Comprehensive changes were effected in the branch authorisation policy in September 2005 in order to rationalise the policy for opening of new branches in India while giving reasonable freedom to banks. The revised framework takes into account the following elements before granting approval to opening of new branches by banks: (a) the nature and scope of banking facilities provided by banks to common persons, particularly in under-banked areas, actual credit flow to the priority sector, pricing of products and overall efforts for promoting financial inclusion, including introduction of appropriate new products and the enhanced use of technology for delivery of banking services; (b) policy on minimum balance requirements and whether depositors have access to minimum banking or "no frills" banking services and commitment to the basic banking activity *viz.,* acceptance of deposits and provision of credit and quality of customer service; (c) need to induce enhanced competition in the banking sector at various locations; and (d) regulatory comfort encompassing compliance with the spirit and underlying principles of the regulation, quality of corporate governance, risk management systems and internal control mechanisms. As regards the procedural aspects, the existing system of granting authorisations for opening individual branches from time to time has been replaced by a system of giving aggregated approvals, on an annual basis, through a consultative and interactive process. The authorisations given on an annual basis would be valid for one year from the date of communication. Reasonable flexibility and freedom have been provided to banks in matters relating to shifting, conversion of branches and upgradation of extension counters.

**Box V.4**

**Committee on Financial Sector Plan for North-Eastern Region**

A Committee (Chairperson: Smt. Usha Thorat, Deputy Governor) with members from banks, State Governments from the North-Eastern States and academics was constituted in January 2006 by the Reserve Bank in order to improve provision of financial services in the North-Eastern Region (NER) and also to prepare an appropriate state-specific monitorable action plan for the region. The Committee has since submitted its report. Some of the major recommendations made by the Committee are as follows:

- In order to achieve greater financial inclusion, banks in the NER should draw up plans for each branch to provide "no frills" account to at least 50 households per month in the next 4 years. Massive awareness campaign and sensitisation of the staff and clientele along with adequate groundwork in the region has been suggested for this purpose.
- Keeping in view the local conditions, extensive recourse to bank/SHG linkage programme and business correspondent/business facilitator model was recommended. Given the improving mobile connectivity in the region, IT based solutions including smart cards based and mobile payments for carrying out banking transactions from non-branch locations may be used for increasing outreach.
- Recognising that community ownership and non-transferable rights on land lead to problems in offering land as collateral, simplified alternatives like land possession certificate/certificate from the group/local tribal bodies/farmers clubs/VDBs regarding the borrowers' right to cultivate land have been suggested.
- In the area of human resources, the existing *ad hoc* incentive package may be replaced with a fresh package comprising two components. While one component would cover usual facilities including suitable cash allowance along with prescription of minimum effective tenure, the other component would involve performance based cash incentive based on parameters suggested by the Committee.
- Revamping of RRBs and cooperative banks, including strengthening of staff and market recruitment of CEOs for RRBs.
- Measures for improving currency management and payments/settlement system in the region.
- Implementation of location specific activity-wise action plans for stepping up flow of credit to agriculture, allied activities and SME sector. Setting up of a dedicated SME Debt Fund by SIDBI to provide co-finance up to 25 per cent of project cost to first time entrepreneurs. An increase in the insurance cover under Credit Guarantee Fund Trust for Small Industries (CGTSI) scheme for the NER has also been recommended.

V.29 The branch authorisation policy for Indian banks shall also be applicable to foreign banks subject to certain criteria: (i) foreign banks are required to bring an assigned capital of US $ 25 million up front at the time of opening the first branch in India; (ii) existing foreign banks having only one branch would have to comply with the above requirement before their request for opening of second branch is considered; and (iii) foreign banks will be required to submit their branch expansion plan on an annual basis. In addition to the parameters laid down for Indian banks, the following parameters would also be considered for foreign banks :

- Foreign bank's and its group's track record of compliance and functioning in the global markets would be considered. Reports from home country supervisors will be sought, wherever necessary.
- Weightage would be given to even distribution of home countries of foreign banks having presence in India.
- The treatment extended to Indian banks in the home country of the applicant foreign bank would be considered.
- Due consideration would be given to the bilateral and diplomatic relations between India and the home country.

The branch expansion of foreign banks would be considered keeping in view India's commitments at the World Trade Organisation (WTO). ATMs will not be included in the number of branches for such computation.

*Opening Up of Financial Sector*

V.30 Indian banks continued to expand their presence overseas during 2005-06. There were 18 Indian banks with overseas operations by end-July 2006, with a network of 168 offices (110 branches, 34 representative offices, 6 joint ventures and 18 subsidiaries) in 47 countries. During the year 2005-06 (July-June), State Bank of India (SBI) opened a branch in Kandy (Sri Lanka), Gulshan (Bangladesh), three branches in UK (Manchester, Leicester and Birmingham) and upgraded its representative office in Shanghai into a branch. SBI also opened a representative office in Istanbul (Turkey). ICICI Bank Ltd. opened branches in Hong Kong and Colombo (Sri Lanka) and representative offices in Johannesburg (South Africa) and Dhaka (Bangladesh). Bank of Baroda opened a branch in Leicester (UK). UTI Bank Ltd. opened a merchant banking unit with ACU capabilities in Singapore. Representative offices were opened by Canara Bank in Shanghai (China), by UCO Bank in Kuala Lumpur (Malaysia), by Andhra Bank in Dubai (UAE), by Bank of India in Beijing (China) and by Indian Overseas Bank in Gaungzou (China) and in Kuala Lumpur (Malaysia).

V.31 SBI has acquired an equity stake of 51 per cent with management control in Indian Ocean International Bank Ltd. (IOIB), a Mauritian Bank. SBI has also taken Reserve Bank's approval for acquiring additional 25 per cent shareholding in IOIB.

V.32 During the calendar year 2005, permission was granted to eight foreign banks to open 13 branches, one more than the existing World Trade Organisation (WTO) commitment of 12 branches in a year. During the calendar year 2006 so far (up to July), four foreign banks have been given permission to open 13 branches. Approval was also given for opening of representative office to one foreign bank during the calendar year 2005. Seven more foreign banks have been given approval to open representative offices during 2006 so far (up to July 2006). At present, 31 representative offices of foreign banks are operating in India. During 2005-06, Commonwealth Bank of Australia from Australia, BPU Banca (Banche Popolari Unite Scrl) and Monte Dei Pasche Di Siena (both from Italy), and Zurcher Kontanal Bank (from Switzerland) opened their representative offices in Mumbai. Vneshtorg Bank and Promswyaz Bank from Russia, and Banca Popalaredi Vicenza from Italy opened their representative offices in New Delhi. During the year, Baden Wurttembergische Bank A G closed its office at Mumbai following its merger with Landes bank Baden-Wruttemberg which already has a representative office in Mumbai. Wachovia Bank NA acquired the correspondent business of the Union Bank of California and accordingly Union Bank of California closed its representative offices at Chennai, Delhi and Mumbai in February-April 2006. Mizuho Corporate Bank Ltd. upgraded its representative office at New Delhi to a branch with effect from May 1, 2006.

V.33 Consequent upon ING Bank NV's acquiring strategic stake of 43.99 per cent in Vysya Bank, ING Bank closed its banking business in India. Consequent upon the global merger of "The Bank of Tokyo-Mitsubishi Ltd." with "UFJ Bank Ltd." effective from January 1, 2006, UFJ Bank Ltd. was excluded from the second schedule of the Reserve Bank of India Act, 1934 and the surviving unit's name was changed to "The Bank of Tokyo-Mitsubishi UFJ Ltd.". Likewise, the Chohung Bank name was changed under Section

42(6) (C) of the RBI Act to "Shinhan Bank" with effect from July 25, 2006 due to global merger of 'Chohung Bank' with Shinhan Bank. At present, 29 foreign banks with 255 branches are operating in India.

*Offshore Banking Units*

V.34 By end-July 2006, six banks *viz.*, State Bank of India, Bank of Baroda, Union Bank of India, Punjab National Bank, Canara Bank and ICICI Bank Ltd. had opened seven offshore banking units in Special Economic Zones at Kochi, Mumbai and Noida.

*Amalgamation of Bank of Punjab Ltd with Centurion Bank Ltd.*

V.35 Centurion Bank Ltd. and Bank of Punjab Ltd. made an application to the Reserve Bank for approval of merger of Bank of Punjab Ltd with Centurion Bank Ltd. After examining the applications of both banks in terms of the extant guidelines, the Reserve Bank sanctioned the scheme of amalgamation vide order dated September 24, 2005. The amalgamation became effective from October 1, 2005 and the Centurion Bank Ltd. subsequently altered its name to Centurion Bank of Punjab Ltd. with effect from October 17, 2005.

*Amalgamation of the Ganesh Bank of Kurundwad Ltd with the Federal Bank Ltd.*

V.36 Based on the recommendations of the Reserve Bank, the Government of India placed Ganesh Bank of Kurundwad Ltd. under moratorium from the close of business on January 7, 2006 and up to and inclusive of April 6, 2006. The Reserve Bank received a proposal from Federal Bank Ltd. for taking over the Ganesh Bank of Kurundwad Ltd. On January 9, 2006 a draft Scheme of Amalgamation of Ganesh Bank of Kurundwad Ltd. with Federal Bank Ltd. was issued. The Government of India sanctioned the said scheme on January 24, 2006 and the Scheme of Amalgamation came into force with effect from January 25, 2006.

V.37 The matter was challenged by Ganesh Bank of Kurundwad Ltd. in the Bombay High Court. The High Court dismissed the petition on April 5, 2006, and four weeks time was given to prefer an appeal before the Supreme Court of India. As the moratorium was coming to an end on April 6, 2006, the Government of India, on application made by the Reserve Bank, extended the order of moratorium for further three months up to July 6, 2006. The Ganesh Bank of Kurundwad Ltd. filed a Special Leave Petition before the Supreme Court on April 21, 2006. The matter was finally heard by the Supreme Court on June 6, 2006 and the Court has reserved its judgement.

V.38 The order of moratorium extended by the Government of India on April 5, 2006 expired on July 6, 2006. As the Banking Regulation Act, 1949 does not provide for placing a bank under moratorium for more than six months, the Reserve Bank issued certain directions to the bank under Section 35A of the Banking Regulation Act, 1949 on July 6, 2006. Furthermore, on an application made by the Reserve Bank, the Government of India issued a fresh order of moratorium on July 6, 2006 for the period from the close of business on July 7, 2006 up to and inclusive of October 6, 2006. The bank has been advised that during the period of the moratorium, it should not make any payment to any depositors or discharge any liabilities or obligation to any other creditors except to the extent and in the manner prescribed in the order of moratorium.

*Supervisory Initiatives*

V.39 The growing number of high-profile operational loss events worldwide has led banks and supervisors to increasingly view operational risk management as an integral part of the risk management activity. Management of specific operational risks is not a new practice; it has always been important for banks to try to prevent fraud, maintain the integrity of internal controls, and reduce errors in transaction processing. However, what is relatively new is the view of operational risk management as a comprehensive practice comparable to the management of credit and market risk. Management of operational risk embodies the identification, assessment, measurement, monitoring and control or mitigation of risk. In view of this recognition, the New Capital Adequacy Framework requires banks to hold capital towards operational risk (Box V.5).

V.40 Draft guidelines for implementation of the new capital adequacy framework were formulated and placed on the Reserve Bank's website on February 15, 2005 for wider dissemination and comments (Box V.6).

V.41 It is imperative for banks to prepare for business disruptions and system failures and ensure continuity of operations. The unprecedented floods in recent times in a few cities and the resultant reports of electronic delivery channels of some of the banks

**Box V.5**

**Guidance Note on Management of Operational Risk**

The New Capital Adequacy Framework, *inter alia,* requires banks to hold capital explicitly towards operational risk. In view of this, a guidance note was prepared by the Reserve Bank and issued to banks in October 2005. The guidance note is an outline of a set of sound principles for effective management and supervision of operational risk by banks.

Clear strategies and oversight by the board of directors and senior management, strong operational risk management culture, effective internal control and reporting, and contingency planning are crucial elements for effective operational risk management. Initiatives required to be taken by banks in this regard include: (i) the recognition that board of directors is primarily responsible for ensuring effective management of the operational risk in banks. The board of directors has the ultimate responsibility for ensuring that the senior management establishes and maintains an adequate and effective system of internal controls; (ii) operational risk management should be identified and introduced as an independent risk management function across the entire bank/banking group; (iii) senior management should have clear responsibilities for implementing operational risk management as approved by the board of directors; (iv) the board of directors and senior management are responsible for creating an awareness of operational risks and demonstrate to all the levels of personnel the importance of operational risk within the bank; (v) the direction for effective operational risk management should be embedded in the policies and procedures that clearly describe the key elements for identifying, assessing, monitoring and controlling/mitigating operational risk; and (vi) the internal audit function assists the senior management and the board by independently reviewing application and effectiveness of operational risk management procedures and practices approved by the board/senior management.

The new capital adequacy framework has put forward various options for calculating operational risk capital charge in a ‘continuum’ of increasing sophistication and risk sensitivity and increasing complexity. Banks in India are required to adopt Basic Indicator Approach for computing capital requirements for operational risk when they adopt Basel II in March 2007. They are required to benchmark their operational risk management systems with the guidance provided and aim to move towards more sophisticated approaches. In this regard, the guidance note should be used to put in place an effective operational risk management system which should be constantly upgraded. The design and architecture for management of operational risk is to be oriented towards banks own requirements dictated by the size and complexity of business, risk perception, market perception and the expected level of capital. The exact approach would, therefore, differ from bank to bank. Hence the systems, procedures and tools given in the guidance note are indicative.

being affected has further reinforced the need for robust business continuity planning (BCP) in banks. In recognition of such eventualities, detailed guidelines were issued by the Reserve Bank in April 2005 requiring commercial banks to put in place business continuity measures within a fixed time frame (Box V.7).

V.42 Banks and financial institutions are increasingly making use of sophisticated financial models in order to aid them in quantifying, aggregating and managing risks across geographical and product lines. Given this extensive use of models, their validation assumes importance because the errors in the modelling exercise can lead to poor management decisions and result in actual losses or foregone income from opportunity costs. The supervisory validation of models forms an important signpost in the road-map for Basel II implementation (Box V.8)

**Box V.6**

**Draft Guidelines on Basel II Implementation**

Banks in India would be adopting the ‘Standardised Approach’ for credit risk and ‘Basic Indicator Approach’ for operational risk under Basel II from March 31, 2007. Under the Standardised Approach, banks are required to compute capital requirements for credit risk exposures on the basis of ratings assigned to these exposures by external credit assessment institutions (ECAI). Final guidelines on implementation of the new capital adequacy framework would be issued after taking into account the recommendations of the in-house Group on accreditation of external credit assessment institutions whose ratings may be relied upon by banks for computing their capital requirements.

In terms of the new capital adequacy framework, the national supervisors are required to identify the rating agencies which meet the minimum requirements laid down therein. They are also responsible for assigning the assessments of the eligible rating agencies to the risk weights available under the Standardised Approach. Accordingly, the Reserve Bank has constituted an internal Working Group to identify the eligible rating agencies and recommend an appropriate risk weight mapping.

**Box V.7**
**Business Continuity Planning in Commercial Banks**

The extensive leverage of technology for various internal processes, for developing sophisticated financial products and for providing multifarious electronic touch-points for customers transactions has brought to the fore the banks' critical dependence on information technology (IT). This growing dependence on IT tips the risk-scale from "high frequency-low impact" observed in manual processes to one of "low frequency-high impact" in the technology-dependent milieu. It is, therefore, imperative for banks to prepare for business disruptions and system failures and ensure continuity of operations. In view of these developments, detailed guidelines were issued by the Reserve Bank in April 2005 requiring commercial banks to put in place business continuity measures within a fixed time-frame. The guidelines encompassed both technological as well as non-technology related components required for a comprehensive Business Continuity Planning (BCP) process.

Banks are required to submit BCP document, approved by the Board, to the Reserve Bank for perusal. Furthermore, banks are required to file an annual report indicating the critical systems, their recovery time objectives (RTO) and the strategy to achieve the RTO. Banks also need to submit a quarterly report indicating major failures of critical systems, customer segments/services impacted by the failures and steps taken to avoid such failures. In order to further buttress the importance of BCP, one-to-one meetings were held by the Reserve Bank with thirty-five banks having high coverage of business under core banking system. Several action points and suggestions emanated from the meetings such as framing of a comprehensive BCP, ensuring robustness of disaster recovery processes for critical systems and electronic delivery channels, avoiding single-point-of-failure scenarios, considering wide area disasters and periodic training, testing, updation and audit of BCP/DR plans. Specific concerns are being followed up with banks wherever necessary.

V.43 With the increase in the complexities of banking business and consequent exposure of their balance sheets to the various risks, particularly market risks, it has become imperative for banks to

**Box V.8**
**Model Risk**

The process of model validation should fundamentally assess the predictive ability of a bank's risk estimates. The model errors may arise from factors such as wrong assumptions or data, misspecification, incorrect implementation and misapplication of model. The existence of potential errors in modelling is called model risk which is essentially an operational risk.

The guiding principle of model validation is that the benefits for risk management need to be balanced with the costs of validation. Validation involves a series of processes designed to ensure that the model accurately captures the relationships in the underlying markets. It is primarily used to identify problems in model design and to ensure that the model functions at an appropriate level of confidence. It also entails establishing model boundaries, including sensitivity of the outputs to changes on modelling assumptions, the circumstances in which it can be useful and those in which it may be inappropriate.

As per Basel prescriptions, banks using internal models must have an independent control unit that is responsible for initial and on-going validation of internal models. The banks should have a regular cycle of model validation. The main features of sound validation policy are:

- Input and output should always be scrutinised and tested.
- Decision makers are kept adequately informed about the underlying assumptions of the model and its potential limitations.
- Responsibilities need to be defined, such as for initial approval of model, approval of assumptions, verification of data flaws, and installation of new releases and tracking of identified bugs.
- Documentation process should be undertaken listing all models used by the bank, procedures for their use, descriptions of their components, personnel responsible for running the models and contingency plan for model and data loss.
- Frequency of changes needs to be limited. Access to all models and key support programmes should be restricted and there should be adequate backup.
- The audit should be responsible for assessing efficacy of policy, adherence to policy and aspects of validation.
- Model validation should be independent from model construction and model validation responsibilities must be clearly defined. The responsibility is on the bank to satisfy the supervisor that a model has good predictive power and that regulatory capital requirements will not be distorted as a result of its application.

**References**


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2. ——(2005), "Studies on the Validation of Internal Rating Systems" May.
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rely on various techniques to manage these risks. While the principal technique used by most of the banks for quantification of market risk is Value at Risk (VaR), there are certain inherent weaknesses/ deficiencies of this technique. Therefore, stress testing has emerged as an important complementary technique to VaR. Stress testing not only helps in understanding the impact of extreme events on the performance of a portfolio, but it also helps in identifying key areas where the vulnerability of the portfolio is higher (Box V.9).

V.44 In order to strengthen compliance structure in banks, the Basel Committee on Banking Supervision (BCBS) released a paper 'Compliance and the Compliance Function in Banks'. The paper released in April 2005 defines compliance risk as "the risk of legal or regulatory sanctions, material financial loss, or loss to its reputation that a bank may suffer as a result of its failure to comply with laws, regulations, rules, related self-regulatory organisation standards, and codes of conduct applicable to its banking activities". Consequently, the Reserve Bank set up a Working Group consisting of a few Compliance Officers of banks in July 2005 to review the present organisational structure and compliance machinery in banks, weaknesses in the existing system, international standards and best practices and to make recommendations with a view to put in place a robust compliance system in banks. The Working Group has submitted its report and its recommendations are being acted upon.

*Customer Service and Grievance Redressal System in Banks*

V.45 The Reserve Bank has been periodically issuing guidelines on public grievance redressal mechanism in banks, including constitution of customer service centres, committees on customer service and method of disposal of complaints. Based on the recommendations of the Committee on Procedures and Performance Audit on Public Services (Chairman: Shri S.S.Tarapore) for bringing about improvements in the quality of services rendered by them, banks have been advised to constitute

**Box V.9**
**Stress Testing in Risk Management**

Stress testing refers to the analysis of portfolio performance and risk under conditions of extreme price/ rate movements. It is a risk management method to assess a bank's internal capital requirements and its risk profile. It, therefore, provides scope to be employed as a forward-looking assessment tool in bank risk management. It complements the traditional VaR model as it enables an informed guess of extreme events that are plausible but not necessarily quantifiable in terms of probability. The importance of stress testing also emanates from the fact that there is a need to ensure the solvency of the institution under unlikely but not impossible extreme situations.

Sensitivity analysis is the simplest form of stress testing. Stress tests based on this approach examine the impact of a pre-defined unusual shock in a specific risk factor. For instance, a currency price may be shocked, say, by plus / minus 10 per cent. The portfolio is then revalued. The change in value of the portfolio is then used to determine the worst case loss on the portfolio. This is typically done using the deltas, although full revaluation may be used.

Scenario analysis formulates an extreme, but possible state. This approach constructs a series of large/extreme price changes and the performance of the portfolio under this combination is then analysed. In effect, scenario analysis is a form of sensitivity analysis using a combination of changes in key risk factors. Unlike sensitivity analysis, the identified risk factors are assumed to change in an adverse manner simultaneously.

Stress tests must be systematically reassessed because financial markets, instruments, regulatory policies and macroeconomic and political environment are dynamic in nature. Bank managements need to play an active role in the design of stress scenarios. A proper understanding of stress scenarios and their effects is essential for assessing whether the risk to which the bank is exposed corresponds with the bank's risk appetite. In the event of an excessive risk in the stress scenarios, the bank's management shall be prepared to take appropriate measures which may include re-evaluation of limits, reduction of the bank's exposure to risky areas, change in the business strategy, and infusion of additional capital. Regular evaluation of adequacy of stress testing should be subject to internal audit and should be an integral part of a bank's risk management.

**References**

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Customer Services Committee of the Board. They have been also advised to include experts as also representatives of customers as invitees in this Committee, which would formulate policies and assess compliance thereof. Furthermore, banks were advised to convert the *ad hoc* Committee of Executives on customer service headed by CMD/ED into a Standing Committee that would periodically review the policies and procedures and working of their internal grievance redressal machinery. Every bank is expected to have a nodal department and a nodal official for customer service at the Head Office and at each controlling office, whom customers with grievances could approach at the first instance, and with whom the Banking Ombudsman and the Reserve Bank could liaise.

V.46 Banks have been advised to periodically conduct comprehensive reviews of their Grievance Redressal Machinery so as to identify drawbacks, if any, in their functioning and take necessary corrective steps. They have also been advised to submit half-yearly reviews of functioning of Customer Service and Grievance Redressal Cell to their respective boards.

V.47 To enhance the accessibility and effectiveness of the redressal machinery, banks have been advised to ensure that details of the officials to be contacted for complaint redressal are kept updated and prominently displayed at the branches, together with their direct telephone/fax numbers, complete address and e-mail address. The name and address of the Banking Ombudsman should also be displayed at the branches. Banks should give wide publicity to the grievance redressal machinery in the press, besides placing such information on their websites. Banks have also been advised that a complaint form along with the name of the nodal officer for complaint redressal may be made available on their homepage to facilitate submission of complaints.

V.48 The Reserve Bank also receives complaints against banks at its offices/departments. The Government of India also forwards to the Reserve Bank complaints against banks received by it. Such complaints are handled at the regional offices of the Reserve Bank by the regulatory departments concerned, which liaise with the banks named in the complaints. At the central office of the Reserve Bank, receipts of such complaints and liaison with banks concerned were centralised at the Public Grievances and Redressal Cell in the Department of Banking Supervision till June 30, 2006. A separate complaints redressal system, with the Complaints Redressal Cell in the Department of Government and Bank Accounts as the nodal point, was also in place till then to attend to customer service and grievance redressal in respect of services rendered by the Reserve Bank. In order to bring together all activities relating to customer service in banks and the Reserve Bank in a single department, the Reserve Bank constituted on July 1, 2006 a new department called 'Customer Service Department (CSD)'. The functions of this new department include administering the Banking Ombudsman scheme, taking steps for ensuring transparency in banker-customer relationship, monitoring the working of internal grievance machinery of banks, and liaison with banks, Indian Banks' Association, Banking Codes and Standards Board of India (BCSBI), Banking Ombudsmen and various customer fora on matters relating to customer service.

V.49 Introduction of the Banking Ombudsman scheme in 1995 to provide expeditious and inexpensive forum to bank customers for resolution of their complaints relating to deficiency in banking services was an important initiative of the Reserve Bank in the area of customer service. The Scheme was revised first in 2002 and again in 2006. The present Banking Ombudsman Scheme, 2006 is applicable to all commercial banks, regional rural banks and scheduled primary cooperative banks having business in India. Banking Ombudsmen currently have their offices in 15 centres spread across the country. The Ombudsman offices are staffed and funded by the Reserve Bank (Box V.10).

V.50 Recognising an institutional gap in measuring the performance of the banks against codes and standards based on established best practices, the Reserve Bank set up the Banking Codes and Standards Board of India (BCSBI) in February 2006 (Box V.11). The BCSBI is an autonomous and independent body, adopting the stance of a self-regulatory organisation in the larger interest of improving the quality of customer services by the Indian banking system. Banks register themselves with the Board as its members and provide services as per the agreed standards and codes. The Board, in turn, monitors and assesses the compliance with codes and standards, which the banks have agreed to. The registration of banks with the BCSBI enables the Reserve Bank to derive greater supervisory comfort.

*Regional Rural Banks*

V.51 In view of the importance of the regional rural banks (RRBs) as purveyors of rural credit, and in order

**Box V.10**
**Banking Ombudsman Scheme**

The Banking Ombudsman scheme in operation since 1995 provides for a system of redressal of grievances against banks in an expeditious and inexpensive manner. In India, any person whose grievance against a bank is not resolved to his satisfaction by that bank within a period of one month can approach the Banking Ombudsman if his complaint pertains to any of the matters specified in the Scheme. Banking Ombudsmen have been authorised to look into complaints concerning (a) deficiency in banking service (b) sanction of loans and advances as they relate to non-observance of the Reserve Bank directives on interest rates, delay in sanction or non-observance of prescribed time schedule for disposal of loan applications or non-observance of any other directions or instructions of the Reserve Bank as may be specified for this purpose, from time to time, and (c) such other matters as may be specified by the Reserve Bank.

The Banking Ombudsman on receipt of any complaint endeavours to promote a settlement of the complaint by agreement between the complainant and the bank named in the complaint through conciliation or mediation. If a complaint is not settled by agreement within a period of one month from the date of receipt of the complaint or such further period as the Banking Ombudsman may consider necessary, he may pass an Award after affording the parties reasonable opportunity to present their case. He shall be guided by the evidence placed before him by the parties, the principles of banking law and practice, directions, instructions and guidelines issued by the Reserve Bank from time to time and such other factors, which in his opinion are necessary in the interest of justice.

The Banking Ombudsman Scheme, 1995 covered all commercial banks and scheduled primary co-operative banks. The Banking Ombudsman Scheme, 2002 which came into effect on 14th June 2002 also included RRBs within its ambit. It additionally provided for the institution of a "Review Authority" to review the Banking Ombudsman's Award, when warranted. A bank against whom an Award has been passed, may with the approval of its Chief Executive, file an application to the Deputy Governor-in-charge of Rural Planning and Credit Department , Reserve Bank to seek a review of the Award, only when the Award appears to be patently in conflict with the Reserve Bank's instructions and/or the law and practice relating to banking. The Banking Ombudsman was also authorised to function as an Arbitrator on reference to him of disputes (value of subject matter not exceeding Rs. ten lakh) either between banks and their customers or between banks.

The various reviews of the Scheme during the year 2005 indicated that though the complaints received at the Banking Ombudsman Offices have been increasing, the Scheme was not addressing some areas of the customer complaints of the customers. Furthermore, the functioning of the Scheme needed to be facilitated by streamlining the process of settlement of customer complaints. As the formulator and monitoring authority of the Scheme, the Reserve Bank needed to have more control over functioning of the Scheme. These issues have been addressed in the Banking Ombudsman Scheme, 2006 which came into effect from January 1, 2006. The following are the major changes in the revised Scheme:

(i) New grounds of complaints such as credit card issues, failure in providing the promised facilities, non-adherence to fair practices code and levying of excessive charges without prior notice have been included.

(ii) In order to facilitate complaint submission, the prescribed application format is not mandatory for filing the complaint. Complaints can be filed online as well as by sending an email.

(iii) Only serving senior officers of the Reserve Bank are appointed as Banking Ombudsmen.

(iv) The cost of running the Scheme, which was shared by all the participant banks, shall be borne by the Reserve Bank.

(v) The secretariat of the office of the Banking Ombudsman, which earlier also consisted of officers from SLBC Convenor banks, will consist of officers deputed from the Reserve Bank only.

(vi) The banks are required to appoint Nodal Officers in their Zonal Offices/Regional Offices for the Scheme.

(vii) The complainants can also appeal against the Award of Banking Ombudsman.

(viii) In order to enable the Banking Ombudsmen concentrate on the complaints, rather than on arbitration of inter-bank disputes, the arbitration option rested with the Banking Ombudsman has been removed in the Banking Ombudsman Scheme, 2006.

to strengthen them, sponsor banks were encouraged to merge, State-wise, the RRBs sponsored by them. In this context, the Government of India, after consultation with NABARD, the concerned State Governments and the concerned sponsor banks initiated the process of amalgamation of the RRBs in September 2005. As a result of these initiatives, 132 RRBs have been amalgamated till August 2, 2006 to form 41 new RRBs (sponsored by 19 banks in 15 States). This has brought down the total number of RRBs from 196 at end-March 2005 and 133 at end-March 2006 to 105 as on August 2, 2006. Some more amalgamation proposals are under consideration of the Government of India.

**Box V.11**

**Banking Codes and Standards Board of India**

The Reserve Bank has made improved customer service to the common person as one of its key objectives. To this effect, a significant recent initiative of the Reserve Bank has been the setting up of an independent body called the Banking Codes and Standards Board of India (BCSBI) as recommended by the Committee on Procedures and Performance Audit on Public Services. The Committee, set up by the Reserve Bank, had noted that there is a disenfranchisement of depositors and customers and recognised the need to bring about a fundamental change in the overall approach to customer service through a change in the mindset of the players themselves. This issue has been addressed by the banks themselves voluntarily drawing up a "Code of Bank's Commitment to Customers". The BCSBI's role is to evaluate, oversee and enforce observance of the Code by banks through the means of a 'covenant' between each member bank and the BCSBI. The BCSBI's objective is to locate and rectify systemic deficiencies by taking collaborative remedial action rather than through penal measures.

The Code is applicable only to banks dealings with customers in their capacity as individuals. The Code has been evolved through collaborative effort between the BCSBI, the Reserve Bank and the banking industry with the objective of promoting best international banking practices by setting minimum standards; increasing transparency; achieving higher operating standards; and promoting cordial banker-customer relationship which would in turn foster confidence of the individual customer in the banking system. Through the Code, the banks have committed to having in place a Tariff Schedule covering all charges and fees and free policy documents, *viz*., the Cheque Collection policy, Compensation policy and Security Repossession policy. The single most significant feature of this Code is that now the common man will have a Charter of Rights in his hand, which he can enforce against his bank.

The Reserve Bank is fully funding the financing of the BCSBI for the first five years so that it can effectively function as a truly independent and autonomous institution. The annual membership subscriptions received from banks would go towards the setting up of a corpus which would enable the Board to become self-financing as and when the Reserve Bank funding phases out.

The BCSBI's membership is voluntary and is open to scheduled commercial banks. 65 of these banks have already registered with the BCSBI indicating their willingness to become members and adopt the voluntary Code.

V.52 With a view to achieving the objective of greater financial inclusion, all RRBs were advised in December 2005 to make available a basic banking 'no-frills' account either with 'nil' or very low minimum balances as well as charges that would make such accounts accessible to vast sections of population. RRBs were also advised to explore the provision of small overdraft facility to account holders in order to encourage more and more persons in their area of operation to open zero balance accounts. The limit of such overdraft could be reviewed depending on repayment record and may not be linked to any specific activity/end use or security.

V.53 In order to reposition RRBs as an effective instrument of credit delivery, the Reserve Bank initiated measures such as enhancing their resource base, permitting them to issue credit/ debit cards and set up ATMs. They have also been allowed to open (on a case by case basis) currency chests and to handle pension and other government businesses as sub-agents of banks.

**Cooperative Banks**

V.54 Urban cooperative banks (UCBs) complement the efforts of the Reserve Bank towards greater financial inclusion by providing credit facilities to middle class/lower middle class population in the urban and semi-urban areas. In recent years, the Reserve Bank's policy initiatives in regard to UCBs have, therefore, focused on ensuring that they emerge as a sound and healthy network of jointly owned, democratically controlled and ethically managed banking institutions, providing need-based quality banking services, essentially to the middle and lower middle classes and marginalised sections of the society. During 2005-06, the Reserve Bank continued to undertake several initiatives to strengthen the cooperative banking sector.

V.55 As UCBs are subject to dual control by the Reserve Bank and State Governments, efforts are on to harmonise the regulation and supervision over UCBs to facilitate the development of the sector. In order to address issues/difficulties related to dual control within the existing legal framework, a working arrangement in the form of Memorandum of Understanding (MoU) has been proposed. Accordingly, the Reserve Bank has so far signed MoU with five State Governments, *viz*., Andhra Pradesh, Gujarat, Karnataka, Madhya Pradesh and Uttaranchal. Other States that have a sizeable presence of UCBs have also been approached for entering into an MoU. The MoU, *inter alia*, envisages constitution of State-level Task Forces for Urban Co-operative Banks (TAFCUBs).

These TAFCUBs would, *inter alia*, be responsible for identifying viable and non-viable UCBs in the States and suggest time-bound programme for revival of the former and non-disruptive exit route for the latter. Accordingly, the Reserve Bank constituted TAFCUBs in five States that have signed the MoUs. Based on the encouraging experience of TAFCUBs, their scope was widened to cover the scheduled UCBs registered in the States concerned. A similar forum for regulatory coordination in respect of UCBs registered under the Multi-State Cooperative Societies Act is also under consideration.

V.56 With a view to facilitating emergence of strong entities and also for providing an avenue for non-disruptive exit of unviable entities, the Reserve Bank issued guidelines on merger/amalgamation in UCB sector in February 2005. The protection of depositors' interests and financial soundness of the merged entity are the twin objectives of the guidelines. In order to smoothen the process of merger in the UCB sector, general permission was given to the acquirer UCBs to amortise the losses taken over from the acquired UCBs over a period of not more than five years, including the year of merger. The Reserve Bank has since then given 'no objection certificate' for 17 merger proposals; of these, 12 mergers have already taken effect. The remaining proposals are under various stages of consideration/operationalisation by the registrars of cooperative societies of the respective States/Union Government.

V.57 In order to revitalise and rehabilitate the scheduled UCBs with negative net worth, the Reserve Bank began a consultative process with the concerned State Governments and banks. The emphasis is on a time bound programme for restructuring of such UCBs by demarcating the contours of their rehabilitation plan and setting up monitorable milestones. During the year, 10 scheduled UCBs were placed under restructuring plan; of these, one cooperative bank *viz*., Cooperative Bank of Ahmedabad has merged with Cosmos Cooperative Urban Bank Ltd., Pune, and the Reserve Bank is closely monitoring the progress of the other banks with a view to protecting depositors' interest and avoiding systemic problems.

V.58 Share capital and retained earnings constitute the owned funds of UCBs. Share capital can be withdrawn by members after the minimum lock-in period and can also be adjusted against their loans and advances. Therefore, the shares of UCBs do not have all the characteristics of equity. Cooperative banks are also not permitted to issue shares at a premium. In order to explore various options for raising capital, a Working Group was constituted comprising representatives of the Reserve Bank, State Governments and the UCB sector to examine the issues involved and to identify alternate instruments/ avenues for augmenting the capital funds of UCBs.

V.59 The Reserve Bank has permitted UCBs in States where MoUs have been signed and those registered under the Multi-State Cooperative Societies Act to offer mutual fund products, as agents, to their customers, subject to certain conditions. The Reserve Bank also allowed well managed UCBs - both scheduled and non-scheduled - to open select off-site/on-site ATMs, based on the recommendation of the TAFCUBs.

V.60 The Reserve Bank has undertaken various regulatory measures to strengthen the urban cooperative banking sector. In line with the international best practices, the 180 days delinquency period for reckoning an advance as non-performing was brought down to 90 days with effect from March 31, 2004. However, this norm was relaxed and deferred for UCBs with deposits of less than Rs.100 crore and having branches within a single district (including unit banks, *i.e.*, having single branch/head office) considering difficulties expressed by them in meeting the norms. These UCBs have been permitted to classify their loan accounts as NPAs based on the 180 days delinquency norm instead of the 90 days norm. The relaxation would be valid up to end-March 2007 to enable the UCBs concerned to build up adequate provisions and strengthen their procedures in order to transit to the 90 days delinquency norm within the stipulated period.

V.61 As in the case of SCBs, general provisioning requirement for 'standard advances' other than direct advances to agriculture and SME sector was increased for UCBs from 0.25 per cent to 0.40 percent. For UCBs that have branches in only one district (including unit banks) and deposits of less than Rs.100 crore, the existing requirement of provisioning of 0.25 per cent for standard assets would continue. These provisions would be eligible for inclusion in Tier II capital for capital adequacy purposes up to the permitted extent as hitherto.

V.62 The risk weight for loans extended against primary/collateral security of shares/debentures was increased to 125 per cent from the existing level of 100 per cent. The risk weight on investment in equities of all-India financial institutions (AIFIs)/units of UTI was increased to 127.5 per cent from 102.5 per cent. As in the case of SCBs, risk weight on the exposure of UCBs to commercial real estate was increased from 100 per cent to 125 per cent in July 2005 and further to 150 per cent in April 2006.

V.63 UCBs were advised in April 2001 to maintain certain percentage of their assets u/s 24 of the Banking Regulation Act, 1949 (AACS) in the form of Government and other approved securities. In view of the difficulty in making investments in Government securities, the UCBs with deposit base of less than Rs.100 crore and having branches within a single district were given partial exemption (not exceeding 15 per cent) from the prescribed SLR of 25 per cent to the extent of funds placed in interest-bearing deposits with public sector banks. Consequently, these banks can obviate market risks associated with investment in Government securities. The exemption would be applicable up to March 31, 2008.

V.64 Based on representations received, UCBs were allowed to shift their securities to HTM category once more before March 31, 2006. In cases, where the market value of the security was lower than the face value, the provision required would be the difference between book value and the face value which could be amortised during the remaining period of maturity instead of five years as advised earlier to scheduled cooperative banks. These revised valuation norms would apply only in respect of transfers to HTM category made during the current financial year.

V.65 For improving flow of credit to SMEs, certain guidelines were issued for restructuring of debt of SMEs. UCBs were advised to formulate the debt restructuring scheme with the approval of concerned State /Central Registrar of Cooperative Societies and give adequate publicity to the scheme among the customers so as to bring it to the notice of all beneficiaries.

V.66 A Task Force on Revival of Rural Cooperative Credit Institutions (Chairman: Prof.A.Vaidyanathan) was appointed by Government of India in August 2004. The Task Force submitted its final report on strengthening the rural cooperative banking system to the Government in February, 2005. The Task Force has broadly advocated four sets of remedial measures: a) special financial assistance to the tune of Rs.14,839 crore; b) institutional restructuring; c) radical changes in the legal framework to empower the Reserve Bank; and d) qualitative improvement of personnel in all tiers. The Government of India has accepted the recommendations of the Task Force in principle and has held consultative meetings with the State Governments. NABARD has begun the process of implementing the recommendations. The Government of India has decided to set up a National Implementing and Monitoring Committee to oversee implementation and monitoring of revival package for Short Term Cooperative Credit Structure. Governor, Reserve Bank has been nominated as Chairman of the Committee.

V.67 In January 2005, the same Task Force was also entrusted the task of strengthening the long-term co-operative credit structure for agriculture and rural development. The Task Force submitted a draft report to the Government of India in December 2005. The Report has been placed by NABARD and Government of India on their websites for wider dissemination and comments. The Reserve Bank's comments on the Report have been sent to the Government of India on March 1, 2006.

V.68 As on March 31, 2006, 130 out of 366 District Central Cooperative Banks (DCCBs) and six out of 31 State Cooperative Banks (StCBs) have not complied with the provisions of Section 11 (1) of the Banking Regulation Act, 1949 (AACS). The number of DCCBs not complying with the provisions of Section 22(3)(a) and Section 22(3) (b) of the Act stood at 134 and 330, respectively, as on March 31, 2006. Show cause notices were issued to eight DCCBs for rejection of licence application during 2005-06. As on March 31, 2006, two State Cooperative Banks and 12 DCCBs were placed under the Reserve Bank directions, prohibiting them from granting any loans and advances and/accepting fresh deposits and renewing the existing ones.

### Financial Institutions

V.69 As in the case of SCBs, general provisioning requirement for 'standard advances' other than direct advances to agriculture and SME sector was increased for FIs from 0.25 per cent to 0.40 percent.

V.70 A minimum framework for disclosures on risk exposures in derivatives of FIs including both qualitative and quantitative aspects has been prescribed with a view to provide a clear picture of the exposure to risks in derivatives, risk management systems, objectives and policies. FIs are required to make these disclosures as a part of the 'Notes on Accounts' to the Balance Sheet with effect from March 31, 2005 (June 30, 2005 in the case of National Housing Bank)

### Non-Banking Financial Companies

V.71 The Reserve Bank continued its efforts to strengthen the non-banking financial companies. The submission of quarterly return on important financial parameters of NBFCs not accepting/holding public deposits and having asset size of Rs.500 crore has been changed to monthly periodicity to facilitate a macro level assessment of large non-deposit taking

companies at more frequent intervals. The asset size was also changed from Rs.500 crore and above to Rs.100 crore and above to widen the coverage. Besides, the reporting format has been amended to incorporate additional information relating to capital market exposure covering financing of IPOs, gross sales and purchases in various segments and guarantees issued on behalf of share brokers.

V.72 In order to enhance transparency in the operations and to protect the depositors interest, all deposit taking NBFCs were advised in October 2005 that they should have systems in place to ensure that the books of account of persons authorised by NBFCs (including brokers/agents so far as they relate to brokerage functions of the company) are available for audit and inspection. Residuary non-banking companies (RNBCs) had already been advised in December 2004 to put in place such system in respect of their agents/brokers.

V.73 All deposit taking NBFCs/RNBCs were advised in October 2005 that all individual cases of frauds involving Rs.1 lakh and above but less than Rs.25 lakh may be reported to the respective regional offices of the Reserve Bank's Department of Non-Banking Supervision (DNBS) in whose jurisdiction the registered office of the company is located. Individual cases of frauds involving amount of Rs.25 lakh and above are required to be reported to the Reserve Bank's Department of Banking Supervision, Fraud Monitoring Cell, Central Office, Mumbai.

V.74 NBFCs/RNBCs with public deposits/deposits of Rs.50 crore and above were advised in December 2005 that it would be desirable to stipulate rotation of partners of audit firms appointed for auditing the company after every three years so that the same partner does not conduct audit of the company continuously for more than a period of three years. However, the partner so rotated will be eligible for conducting the audit of the NBFC/RNBC after an interval of three years, if the NBFC/RNBC so decides. Companies were advised to incorporate appropriate terms in the letter of appointment of the firm of auditors and ensure its compliance.

V.75 With a view to ensuring financial inclusion of persons belonging to low income group both in urban and rural areas, KYC procedure for opening accounts by NBFCs, as in the case of SCBs, were simplified for those persons who intend to keep balances not exceeding Rs.50,000 in all their accounts taken together and the total credit in all the accounts taken together is not expected to exceed Rs.1,00,000 in a year, subject to certain conditions.

V.76 RNBCs were earlier advised that effective April 1, 2006, no discretionary investments would be permitted. On a review, the Reserve Bank decided to modify the pattern of the investments. Under the modified pattern, RNBCs have been permitted to continue (up to March 31, 2007) with the discretionary investments of not more than five per cent of the outstanding aggregate liability to depositors (ALD) as on December 31, 2005 or one time of net owned funds of the company, whichever is less. No discretionary investment is permitted on the incremental ALD (*i.e.,* incremental over end-December 2005). There will be no discretionary investment from April 1, 2007.

V.77 The Chairmen/CEOs of NBFCs were earlier advised to personally monitor the progress in regard to compliance with the policy framework on KYC and Anti-Money Laundering Standards and take appropriate steps to ensure that systems and procedures were put in place and instructions had percolated to the operational levels. They were further advised to ensure that there was a proper system of fixing accountability for serious lapses and intentional circumvention of the prescribed procedures and guidelines. NBFCs have to appoint a Principal Officer and put in place a system of internal reporting of suspicious transactions and cash transactions of Rs.10 lakh and above. In terms of the Rules framed under Prevention of Money Laundering Act 2002 (PMLA), the provisions of the Act came into effect from July 1, 2005. Section 12 of the PMLA, 2002 casts certain obligations on the NBFCs in regard to preservation and reporting of customer account information. NBFCs were advised to go through the provisions of the PMLA, 2002 and Rules notified thereunder and take all steps considered necessary to ensure compliance with the requirements of Section 12 of the Act.

## MACRO-PRUDENTIAL INDICATORS REVIEW

V.78 In order to monitor the health and the stability of financial system in India, the Reserve Bank has been compiling macro-prudential indicators (MPIs) from March 2000 onwards. The MPIs comprise both aggregated micro-prudential indicators of the health of individual financial institutions and macroeconomic indicators associated with financial system soundness. India is one of the countries which volunteered to participate in the coordinated compilation exercise of the financial soundness indicators for December 2005 under the aegis of the International Monetary Fund (IMF); the requisite data was forwarded to the IMF on July 31, 2006.

**Table 5.1: Select Financial Indicators**

(Per cent)

| Item | Year | Scheduled Commercial Banks | Scheduled Urban Cooperative Banks | Development Finance Institutions | Primary Dealers | Non-Banking Financial Companies |
|---|---|---|---|---|---|---|
| 1 | 2 | 3 | 4 | 5 | 6 | 7 |
| CRAR | 2005 | 12.8 | 12.7 | 23.9 | 54.3 | 18.2 |
| | 2006 | 12.4 | 12.1 | 22.5 | 53.9 | 15.5 |
| Gross NPAs to Gross Advances | 2005 | 5.2 | 24.8 | 11.6 | n.a. | 5.4 |
| | 2006 | 3.5 | 18.2 | 8.8 | n.a. | 4.1 |
| Net NPAs to Net Advances | 2005 | 2.0 | 6.5 | 3.6 | n.a. | 2.3 |
| | 2006 | 1.3 | 3.0 | 1.3 | n.a. | 1.0 |
| Return on Total Assets | 2005 | 0.9 | 0.3 | 1.5 | -1.8 | 1.9 |
| | 2006 | 0.9 | 0.6 | 1.1 | 5.6 | n.a. |
| Return on Equity | 2005 | 13.6 | n.a. | 6.8 | -5.1 | 14.6 |
| | 2006 | 12.7 | n.a. | 4.7 | 12.5 | n.a. |
| Cost/Income Ratio | 2005 | 49.4 | 25.5 | 1.7 | 29.7 | 16.8 |
| | 2006 | 51.5 | 24.6 | 1.5 | 32.8 | n.a. |

n.a.: Not Available.

**Note**: 1. Data for March 2006 are provisional.
2. Data for 2006 in respect of NBFCs pertain to the period ended September 2005.
3. Data for scheduled commercial banks pertain to domestic operations only and may not tally with the balance sheet data.

V.79 An overview of MPIs for 2005-06 indicates a further improvement in asset quality of all the constituents of the financial sector (Table 5.1). Although there was some decline in the capital adequacy ratios, they remained above the minimum requirements. Return on assets of scheduled commercial banks during 2005-06 was almost the same as in the previous year while that of primary dealers (PDs) witnessed a substantial turnaround.

### Capital Adequacy

V.80 At end-March 2006, scheduled commercial banks were well placed in respect of capital requirements, notwithstanding a modest decline in the aggregated capital ratios during the year (see Table 5.1). The decline in CRAR during 2005-06 could be attributed to the higher rate of increase in total risk weighted assets *vis-à-vis* the expansion in capital during the year. Higher growth in risk weighted assets, in turn, reflected (i) higher growth in the advances portfolio of banks as compared with investments in Government securities (ii) increase in risk weights for personal loans, real estate and capital market exposure and (iii) application of capital charge for market risk for investments held under the AFS category from March 2006. Although the overall CRAR declined, the core capital (*i.e.*, Tier I) ratio of the banks increased from 8.4 per cent at end-March 2005 to 9.3 per cent at end-March 2006 reflecting increased access by banks to primary capital market as also transfer of IFR from Tier II to Tier I capital. The increase in Tier I ratio would provide more headroom to banks in raising capital funds through Tier II, especially in the context of implementation of Basel II norms from March 2007. Only three scheduled commercial banks, of which one is under moratorium, could not meet the prescribed CRAR requirements at end March 2006 (Table 5.2).

**Table 5.2: Scheduled Commercial Banks: Frequency Distribution of CRAR (end-March 2006)**

| Bank Group | Negative per cent | Between 0 and 9 per cent | Between 9 and 10 per cent | Between 10 and15 and above | 15 per cent | Total |
|---|---|---|---|---|---|---|
| 1 | 2 | 3 | 4 | 5 | 6 | 7 |
| | | | Number of Banks | | | |
| Public Sector Banks | 0 (0) | 0 (0) | 0 (2) | 28 (22) | 0 (4) | 28 (28) |
| Nationalised Banks | 0 (0) | 0 (0) | 0 (2) | 20 (14) | 0 (4) | 20 (20) |
| SBI Group | 0 (0) | 0 (0) | 0 (0) | 8 (8) | 0 (0) | 8 (8) |
| Private Sector Banks | 0 (1) | 3 (2) | 1 (4) | 21 (15) | 3 (7) | 28 (29) |
| Old Private Sector Banks * | 0 (1) | 3 (2) | 0 (2) | 15 (10) | 2 (5) | 20 (20) |
| New Private Sector Banks | 0 (0) | 0 (0) | 1 (2) | 6 (5) | 1 (2) | 8 (9) |
| Foreign Banks | 0 (0) | 0 (0) | 2 (2) | 8 (9) | 19 (19) | 29 (30) |
| **All Banks** | **0 (1)** | **3 (2)** | **3 (8)** | **57 (46)** | **22 (30)** | **85 (87)** |

* : Including one bank under order of moratorium

**Note** : 1. Data are provisional and unaudited.
2. Figures in parentheses are data for March 2005.

**Source** : Off-site supervisory returns submitted by the banks pertaining to their domestic operations only.

**Table 5.3: Key Financial Indicators of Scheduled UCBs**

(Rupees crore)

| Indicator | End-March 2005 | End-March 2006 | Percentage variation |
|---|---|---|---|
| 1 | 2 | 3 | 4 |
| Number of Scheduled UCBs | 55 | 55 | |
| Paid-Up Capital | 761 | 881 | 15.7 |
| Reserve Fund and other Reserves | 4,841 | 4,664 | -3.6 |
| Tier I Capital | 816 | 1,216 | 48.9 |
| Tier II Capital | 452 | 592 | 31.0 |
| Deposits | 40,606 | 44,938 | 10.7 |
| Investments in Government and other approved securities | 15,428 | 16,527 | 7.1 |
| Loans and Advances | 24,934 | 27,745 | 11.3 |
| Gross NPAs | 6,193 | 5,053 | -18.4 |
| Net NPAs | 1,515 | 806 | -46.8 |
| Net Profit * | 298 | 509 | 70.7 |
| Net Loss @ | 154 | 118 | -23.2 |
| Accumulated Loss | 468 | 1,598 | 241.8 |

* : 45 banks in 2005; 46 banks in 2006.
@ : 7 banks in 2005; 8 banks in 2006.
**Note :** Data as on March 2006 are unaudited and provisional.

V.81 The CRAR of the scheduled UCBs was 12.1 per cent at end March 2006, marginally lower than 12.7 per cent at end March 2005 (Table 5.1). Both Tier I and Tier II capital increased during the year (Table 5.3).

V.82 The aggregated CRAR of FIs decreased from 23.9 per cent at end-March 2005 to 22.5 per cent at end-March 2006 (Table 5.1). Two FIs continued to have negative CRAR in view of repeated financial losses resulting into erosion in their reserves and capital (Table 5.4).

**Table 5.4: CRAR and Net NPAs of Select FIs (end-March 2006)**

| Financial Institution | CRAR (Per cent) | Net NPAs (Rupees crore) | Net NPAs to Net Loans (Per cent) |
|---|---|---|---|
| 1 | 2 | 3 | 4 |
| **Term-Lending Institutions (TLIs)** | | | |
| IFCI | -30.4 | 666 | 9.6 |
| EXIM Bank | 18.4 | 105 | 0.6 |
| IIBI | -46.2 | 387 | 72.0 |
| TFCI | 35.1 | 19 | 3.9 |
| **All TLIs** | **-0.3** | **1,176** | **4.6** |
| **Refinancing Institutions (RFIs)** | | | |
| NABARD | 34.4 | 0 | 0 |
| NHB | 22.2 | 0 | 0 |
| SIDBI | 43.2 | 261 | 2.0 |
| **All RFIs** | **35.6** | **261** | **0.3** |
| **All FIs** | **22.5** | **1,437** | **1.3** |

**Source :** Off-site returns submitted by FIs.

V.83 The aggregate capital ratio of the NBFCs fell to 15.5 per cent at end-September 2005 from 18.2 per cent at end-March 2005, but remained well above the regulatory minimum (12 per cent for equipment leasing and hire purchase finance companies and 15 per cent for other NBFCs). As at end-September 2005, 96.3 percent of reporting companies had CRAR equal to or in excess of 12 per cent (Chart V.1). The CRAR of PDs remained high at 53.9 per cent as at end-March 2006, although marginally down from 54.3 per cent at end-March 2005.

### Asset Quality

V.84 Asset quality of scheduled commercial banks improved further during the year, with gross and net NPA ratios reaching historical low levels of 3.5 per cent and 1.3 per cent, respectively, at end-March 2006 (Table 5.5). Robust economic activity and better recovery climate have facilitated reduction in non-performing assets in recent years. Only five banks had net NPAs in excess of five per cent of their net advances (Table 5.6). Financial institutions, scheduled UCBs and NBFCs also recorded an improvement in their asset quality during 2005-06, with net NPA ratios reaching 1.3 per cent, 3.0 per cent and 1.0 per cent, respectively, of their net advances at end-March 2006 (see Table 5.1).

### Earnings and Profitability Indicators

V.85 Total income of SCBs declined from 8.21 per cent of their assets in 2004-05 to 8.03 per cent in

**Chart V.1: Frequency Distribution of CRAR of Reporting NBFCs**

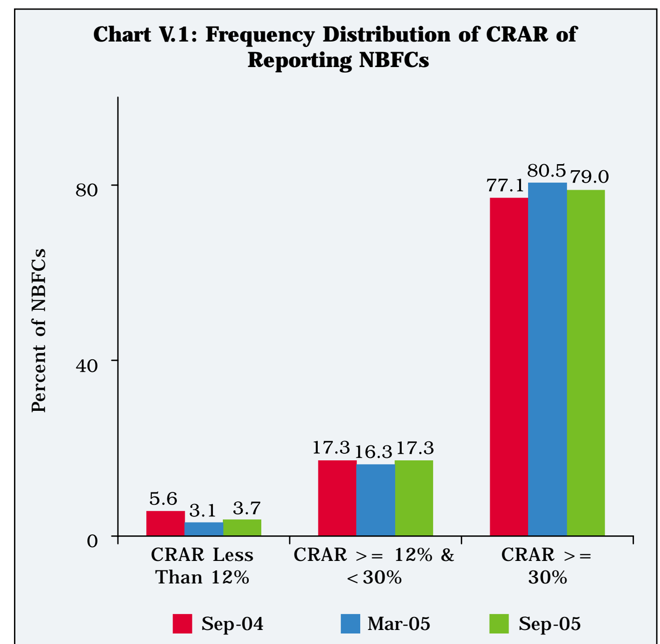

**Table 5.5: Scheduled Commercial Banks – Performance Indicators**

(Per cent)

| Item/ Bank Group | 2005-06 Q1 | 2005-06 Q2 | 2005-06 Q3 | 2005-06 Q4 | 2006-07 Q1 |
|---|---|---|---|---|---|
| 1 | 2 | 3 | 4 | 5 | 6 |
| **Operating Expenses/ Total Assets*** | | | | | |
| Scheduled Commercial Banks | 2.2 | 2.3 | 2.4 | 1.7 | 2.3 |
| Public Sector Banks | 2.1 | 2.3 | 2.4 | 1.7 | 2.2 |
| Old Private Sector Banks | 2.3 | 2.2 | 2.3 | 1.5 | 2.1 |
| New Private Sector Banks | 2.4 | 2.4 | 2.1 | 1.6 | 2.6 |
| Foreign Banks | 2.8 | 2.7 | 3.5 | 2.0 | 2.7 |
| **Net Interest Income/Total Assets*** | | | | | |
| Scheduled Commercial Banks | 3.1 | 2.8 | 3.1 | 2.3 | 3.0 |
| Public Sector Banks | 3.2 | 2.8 | 3.2 | 2.4 | 3.0 |
| Old Private Sector Banks | 3.0 | 2.8 | 3.0 | 2.1 | 3.0 |
| New Private Sector Banks | 2.3 | 2.5 | 2.3 | 1.6 | 2.6 |
| Foreign Banks | 3.8 | 3.7 | 3.6 | 2.8 | 4.2 |
| **Net Profit/Total Assets*** | | | | | |
| Scheduled Commercial Banks | 0.9 | 1.0 | 1.0 | 0.7 | 0.9 |
| Public Sector Banks | 0.8 | 0.9 | 1.0 | 0.6 | 0.7 |
| Old Private Sector Banks | 0.7 | 0.6 | 0.8 | 0.3 | 0.8 |
| New Private Sector Banks | 1.1 | 1.1 | 1.0 | 0.6 | 0.8 |
| Foreign Banks | 1.7 | 1.9 | 1.0 | 1.5 | 2.4 |
| **Gross NPAs to Gross Advances**** | | | | | |
| Scheduled Commercial Banks | 5.1 | 4.7 | 4.1 | 3.5 | 3.4 |
| Public Sector Banks | 5.5 | 5.2 | 4.5 | 3.9 | 3.8 |
| Old Private Sector Banks | 6.2 | 5.8 | 5.4 | 4.5 | 4.6 |
| New Private Sector Banks | 3.1 | 2.6 | 2.1 | 1.8 | 1.9 |
| Foreign Banks | 3.0 | 2.5 | 2.4 | 2.1 | 1.9 |
| **Net NPAs to Net Advances**** | | | | | |
| Scheduled Commercial Banks | 1.9 | 1.7 | 1.4 | 1.3 | 1.3 |
| Public Sector Banks | 2.0 | 1.8 | 1.5 | 1.4 | 1.4 |
| Old Private Sector Banks | 2.7 | 2.5 | 2.2 | 1.7 | 1.6 |
| New Private Sector Banks | 1.6 | 1.1 | 1.0 | 0.8 | 0.9 |
| Foreign Banks | 0.9 | 0.7 | 0.7 | 0.8 | 0.7 |
| **CRAR**** | | | | | |
| Scheduled Commercial Banks | 12.7 | 12.4 | 12.8 | 12.4 | 12.0 |
| Public Sector Banks | 12.8 | 12.6 | 12.7 | 12.2 | 12.0 |
| Old Private Sector Banks | 13.1 | 12.2 | 12.1 | 11.8 | 11.6 |
| New Private Sector Banks | 12.1 | 11.4 | 13.0 | 12.6 | 12.2 |
| Foreign Banks | 13.4 | 13.2 | 13.3 | 13.0 | 12.3 |

* : Annualised to ensure comparability between quarters.

** : Position as at the end of the quarter.

**Note :** Data are un-audited and provisional.

**Source :** Off-site supervisory returns submitted by the banks pertaining to their domestic operations

**Table 5.6: Net NPAs to Net Advances of Scheduled Commercial Banks**

(Frequency Distribution)

| Year/Net NPAs to Net Advances Ratio | Public Sector Banks: SBI Group | Public Sector Banks: Nationalised Banks | Private Sector Banks: Old | Private Sector Banks: New | Foreign Banks |
|---|---|---|---|---|---|
| 1 | 2 | 3 | 4 | 5 | 6 |
| | **Number of Banks** | | | | |
| **2001-02** | | | | | |
| Up to 2 per cent | 0 | 0 | 1 | 1 | 20 |
| Above 2 per cent and up to 5 per cent | 4 | 4 | 2 | 3 | 4 |
| Above 5 per cent and up to 10 per cent | 4 | 12 | 13 | 5 | 1 |
| Above 10 per cent | 0 | 3 | 6 | 0 | 14 |
| **2002-03** | | | | | |
| Up to 2 per cent | 1 | 3 | 1 | 3 | 21 |
| Above 2 per cent and up to 5 per cent | 6 | 6 | 4 | 2 | 2 |
| Above 5 per cent and up to 10 per cent | 1 | 8 | 13 | 4 | 5 |
| Above 10 per cent | 0 | 2 | 2 | 1 | 8 |
| **2003-04** | | | | | |
| Up to 2 per cent | 6 | 5 | 2 | 4 | 19 |
| Above 2 per cent and up to 5 per cent | 2 | 9 | 9 | 5 | 4 |
| Above 5 per cent and up to 10 per cent | 0 | 4 | 7 | 0 | 3 |
| Above 10 per cent | 0 | 1 | 2 | 1 | 7 |
| **2004-05** | | | | | |
| Up to 2 per cent | 7 | 10 | 4 | 5 | 22 |
| Above 2 per cent and up to 5 per cent | 1 | 8 | 11 | 3 | 2 |
| Above 5 per cent and up to 10 per cent | 0 | 2 | 5 | 1 | 2 |
| Above 10 per cent | 0 | 0 | 0 | 0 | 4 |
| **2005-06 P** | | | | | |
| Up to 2 per cent | 7 | 15 | 11 | 6 | 26 |
| Above 2 per cent and up to 5 per cent | 1 | 5 | 7 | 2 | 0 |
| Above 5 per cent and up to 10 per cent | 0 | 0 | 2 | 0 | 0 |
| Above 10 per cent | 0 | 0 | 0 | 0 | 3 |

P : Data as on March 31, 2006 are unaudited and provisional.

**Source :** Off-site supervisory returns submitted by the banks pertaining to their domestic operations only.

2005-06, as both interest and non-interest income moderated during the year (Table 5.7). Total expenditure (as per cent to total assets), on the other hand, was unchanged from the previous year. As a result, earnings before provisions and taxes, as per cent to total assets, during 2005-06 were lower than the previous year. However, in view of lower provisions, profits after tax, as per cent to total assets, at 0.88 per cent during 2005-06 were almost the same as during 2004-05 (0.89 per cent). As many as 45 banks (out of the total of 85 banks) recorded an increase in the profits ratio during the year (Table 5.8).

V.86 The return on total assets of scheduled UCBs increased from 0.3 per cent in 2004-05 to 0.6 per cent in 2005-06. The return on assets of the PDs witnessed substantial turnaround to reach 5.6 per cent during 2005-06. The return on assets had turned negative during the year 2004-05 on account of upward

**Table 5.7: Operational Results of Scheduled Commercial Banks – Key Ratios**

(Per cent to total assets)

| Indicator | 2004-05 | 2005-06 |
|---|---|---|
| 1 | 2 | 3 |
| 1. Total Income | 8.21 | 8.03 |
| Interest Income (net of interest tax) | 6.72 | 6.64 |
| Non-Interest Income | 1.49 | 1.38 |
| 2. Total Expenditure | 5.98 | 5.98 |
| Interest Expenses | 3.83 | 3.82 |
| Operating Expenses | 2.15 | 2.16 |
| 3. Earnings Before Provisions and Taxes (EBPT) | 2.22 | 2.05 |
| 4. Provisions and Contingencies | 1.33 | 1.17 |
| 5. Profit after Tax | 0.89 | 0.88 |

**Note :** Data for March 2006 are provisional and unaudited.
**Source :** Off-site supervisory returns submitted by the banks pertaining to their domestic operations only.

movement in the yield curve and the consequent losses suffered by the PDs on their portfolio.

### Sensitivity to Market Risk

*Interest Rate Risk*

V.87 Given the substantial holdings of investments in Government securities, the balance sheets of commercial banks is sensitive to interest rate movements. Banks have adopted various portfolio management techniques like reduction of duration particularly in case of trading book in conjunction with reduction in the size of the trading book itself (thereby immunising themselves significantly from marked to market losses) to counter interest rate risk to the extent possible. In this context, it may be noted that in view of sustained demand for bank credit from the commercial sector, banks restricted their incremental investments in Government securities during 2005-06. As a result, the share of investments in Government securities in total assets declined during 2005-06.

*Currency Risk*

V.88 In the foreign exchange market, the Indian rupee exhibited two-way movement *vis-à-vis* the US dollar during 2005-06, moving in a range of Rs.43.30-46.33 per US dollar. The two way movement in exchange rates and the risks involved in unhedged foreign exchange positions need to be recognised.

*Equity Risk*

V.89 The Reserve Bank has put in place several regulatory requirements in place to ensure that the banks foray into the capital market is within prudential limit. The margin requirements ensure that the bank advances are well collateralised. The capital market exposure of the banking system, as per cent of gross advances, was 2.1 per cent at end-March 2006, remaining well within the regulatory limit of 5 per cent.

*Liquidity*

V.90 The ratio of liquid assets to total assets in respect of SCBs declined to 34.5 per cent as at

**Table 5.8: Operational Results of Scheduled Commercial Banks – 2005-06**
(Number of banks showing increase in ratios during the period)

| Ratio to Total Assets | Public Sector Banks | | Private Sector Banks | | Foreign Banks | All Banks |
|---|---|---|---|---|---|---|
| | SBI Group | Nationalised Banks | Old Private Sector Banks | New Private Sector Banks | | |
| 1 | 2 | 3 | 4 | 5 | 6 | 7 |
| 1. Total Income | 1 | 4 | 6 | 6 | 18 | 35 |
| Interest Income | 3 | 5 | 5 | 5 | 21 | 39 |
| Non-Interest Income | 3 | 2 | 12 | 6 | 16 | 39 |
| 2. Total Expenditure | 5 | 7 | 7 | 6 | 21 | 46 |
| Interest Expenses | 5 | 7 | 5 | 6 | 20 | 43 |
| Operating Expenses | 5 | 7 | 15 | 5 | 13 | 45 |
| 3. Earnings before Provisions and Taxes (EBPT) | 1 | 2 | 10 | 6 | 18 | 37 |
| 4. Provisions and Contingencies | 1 | 4 | 3 | 6 | 16 | 30 |
| 5. Profit after Tax | 2 | 9 | 14 | 3 | 17 | 45 |

**Note :** Data are provisional and unaudited.
**Source :** Off-site supervisory returns submitted by the banks pertaining to their domestic operations only.

end-March 2006 from 39.2 per cent as at end-March 2005. This decrease in ratio can be attributed primarily to sustained large demand for bank credit in an environment of acceleration in economic activity.

**Outlook**

V.91 The Reserve Bank would continue to undertake regulatory and supervisory initiatives to strengthen the financial sector in order to enhance efficiency of resource allocation while ensuring financial stability in the economy. These initiatives will be guided by the objective of benchmarking the financial sector in India to the best international standards, but with emphasis on gradual harmonisation with the international best practices. All commercial banks in India are required to start implementing Basel II with effect from March 31, 2007. While banks will initially adopt the Standardised Approach for credit risk and the Basic Indicator Approach for operational risk, some of them may be allowed to migrate to the Internal Rating Based (IRB) Approach after adequate skills are developed, both by the banks and the supervisors. Banks which are internationally active should look to significantly improve their risk management systems and migrate to the advanced approaches under Basel II since they will be required to compete with the international banks which are adopting the advanced approaches. This strategy would also be relevant to other banks which are looking at adoption of the advanced approaches. Finally, while pursuing with its initiatives to strengthen the financial sector, the Reserve Bank would intensify its efforts to ensure financial inclusion so that banking services are available to all segments of the population.