# VI REGULATION, SUPERVISION AND FINANCIAL STABILITY

*After the outbreak of the global financial crisis, pursuit of financial stability as an explicit policy objective, especially by central banks, is gaining prominence. In India, the Reserve Bank's regulatory and supervisory policies have always been oriented towards maintenance of systemic stability. The Indian banking system remained largely sound and resilient to shocks as indicated by various stress tests. The high level of leverage in developed countries, which was one of the causal factors behind the global financial crisis, continues to remain low in India. The regulatory and supervisory structure of the Reserve Bank was further strengthened during the year. The important policy decisions for SCBs included, inter alia, strengthening countercyclical provisioning norms, measures to avoid excessive leverage in housing loan segment, credit support to Micro Finance Institutions(MFIs) etc. After the consolidation in the UCB sector there is substantial improvement in their financial health.*

VI.1 The mandate of central banks in many countries is getting widened to include systemic regulation and macroprudential supervision in the aftermath of the global financial crisis. In India, the regulation and supervision have since long been the most crucial functions of the Reserve Bank. The Reserve Bank currently has the mandate to regulate banks as well as non-banking financial companies (NBFCs) and has conducted its regulatory and supervisory functions with the objective of maintaining systemic financial stability as well as preventing failure of individual entities.

VI.2 The focus on regulation, supervision and financial stability helped the Indian banking system to sustain the downturn witnessed during the global financial crisis. Strong prudential regulations were adopted by the Reserve Bank much ahead of the outbreak of the crisis. The Indian financial system still remains largely bank oriented and therefore a resilient banking system is crucial in maintaining systemic stability. The stress test results suggest that Indian banking system is largely resilient and can withstand plausible shocks.

## FINANCIAL STABILITY ASSESSMENT

VI.3 Post-crisis, financial stability has come to be recognised as an integral element of macroeconomic policy framework globally. In the international fora, a Financial Stability Board (FSB) is set up to detect systemic vulnerabilities and strengthen the supervisory and regulatory structure with a view to promoting financial stability. India is also a member of FSB and has committed to adopt international best practices (Box VI.1).

VI.4 The multiple indicator approach to monetary policy as well as prudent financial sector management has enabled the Reserve Bank to maintain financial stability in the country even in the face of strong headwinds from the global economy. The post crisis focus on establishing an institutional mechanism for coordination among regulators and the Government has culminated in the establishment of the Financial Stability and Development Council (FSDC) in December 2010. The FSDC is chaired by the Finance Minister and assisted by a Sub-Committee to be chaired by the Governor of the Reserve Bank. This structure attempts to strike a balance between the sovereign's objective of ensuring financial stability and the operative arrangements involving the central bank and other regulators. While the Sub-Committee is expected to evolve as a more active, hands-on body for financial stability in normal times, the FSDC would have a broad oversight and will assume a central role during crises (Box VI.2).

VI.5 Further, the Financial Sector Legislative Reforms Commission (FSLRC) has been constituted under the Chairmanship of Justice B.N. Srikrishna by the Central Government in March 2011, with a view to rewriting and streamlining the financial sector laws, rules and regulations to bring them in harmony with the requirements of India's fast growing financial sector.

### Box VI.1
### Financial Stability Board (FSB)

The FSB, which was established in 2009 as a successor to the Financial Stability Forum (FSF), is an international body established to address financial system vulnerabilities and to drive the development and implementation of strong regulatory, supervisory and other policies in the interest of financial stability. The FSB has identified a range of issues with potential implications for systemic stability and various initiatives, as under, are now underway, internationally, to tackle these issues:

1. Developing macroprudential frameworks and policy measures as an essential tool for ensuring financial stability;
2. Implementing the Basel Committee proposals to enhance the capital and liquidity standards of financial institutions, now commonly known as Basel III. The proposals envisage a minimum Common Equity Capital ratio of 4.5 per cent, a Capital Conservation Buffer of up to 2.5 per cent, calibration of a Liquidity Coverage Ratio (LCR) and a Net Stable Funding Ratio (NSFR), *etc*.;
3. Reforming policies relating to Systemically Important Financial Institutions (SIFI), with a view to reducing the probability and impact of failure, improving resolution capacity and strengthening core financial infrastructures and markets;
4. Exploring possible regulatory measures to address the systemic risk and regulatory arbitrage concerns posed by the shadow banking system;
5. Improving the OTC and Commodity Derivatives Market through measures requiring all standardised OTC derivative contracts to be traded on exchanges or electronic trading platforms and, where appropriate, cleared through central counterparties; reporting of OTC derivative contracts to trade repositories; and higher capital requirements for non-centrally cleared contracts;
6. Other measures such as reforming compensation practices of financial institutions, enhancing and strengthening accounting standards and reducing reliance on Credit Rating Agencies (CRAs).

***Reserve Bank's views***

India is a member of the FSB and the Reserve Bank is actively involved in the process of policy formulation in the Board. It remains committed to adoption of international standards and best practices, in a phased manner and calibrated to local conditions, wherever necessary.

Banks in India are well capitalised and the Basel III norms are unlikely to put undue pressure on the banking system in the aggregate, though a few individual banks may need to raise additional capital to comply to these standards, once they are phased in. Many regulatory prescriptions being contemplated internationally, especially with respect to core capital, had been inducted into the Indian regulatory framework well before the crisis.

A framework for monitoring the activities of the Financial Conglomerates (FCs) is in place in the country. Though none of the Indian institutions are likely to qualify as a global SIFI, nonetheless, the progress made in SIFI identification and resolution mechanism will have to be incorporated into the domestic regulatory regime.

The shadow banking sector, as it is understood globally, does not exist in India. The NBFC sector which is loosely identified with shadow banking is also largely regulated. There remain some regulatory gaps which leave scope for arbitrage. A Working Group has been, *inter alia*, mandated to identify such gaps and suggest measures to plug them.

Unlike in most jurisdictions, where centralised trade reporting has come into focus only post-crisis, India has had arrangements for reporting of various OTC derivative transactions ranging from summary information to transaction level data. The existing reporting arrangements require trades in foreign exchange, interest rate, government securities, corporate bonds and money market instruments to be reported to the Clearing Corporation of India Ltd. (CCIL). A Working Group constituted by the Reserve Bank has further suggested a range of measures towards expanding the menu of products which are reported and requiring such reporting through regulatory mandates.

Macroprudential policy tools to address issues of systemic concerns have been employed in India for quite some time and the results have been largely positive. The tools used in India included specifying/revising exposure norms, provisioning for standard assets, differentiated risk weights for sensitive sectors, specification of loan to value ratio, *etc*. To sustain the efficacy of such instruments, going forward, a wide range of qualitative and quantitative indicators will need to be developed and the integrity of data will have to be enhanced.

VI.6 By the Securities and Insurance Laws (Amendment and Validation) Act, 2010, a new chapter (chapter III-E) has been inserted in the Reserve Bank of India Act, 1934. This chapter provides for a joint mechanism, consisting of Union Finance Minister as Chairperson, Governor, Reserve Bank of India as

### Box VI.2
### Developments Related to FSDC and its Sub-Committee

Following the announcement in the Union Budget of 2010-11, the Financial Stability and Development Council (FSDC) was set up in December 2010 with a view to institutionalise and strengthen the mechanism for maintaining financial stability. The FSDC will, *inter alia*, deal with issues relating to financial stability, financial sector development, inter-regulatory coordination and macroprudential supervision of the economy including the functioning of large financial conglomerates.

The FSDC is chaired by the Union Finance Minister and its members include the heads of the financial sector regulators and representatives from key departments of the Ministry of Finance. The FSDC is assisted by its Sub-Committee, which meets frequently (at quarterly intervals) to assess the health of the financial sector and monitor any incipient signs of vulnerability. The Sub-Committee is chaired by the Governor of the Reserve Bank and its members also include the heads of the financial sector regulators and representatives from the Ministry of Finance. The Sub-Committee has replaced the erstwhile High Level Co-ordination Committee on Financial Markets (HLCCFM).

Since its inception, the FSDC has met thrice and has taken stock of issues related to the macroeconomy, implications of the developments in the advanced countries on India, sovereign rating of India and the impact of competitive devaluation by different jurisdictions. The Sub-Committee has also met thrice since its constitution and has reviewed the major macroeconomic and financial sector developments, focusing on issues related to systemic risk. It is  engaging itself on an institutional mechanism for inter-regulatory coordination for the supervision of financial conglomerates and putting in place a robust reporting platform for over-the-counter (OTC) derivatives market. Bridging the existing regulatory gaps in the NBFC sector, regulation of government sponsored NBFCs, regulation of investment advisory services, conflict of interest in the distribution of financial products, development of repos in corporate bonds, introduction of infrastructure development funds (IDF), financial inclusion and financial literacy are also critical issues on its agenda.

Vice-Chairperson, the Secretary, Department of Economic Affairs, the Secretary, Department of Financial Services and the Chairpersons of SEBI, IRDA and PFRDA as members to resolve any difference of opinion amongst the regulators. The Act provides for a reference being made to the Joint Committee only by the regulators and not by the Central Government. The decision of the Joint Committee shall be binding on the Reserve Bank of India, the Securities and Exchange Board of India (SEBI), the Insurance Regulatory and Development Authority (IRDA) and the Pension Fund Regulatory and Development Authority (PFRDA).

## MONITORING OF FINANCIAL STABILITY

VI.7 Stress testing exercises are regularly carried out by the Reserve Bank as part of its macroprudential oversight. A series of stress testing in respect of credit, liquidity and interest rate risks showed that Indian banking system remained reasonably resilient though their profitability could be affected significantly. The stress tests show that credit risk would be well contained even if 30 per cent of restructured standard assets turned into NPAs. Though under the most stringent credit quality shock of 150 per cent on the baseline, the system level CRAR was adversely affected, the banking system was able to withstand an adverse NPA shock reasonably with their capital fund. Liquidity stress tests revealed some areas of concern even though the scenario has improved as compared to the last assessment. The credit risk stress tests on systemically important non-deposit taking NBFCs (NBFC-ND-SI) and scheduled UCBs revealed that the impact on CRAR under different scenarios would not be alarming.

*Leverage of Corporate and Household Sector*

VI.8 In the recent period, high leverage levels of corporate and household sector are causes of concern, especially in developed countries. Of these, leverage in household and to a large extent even the corporate sector has been an area which is not directly regulated, even though macroprudential guidelines exist for bank and non-bank lending to corporate sector and retail sector. In India, however, the level of leverage for corporate and household sector is much lower as compared to the high levels prevailing in developed countries (Box VI.3).

## ASSESSMENT OF THE BANKING SECTOR

VI.9 The robust economic growth during 2010-11 was accompanied by a strong credit growth, even though deposit growth did not keep pace and the gap was funded through an increasing share of market

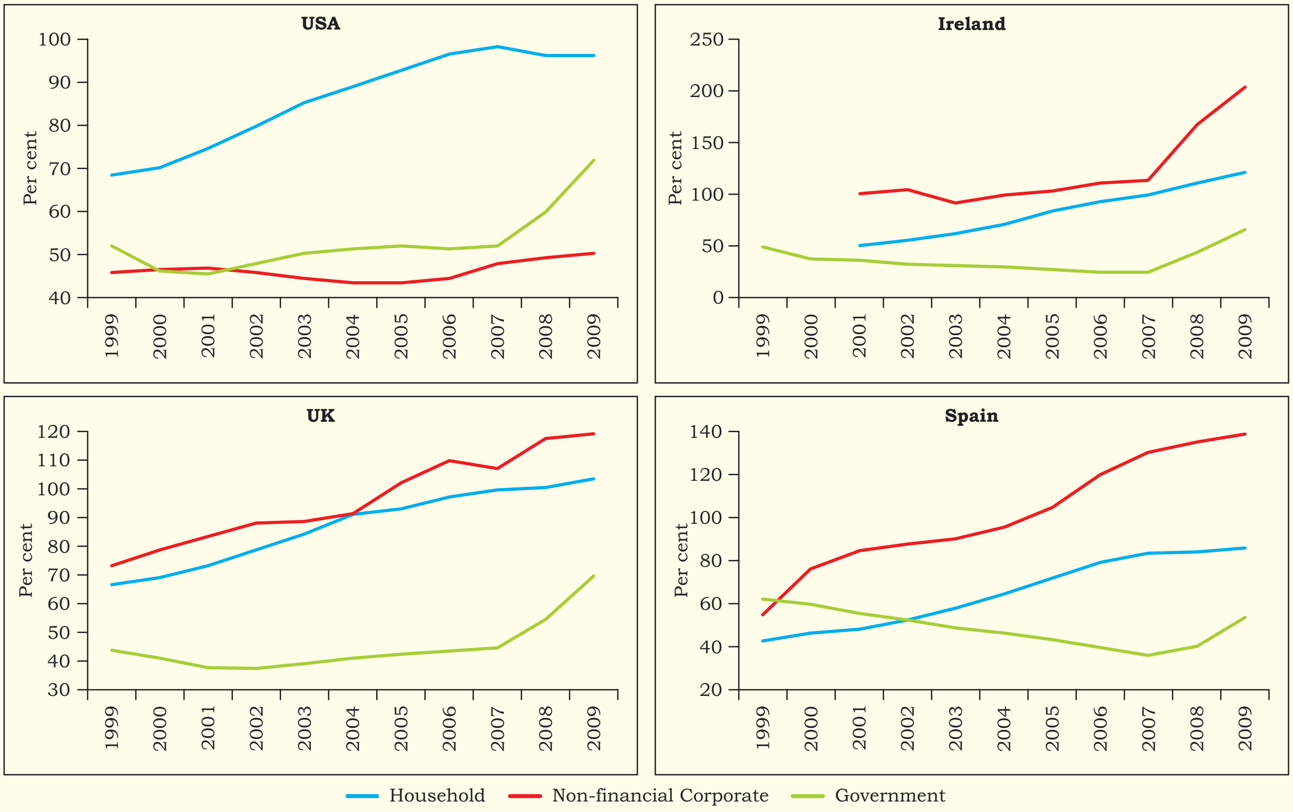
## Box VI.3
## Corporate and Household Leverage, Credit Cycle and Economic Growth

The high level of debt and steady and sharp rise in leverage in the developed economies, especially after 2000, has been identified as one of the major causal factors that sparked off the global financial crisis. The high level of leverage was particularly significant in case of household sector and corporate sector. In the years preceding the financial crisis, household debt rose significantly, especially in countries which experienced a boom in the housing sector, like USA, UK, Ireland and Spain. Corporate debt ratios also increased sharply in some countries like Ireland, Spain, Portugal and UK but were stable in the US (Chart 1). In contrast, the government debt ratios were stable in most of the countries. Surprisingly, even though household sector and corporate sector were highly leveraged, aggregate financial sector leverage in most countries grew only modestly or declined during the years preceding the crisis. This was mainly because of rise in securitisation which allowed banks to shift non-performing loans off their balance sheets.

It is well documented in economic literature that financial crises often take place after a credit boom as reflected in a sharp rise in the ratio of credit to GDP. The leverage is high during credit boom periods, suggesting risk taking behaviour of both lenders as well as borrowers, thereby leading to build-up of systemic risk. This subsequently results in a bust when risk materialises. These types of credit cycles are fairly regular and clearly identifiable across countries and across time and may subsequently lead to banking crises. Thus, even though high leverage in the initial period may lead to a phase of high economic growth through credit boom, as the bubble bursts, the spillover effects may have adverse implications for growth. This is usually followed by a long and often painful process of deleveraging, as financial sector, households and corporates reduce their debt exposures. Following the recent crisis as well, the process of deleveraging has begun in developed economies, though by no means yet complete. Thus, while household and corporate sector debt is beginning to decline, government borrowing is increasing sharply in many economies to finance crisis related stimulus programmes and financial sector bailouts. In contrast, the process of deleveraging is faster in case of financial institutions as these institutions reduced lending and resorted to shrinking balance sheets.

In sharp contrast to the developing countries, the debt levels in India have remained low. In fact, the leverage of corporate sector has been falling in recent years implying that the

**Chart 1: Debt GDP Ratio: Cross Country Experience**



**Data sources:** Eurostat, OECD Stat, National Economic Accounts data, USA.

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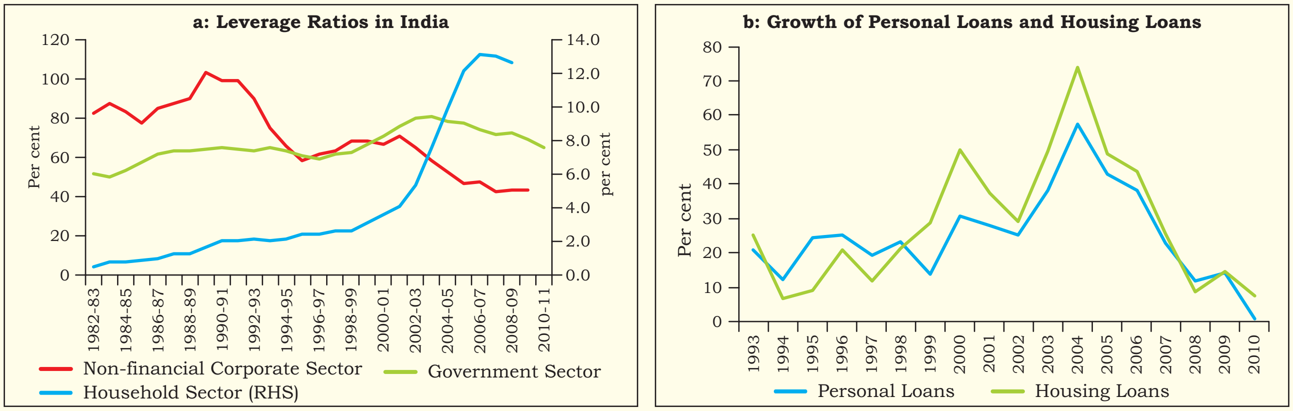
### Chart 2: Indebtedness in India



**Note:** In chart 2a, the leverage ratio refer to debt-equity ratio of non-Government non-financial companies, combined total liabilities of centre and state to GDP ratio for Government sector and household sector credit by SCBs to personal disposable income for household sector.

corporates have preferred the equity route to raise money as compared to the debt route. Microstructure issues like improved ease of raising finances through capital markets due to liberalisation of norms relating to issue and pricing of shares coupled with encouraging market environment have played a crucial role in a shift from debt to equity for corporate. The household indebtedness, which remains a major cause of concern in the developed countries, is comparatively very low in India. Even though the debt ratio witnessed a sharp rise during the period 2000-01 onwards, it has moderated in the post-financial crisis period. Housing loans constitute around half of the total personal loans in India and as a result a boom and bust in the housing market can affect quality of assets. The build-up of systemic risk in this area in India was avoided mainly due to implementation of macroprudential policy by the Reserve Bank like changing the risk weights for loans to real estate.

**References:**

Tang, G. and Upper, C. (2010): 'Debt Reduction after Crises', *BIS Quarterly Review*, September, 25-38.

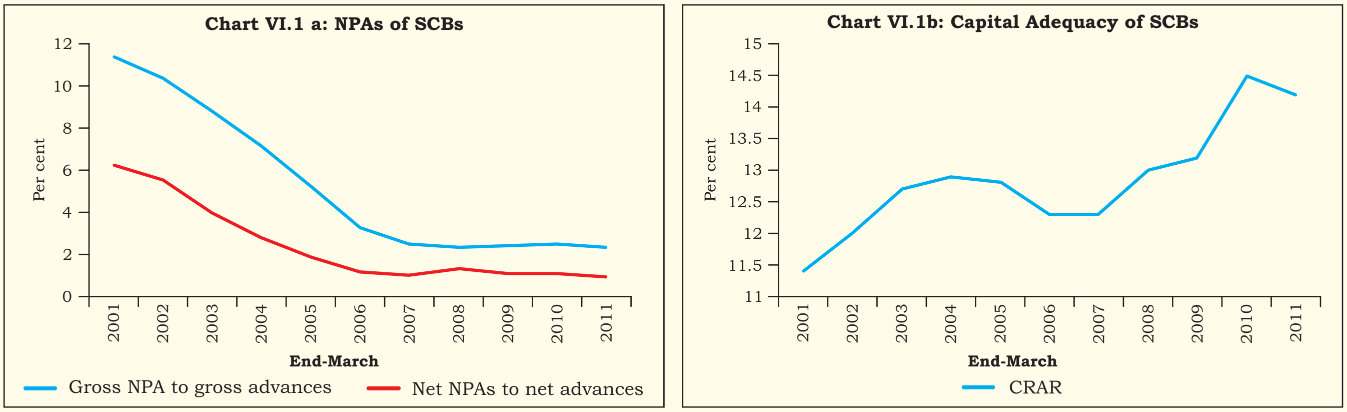
Roxburgh, C. *et.al* (2010): *Debt and Deleveraging: The Global Credit Bubble and its Economic Consequence*', McKinsey Global Initiative, January.

Geanakoplos, J. (2010): 'Solving the Present Crisis and Managing the Leverage Cycle', *FRBNY Economic Policy Review*, August, 101-131.

borrowings. This increased reliance on borrowed funds raised concerns about asset liability mismatches. In the recent period however, the divergent trend between credit and deposit growth has significantly reversed.

VI.10 The strong credit growth during 2010-11 outpaced the growth in NPAs resulting in better asset quality of the banking sector (chart VI.1a). The NPA write-offs by banks to cleanse their balance sheets also helped in achieving a lower gross NPA ratio. Even

### Chart VI.1: Soundness Indicators on SCBs



though the credit portfolio of banking system is fairly diversified, the credit growth mainly emanated from three sectors – infrastructure, retail and commercial real estate. As each of these sectors has a peculiar set of asset quality propositions, the brisk growth in exposure seen during 2010-11 poses some concerns.

VI.11 The system level CRAR under Basel-II norms stood at 14.2 per cent as at end-March 2011 which was well above the regulatory requirement of 9 per cent (Chart VI.1b). Subsequently however there was a decline in CRAR at 13.8 per cent as at end June 2011 largely due to robust credit off-take. All the bank groups had CRAR above 12 per cent as at end-March 2011 under Basel-II norms.

VI.12 Despite significant decline in securities trading and hence in non-interest income and also higher risk provisioning, SCBs could record a growth of 20 per cent in their net profit during 2010-11, mainly due to an impressive growth of 35 per cent in net interest income. Accordingly, return on equity (RoE) and return on assets (RoA) as well as net interest margin (NIM) of SCBs recorded an increase. The ratio of liquid assets to total assets deteriorated during 2010-11 and stood at around 30 per cent at end-March 2011 as compared to more than 32 per cent for last several years.

VI.13 The financial soundness indicators of scheduled UCBs have improved in recent years. Asset quality and profitability of NBFCs-ND-SI also improved over the previous year. Asset quality of deposit taking NBFCs (NBFCs-D) showed an improvement in 2010-11compared with last year, even though capital adequacy ratio declined marginally (Table VI.1).

## MAJOR DECISIONS TAKEN BY BOARD FOR FINANCIAL SUPERVISION

VI.14 The Board for Financial Supervision (BFS), constituted in November 1994, remains the chief guiding force behind the Reserve Bank's supervisory and regulatory initiatives. The BFS held twelve meetings during the period July 2010 to June 2011.

### Table VI.1: Select Financial Indicators

(Per cent)

| Item | End-March | Scheduled Commercial Banks | Scheduled Urban Co-operative Banks | All India Financial Institutions | Primary Dealers | Non-Banking Financial Companies-D | NBFCs-ND-SI |
|---|---|---|---|---|---|---|---|
| 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 |
| CRAR | 2010 | 14.5 | 12.8 | 24.2 | 43.5 | 22.2 | 42.1 |
| | 2011 | 14.2 | 12.7 | 22.1 | 46.2 | 21.0 | N.A. |
| Gross NPAs to Gross Advances | 2010 | 2.5 | 9.3 | 0.3 | N.A. | 2.0 | 2.5 |
| | 2011 | 2.3 | 7.4 | 0.3 | N.A. | 0.9 | 1.9 |
| Net NPAs to Net Advances | 2010 | 1.1 | 4.4 | 0.1 | N.A. | - | 1.2 |
| | 2011 | 0.9 | 3.1 | 0.1 | N.A. | - | 0.8 |
| Return on Total Assets | 2010 | 1.1 | 0.8 | 1.2 | 1.8 | 1.5 | 2.0 |
| | 2011 | 1.1 | 0.9 | 1.0 | 1.1 | N.A. | 2.2 |
| Return on Equity | 2010 | 13.3 | N.A. | 10.4 | 6.8 | 9.0 | 7.0 |
| | 2011 | 13.7 | N.A. | 9.2 | 5.1 | N.A. | 8.7 |
| Efficiency (Cost/Income Ratio) | 2010 | 45.8 | 58.8 | 14.6 | 31.2 | 81.8 | 73.5 |
| | 2011 | 46.0 | 49.9 | 19.3 | 36.1 | N.A. | 68.7 |
| Interest Spread (per cent) | 2010 | 2.7 | N.A. | 2.3 | N.A. | 3.9 | 1.8 |
| | 2011 | 3.1 | N.A. | 2.0 | N.A. | N.A. | 1.9 |

N.A.: Not Available.

**Note:** 1. Data for 2011 are unaudited and provisional.
2. Data for SCBs are excluding LABs.
3. Data for SCBs covers domestic operations, except for CRAR.
4. Data on CRAR on Scheduled UCBs exclude Madhavpura Mercantile Co-operative Bank Ltd.
5. For NBFC-D, data for 2011 pertain to period ended September 2010.

**Source:** 1. SCBs: Off-site supervisory returns.
2. UCBs: Off-site surveillance returns.

In these meetings, it considered, *inter alia*, the performance and the financial position of banks and financial institutions during 2009-10. It reviewed 94 inspection reports (25 reports of public sector banks, 28 of private sector banks, 31 of foreign banks, 4 of local area banks, and 6 of financial institutions). During the period, the BFS also reviewed 15 summaries of inspection reports pertaining to scheduled urban co-operative banks and 43 summaries of financial highlights pertaining to scheduled UCBs classified in Grade I/II. With a view to fine tuning of supervisory rating, the BFS sought a complete review of the rating methodology, which is currently under process.

VI.15 Based on the recommendations of BFS, a High Level Committee (Chairman: Dr. K. C. Chakrabarty) has been constituted to assess the adequacy of the RBI's supervisory policies, procedures and processes, and suggest enhancements for benchmarking the supervisory framework to global standards. Further, with a view to address supervisory concerns arising out of growing volumes as well as complexity of business of banks, the supervisory processes and the organisational structure of the Department of Banking Supervision has been reorganised. The supervisory process (both on-site and off-site) in respect of the major banking groups is being brought together within a division (Financial Conglomerates Monitoring Division - FCMD) in the department so as to achieve better synergy and optimum utilisation of available supervisory resources. Further a need-based reorganisation of the other operational areas of the Department will also be undertaken.

VI.16 While deliberating on issues relating to the Internal Vigilance Framework in private sector/foreign banks, the BFS decided, *inter alia*, that the banks may be advised to frame their own policy for identification of sensitive positions at all levels and for evolving a framework for periodic rotation and mandated leave periods.

VI.17 While deliberating on the issues relating to constitution and performance of co-operative courts in different states, BFS had observed that recovery is treated as dispute under co-operative law, and it would be desirable for UCBs to incorporate in their bye-laws and loan agreements a provision for settling recovery of loans internally through an arbitration council set up by the general body. Based on the directions of the BFS, the views of the respective Task Forces for Co-operative Urban Banks (TAFCUBs) and those of the Legal Department in the matter were obtained. Subsequently, the Secretaries and Registrars of Co-operative Societies of all the State Governments have been advised on July 8, 2010 that the State Co-operative Societies Act may be amended for setting up an internal disputes resolution mechanism where the Act does not provide for arbitration.

## COMMERCIAL BANKS

### Regulatory Initiatives

*Entry of new banks in the private sector*

VI.18 Following the announcement made in the Annual Policy Statement for 2010-11, a discussion paper on new bank license was published in August 2010 inviting suggestions and comments from all concerned. Subsequently a gist of such comments received on the discussion paper and the views emerged in the discussions with stakeholders were placed on the Reserve Bank's website in December 2010. Based on the experience gained from the licensing of new banks under the guidelines issued in 1993 and 2001 and the comments/ suggestions received from the stakeholders and general public, draft guidelines on 'entry of new banks in the private sector' are in the process of being finalised in consultation with the Government of India.

*Entry of foreign banks*

VI.19 A revision to the Reserve Bank's "Roadmap for Presence of Foreign Banks in India", released in February 2005 was due in April 2009. At that juncture, however, the global financial markets were in turmoil and there were uncertainties surrounding the financial strength of banks around the world. In this backdrop, it was decided to review the roadmap once there was greater clarity regarding stability and recovery of the global financial system. Presently various international fora are engaged in setting out policy frameworks incorporating the lessons learnt from the crisis. Drawing lessons from the crisis, a discussion paper on 'Presence of Foreign Banks in India' was released in January 2011 seeking feedback / suggestions from stakeholders and general public. The guidelines delineating the road-map for presence of foreign banks in India would be finalised after taking into account the feedback/suggestions received from the stakeholders.

VI.20 Reserve Bank, however, continues to grant licenses to foreign banks to open branches in India on a case to case basis. During the year 2010-11, the Reserve Bank issued 4 approvals to foreign banks for maiden presence in India, taking the total numbers of foreign banks operating in India to 37 as at end-June 2011. Besides, 47 foreign banks have also representative offices in India.

*Basel II – Implementation of advanced approaches*

VI.21 In line with the Basel II framework, Reserve Bank issued detailed guidelines on Advanced Measurement Approach (AMA) for computing capital charge for operational risk in April 2011. Banks intending to migrate to AMA were advised to assess their preparedness with reference to these guidelines. As and when they are ready for implementation, they may approach RBI with a notice of intention.

VI.22 All the commercial banks in India were advised to continue the parallel run under Basel I framework till March 31, 2013 subject to review and ensure that their Basel II minimum capital requirement is higher than 80 per cent of the minimum requirement under Basel I.

*Basel III*

VI.23 Pursuant to the release of the document titled 'Basel III: A global regulatory framework for more resilient banks and banking system' by the BCBS in December 2010, which becomes operational beginning January 2013, banks have been advised not to issue Tier I and Tier II capital instruments with 'step up options', so that such instruments can qualify for inclusion in the new definition of regulatory capital (Box VI.4).

*Provisioning Coverage Ratio (PCR) for advances and other provisioning requirements*

VI.24 As a macroprudential measure, banks were required to maintain PCR of 70 per cent of gross NPAs with reference to the position as on end-September 2010. The surplus of the provision over and above the prescribed prudential norms should be segregated into a separate account styled as "countercyclical provisioning buffer" which will be allowed to be used during periods of system-wide downturn with the prior approval of Reserve Bank. This was intended to be an interim measure till such time the Reserve Bank introduces a more comprehensive methodology of countercyclical provisioning taking into account the evolving international standards.

VI.25 Reserve Bank increased the provision requirements in case of certain categories of non-performing and restructured accounts in May 2011. The provision requirement for 'sub-standard' assets was increased from 10 per cent to 15 per cent. The provisioning requirement for unsecured exposure in this category was increased from 20 per cent to 25 per cent. The provisioning in respect of secured portion of advances which have remained in 'doubtful' category up to one year was increased from 20 per cent to 25 per cent, whereas that for advances which remained 'doubtful' between one to three years was increased from 30 per cent to 40 per cent.

VI.26 Restructured accounts classified as standard advances will now attract a provision of 2 per cent in the first two years from the date of restructuring. In case of moratorium on payment of interest/principal after restructuring, such advances will now attract a provision of 2 per cent for the period covering moratorium and two years thereafter. Restructured accounts classified as NPAs when upgraded to standard category will now attract a provision of 2 per cent in the first year from the date of upgradation.

## Box VI.4
## Initiatives Taken by the Reserve Bank to Migrate Towards the Basel III Norms

In the wake of financial crisis, the Basel Committee on Banking Supervision (BCBS) has initiated several post-crisis reform measures mainly building on the Basel II capital adequacy framework. The framework was bolstered significantly in July 2009 through a series of enhancements to each of the three pillars; notably, to address the undercapitalisation of trading book exposures of banks. Subsequently, in December 2010, the BCBS has released revised sets of rules for capital and liquidity regulations *viz.* *'Basel III: A global regulatory framework for more resilient banks and banking systems'* and *'Basel III: International framework for liquidity risk measurement, standards and monitoring'* which *inter alia* aim at promoting a more resilient banking sector and strengthening liquidity regulations. Collectively, the revised Basel II capital framework and the new global standards have been commonly referred to as "Basel III".

Though Basel III can be viewed as a modification to Basel II framework, it differs significantly from Basel II in terms of its comprehensiveness. More particularly, apart from revising the definition of regulatory capital, it is much wider in risk coverage and encompasses measures to address the systemic risks. Implementation of Basel III has thrown up significant challenges to both banks and the banking supervisors alike.

So far as implementation of Basel III in India is concerned, availability of adequate amount of capital, both in terms of quality and quantity provides significant comfort to begin implementation of the new framework as per the time schedule fixed by the BCBS. Nevertheless, RBI has taken a number of initiatives to ensure smooth transition of the banking sector to Basel III framework. RBI's representation at the Financial Stability Board (FSB), BCBS and their various sub-groups provides the much needed opportunity to understand and contribute to the formulation of policies relating to regulation and supervision of the banking sector at the international level, particularly, Basel III. In order to raise awareness among banks about Basel III, RBI has been regularly briefing the Chief Executives of banks since RBI became member of BCBS in 2009. These meetings also provide an opportunity to RBI to assess the level of preparedness of banks to implement Basel III and clarify any issues which they may have in this regard. Other initiatives taken by RBI include organising various training programmes through its training establishments, seminars, meetings and participation in seminars organised by the Indian Banks' Association (IBA) and other self regulatory bodies.

The BCBS is monitoring the impact of Basel III proposals through the semi-annual Quantitative Impact Study (QIS) on banks. Ten Indian banks are participating in this QIS exercise. The outcome of the QIS will not only give an idea about the impact of the Basel III rules on Indian banks, but will also help in enhancing the understanding of banks about the subtle nuances of various aspects of Basel III proposals.

Meanwhile, RBI is examining the Basel III regulations and will issue guidelines to the extent applicable for banks operating in India in due course of time. RBI is also working on operationalisation of Countercyclical Capital Buffer under Basel III. RBI would adhere to internationally agreed phase-in period starting in January 1, 2013 for implementation of Basel III.

### *Housing loans by commercial banks – LTV ratio, risk weight and provisioning*

VI.27 In order to prevent excessive leveraging in housing loans portfolio, banks were advised in December 2010 that the Loan to Value (LTV) ratio in respect of housing loans should not exceed 80 per cent. However, for small value housing loans, *i.e.* housing loans up to ₹20 lakh, the LTV ratio should not exceed 90 per cent. The risk weight for residential housing loans of ₹75 lakh and above, irrespective of the LTV ratio, will be 125 per cent. The standard asset provisioning on the outstanding amount of housing loans at teaser rates was increased from 0.40 per cent to 2 per cent. The provisioning on these assets would revert to 0.40 per cent after one year from the date on which the rates are reset at higher rates if the accounts remain 'standard'.

### *Credit support to Micro Finance Institutions (MFIs)*

VI.28 Considering the fact that the problems afflicting the Micro Finance Institutions (MFIs) sector were not necessarily on account of any credit weakness *per-se* but were mainly due to exogenous factors, it was decided in January 2011 that the special regulatory asset classification benefit could be extended to restructured MFI accounts, which were standard at the time of restructuring, even if they are not fully secured. This relaxation was granted purely as a temporary measure and was applicable to standard MFI accounts restructured up to March 31, 2011. This time line was extended up to June 6, 2011 in the case of MFI loans restructured under the consortium approach adopted by banks and under the CDR mechanism. The objective was to provide some liquidity support to MFIs and facilitate a 'holding on' operation for some time till appropriate measures were taken to bring about long term and structural changes in the functioning of MFIs.

*Prudential norms on investment in Zero Coupon Bonds*

VI.29 It was observed that banks were investing in long term Zero Coupon Bonds (ZCBs) issued by corporates including those issued by NBFCs. Since the issuers of ZCBs are not required to pay any interest or instalments till the maturity of bonds, the credit risk in such investments would go unrecognised till the maturity of bonds and this risk could especially be significant in the case of long term ZCBs. Further, since such issuances and investments if done on a large scale could pose systemic problems, banks were advised in September 2010 that they should not invest in ZCBs unless the issuer builds up sinking fund for all accrued interest and keeps it invested in liquid investments/securities (Government bonds). Banks were also advised to put in place conservative limits for their investments in ZCBs. Similar guidelines were also issued for UCBs.

*Permanent diminution in the value of investments in banks' subsidiaries /joint ventures*

VI.30 In the absence of any specific instructions on the method of assessment/measurement of permanent diminution in the value of banks' investments in subsidiaries/ joint ventures which are included under 'Held to Maturity' (HTM) category, banks were not making any attempt to determine whether there is any permanent diminution in their strategic equity investments held under HTM or 'Available for Sale' (AFS) categories. In January 2011 banks were advised about the circumstances under which the need to determine impairment arises and in such an eventuality they would be required to obtain valuation of such investments by a reputed/qualified valuer and make provision for the impairment required, if any.

*Sale of Investments held under HTM category*

VI.31 Securities under HTM category are intended to be held till maturity by the banks and accordingly are not required to be marked to market. However, it was observed that many banks were resorting to sale of securities under HTM category, that too frequently to take advantage of favourable market conditions and to book profit. Therefore, banks were advised in August 2010 that if the value of sales and transfers of securities to/from HTM category exceeds 5 per cent of the book value of investments held in HTM category at the beginning of the year, they should disclose in the notes to accounts to the balance sheet the market value of the investments held in the HTM category and indicate the excess of book value over market value for which provision is not made. However, the one-time transfer of securities to/from HTM category with the approval of Board of Directors permitted to be undertaken by banks at the beginning of accounting year and sales to RBI under pre-announced OMO auctions, will be excluded from the 5 per cent cap mentioned above.

*Accounting Procedure for Investment*

VI.32 It was observed that banks were not following a uniform methodology in accounting their investment in government securities. They were following either 'trade date' accounting or 'settlement date' accounting. Therefore, to bring about uniformity, the banks were advised to follow only the 'Settlement Date' accounting. Similar guidelines were also issued for UCBs.

*Investment in Non-SLR Securities*

VI.33 Reserve Bank issued a circular in December 2010 permitting banks to invest in non-convertible debentures (NCDs) with original or initial maturity up to one year issued by corporates (including NBFCs), subject to extant prudential guidelines.

*Guidelines on banks' ALM-Interest Rate Risk*

VI.34 Detailed guidelines on banks' Asset Liability Management (ALM) Framework on Interest Rate Risk were issued by the Reserve Bank on November 4, 2010. In the guidelines, the banks were advised to adopt the Duration Gap Analysis (DGA) for interest rate risk management in addition to the Traditional Gap Analysis (TGA) previously mandated.

*Issue of Irrevocable Payment Commitments (IPCs)*

VI.35 Certain risk mitigating measures were prescribed by the Reserve Bank in September 2010 in the context of banks issuing IPCs to various stock exchanges on behalf of mutual funds and FIIs, as a transitory measure up to end-October 2011. Banks were advised therein to incorporate a clause in the agreement with their clients which gives them an inalienable right over the securities to be received as payout in any settlement, before November 1, 2010. In view of operational difficulties expressed by some banks, this deadline was subsequently extended up to end-December 2010.

*Revised Business Correspondents (BC) guidelines*

VI.36 Guidelines were issued in September 2010, permitting banks to engage companies registered under the Companies Act, 1956 (excluding NBFCs) with large and widespread retail outlets as BCs in addition to the individuals/entities permitted earlier.

*Credit card operations of banks*

VI.37 Inspite of instructions issued to banks from time to time on credit card operations, complaints are received from card holders both at Reserve Bank and at the offices of the Banking Ombudsmen. Banks were therefore, once again advised that if they fail to adhere to the prescribed guidelines, Reserve Bank would initiate suitable penal action, including levy of monetary penalties.

*Branch authorisation policy*

VI.38 In view of the need to step up opening of branches in rural areas so as to meet the objectives of financial inclusion and increased banking penetration, banks have been mandated to open at least 25 per cent of the total number of branches proposed to be opened during a year in unbanked rural (tier 5 and tier 6) centres.

*Fair practices code-disclosure*

VI.39 With a view to bringing in fairness and transparency, banks were advised to disclose to the borrowers all-in cost information inclusive of all charges involved in processing/sanction of loans in the loan application in a transparent manner. Banks were also advised to ensure that the charges/fees are non-discriminatory.

*Bank's participation in trading of Currency Options*

VI.40 Pursuant to the issue of guidelines on trading of currency options on recognised stock/new exchanges, AD category-1 commercial banks fulfilling required criteria were permitted to become trading and clearing members of the exchange traded currency options market of the recognised stock exchanges, on their own account and on behalf of their clients. All other SCBs are permitted to participate only as clients. NBFCs-ND-SI were also permitted to participate in the designated currency options exchanges recognised by SEBI as clients, only for the purpose of hedging their underlying forex exposures. UCBs licensed as AD category I were allowed to participate in the exchange traded currency option market of a designated exchange recongnised by SEBI, only as clients, subject to RBI guidelines. Such participation is allowed only for hedging underlying forex exposure arising from customer transactions.

*Reopening of pension option- prudential treatment*

VI.41 To mitigate the difficulties faced by public sector banks in absorbing the enhanced expenditure arising on account of enhancement of gratuity limits and reopening of pension option to their employees, special regulatory dispensation of amortisation was granted to such banks and was subsequently extended to ten old private sector banks, which came under the 9th bipartite settlement under the aegis of Indian Banks' Association (IBA). These banks were permitted to amortise the expenditure over a period of 5 years beginning with the financial year 2010-11 subject to a minimum of 1/5th of the total amount being amortised every year. Upon the introduction of International Financial Reporting Standards (IFRS) from April 2013 as scheduled, the opening balance of reserves of banks will be reduced to the extent of the unamortised carry forward expenditure. Further the unamortised expenditure shall not include any amount relating to retired employees. The unamortised expenditure would not be reduced from Tier I capital, as a special case in view of the exceptional nature of the event.

*The Banking Laws (Amendment) Bill, 2011*

VI.42 The Banking Laws (Amendment) Bill 2011 has been introduced in Lok Sabha in March 2011. The Bill seeks to amend certain provisions of the Banking Regulation Act, 1949 and the Banking Companies (Acquisition and Transfer of Undertakings) Act of 1970 and 1980. The proposed amendments to the BR Act envisages, *inter alia*, removal of restriction on voting rights, enabling banking companies to raise capital in accordance with the international best practices, formation of Depositors' Education and Awareness Fund, conferring powers on Reserve Bank to supersede the Board of Directors of a banking company in certain cases, to call for information from/ to inspect the associate enterprises of a banking company and to exempt mergers of banking companies from the applicability of the provisions of the Competition Act, 2002, thus making the regulatory powers of RBI more effective.

VI.43 The proposed amendments to the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 and 1980 envisages raising the authorised capital of the nationalised banks, enable them to raise capital through right issue/issue of bonus shares and raising the restriction on voting rights.

## Supervisory Initiatives

*Cross Border Supervision and Co-operation*

VI.44 The process of entering into bilateral MoUs with 16 identified jurisdictions/countries for cross border supervision has been initiated. Out of the 16 pre-identified overseas supervisors, MoUs with China Banking Regulatory Commission (CBRC) and Dubai Financial Services Authority (DFSA), the independent integrated financial services and market regulators of the Dubai International Financial Centre (DIFC), have been signed. Proposals in respect of 7 other overseas supervisors are at various stages of finalisation.

*Regulatory and Audit Compliance*

VI.45 In view of the concerns about the adequacy of regulatory compliance by foreign banks in India, it was advised that for all foreign banks operating in India, the Chief Executive Officer would be responsible for effective oversight of regulatory and statutory compliance as also the audit process and the compliance thereof in respect of all operations in India.

## Developments in Fraud Monitoring

VI.46 RBI as a part of its supervisory process alerts the banks about common fraud prone areas, *modus operandi* of frauds and the measures to be taken by them to prevent/reduce incidence of frauds in banks on an ongoing basis. During 2010-11, the Reserve Bank took several measures for strengthening the frauds monitoring mechanism in banks.

*Enhancement of governance of IT security measures*

VI.47 A Working Group on Information Security, Electronic Banking Technology, Risk Management and Cyber Frauds (Chairman: Shri G. Gopalakrishna), was formed by the Reserve Bank following the announcement in the Annual Monetary Policy Statement of 2010. Based on the recommendations of the group and the feedback received from stakeholders, detailed guidelines were issued to the banks on April 29, 2011. These guidelines are aimed at enhancing the governance of IT information security measures, cyber frauds, independent assurance about the effectiveness of the IT controls and related areas.

*Internal vigilance in banks*

VI.48 In an endeavour to align the vigilance function in private sector and foreign banks to that of the public sector banks, detailed guidelines for the former have been issued so that all issues arising out of lapses in the functioning of the private sector and foreign banks especially relating to corruption, malpractices, frauds *etc.* can be addressed uniformly by the banks for timely and appropriate action.

*Guidelines for prevention of frauds*

VI.49 A study was also made across banks to ascertain the policy and operating framework in place for detection, reporting and monitoring of frauds. The study revealed that while the banks do have control policies and processes, these are not well structured and systematic to ensure proper focus on typical fraud events. Besides, there was lack of consistency in treatment of transactions having characteristics of fraud as also in their reporting to the competent authority. The banks have been advised to suitably modify their policies and streamline the operating framework. In order to ensure close monitoring and tighter controls so as to thwart frauds especially in housing loan, export finance, loans against fixed deposit receipts *etc*., the banks have been asked to structure their operating framework on three tracks *viz*. (i) Detection and reporting of frauds (ii) Corrective action and(iii) Preventive and punitive action.

## URBAN CO-OPERATIVE BANKS

*Consolidation through mergers*

VI.50 The consolidation of the urban co-operative banking sector through the process of merger of weak banks with stronger ones while providing an avenue for non-disruptive exit to the weak entities has been set in motion since 2005-06. During last six years, the Reserve Bank has received 158 proposals for merger. The Reserve Bank issued no objection certificate (NOC) for 120 cases. Out of the 120 NOCs issued, 95 mergers had actually been effected upon the issue of statutory orders by the Central Registrar of Co-operative Societies (CRCS)/Registrar of Co-operative Societies (RCS) of the State concerned. Out of the 95 mergers, 59 UCBs had negative net worth. Profit making UCBs were also permitted to merge with other financially strong UCBs with the aim of consolidation and strengthening the sector.

*Transfer of assets and liabilities of UCBs to Commercial Banks*

VI.51 Certain financially weak UCBs with relatively bigger size balance-sheets (*i.e*. Tier II UCBs) could not opt for mergers as there were no willing UCBs to take over such UCBs with higher accumulated losses. To overcome this problem, specific guidelines about transfer of certain assets and liabilities with mutual consent of both the UCB and the interested SCBs were issued for the first time in February 2010. So far there have been two such cases of transfer of assets and liabilities of UCBs to SCBs. Specific assets and liabilities of Shree Suvarna Sahakari Bank Ltd., Pune were taken over by the Indian Overseas Bank and similarly the assets and liabilities of the Memon Co-operative Bank Ltd., Mumbai were taken over by the Bank of Baroda.

*Unlicensed UCBs and licensing of new UCBs*

VI.52 Based on the guidelines issued by the BFS in August 2009, a review of unlicensed UCBs was made and 51 UCBs have been granted banking licenses. As on March 31, 2011, there are four unlicensed banks and review in respect of these UCBs is in progress. Further, the Reserve Bank has constituted an expert committee for studying the advisability of granting new urban cooperative banking licenses (Box VI.5).

*Maximum limits on unsecured loans and advances*

VI.53 The maximum limits for grant of unsecured loans by the UCBs (with or without surety or for cheque purchase) for individual and group borrowers were enhanced suitably keeping in view the twin criteria of capital adequacy (CRAR) and size of demand and time liabilities (DTL) of the UCBs. The enhanced limits ranged between ₹0.25 lakh (for UCB with DTL up to ₹10 crore and CRAR below nine per cent) and ₹5.00 lakh (for UCB with DTL above ₹100 crore and CRAR above nine per cent). The total unsecured loans and advances granted by an UCB are limited to 10 per cent of its total assets as per audited balance sheet as on 31 March of the preceding financial year.

### Box VI.5
### Expert Committee on Licensing of New Urban Cooperative Banks

In the light of the past experience regarding newly licensed UCBs becoming financially unsound in short span of time and the prevailing precarious financial health of the UCB sector, the Reserve Bank issued a comprehensive policy in 2005 on UCBs with a view to improving the financial health of this sector. It was also decided not to issue any fresh licences thereafter for new UCBs. The Reserve Bank entered into memoranda of understanding (MoU) with all State Governments and the Central Government for coordination of regulatory policies and encouraged voluntary consolidation in the sector by merger of non-viable UCBs with financially sound and well managed UCBs. Pursuant to these policies, the share of financially sound banks has increased from 61.3 per cent in 2005 to 80.3 per cent in 2010. As the financial position of the sector improved considerably, UCBs were permitted to enter into new areas of business.

Against this backdrop a Committee (Chairman: Shri Y. H. Malegam), has been set up for studying the advisability of granting new urban co-operative banking licences. Further, as announced in the Second Quarter Review of Monetary Policy 2010-11, the Committee was advised to look into the feasibility of an umbrella organisation for the UCB sector.

The terms of references of the Committee are as under:

i) To review the role and performance of UCBs over the last decade and especially since the adoption of Vision document in 2005,

ii) To review the need for organisation of new UCBs in the context of the existing legal framework for UCBs, the thrust on financial inclusion in the economic policy and proposed entry of new commercial banks into the banking space,

iii) To review the extant regulatory policy on setting up of new UCBs and lay down entry point norms for new UCBs,

iv) To examine whether licensing could be restricted only to financially sound and well managed cooperative credit societies through conversion route,

v) To make recommendations relating to the legal and regulatory structure to facilitate the growth of sound UCBs especially in the matter of raising capital consistent with co-operative principles.

vi) To examine the feasibility of an umbrella organisation for the UCB Sector.

vii) To examine other issues incidental to licensing of UCBs and make appropriate recommendations.

*Share linking to borrowing norm in UCBs*

VI.54 UCBs which maintain a minimum capital to risk-weighted assets ratio (CRAR) of 12 per cent on a continuous basis were exempted from the mandatory share linking norms.

*Credit exposure to housing and commercial real estate sectors*

VI.55 The permitted credit exposure of UCBs to housing, real estate and commercial real estate sectors was revised from the earlier limit of 15 per cent of deposits to 10 per cent of their total assets. This limit of 10 per cent could be exceeded by an additional limit of five per cent of total assets in housing loans to individual up to ₹15 lakh.

*Extension of area of operation of UCBs*

VI.56 All financially sound and well managed UCBs having minimum assessed net worth of ₹50 crore, subject to meeting other norms, were permitted to extend their area of operation beyond the State of original registration as also to any other States of their choice. Further if such UCBs have acquired weak banks in other States, they would be allowed to extend their area of operation to the entire State of registration of the target bank.

*Liberalised norms for opening of branches by UCBs*

VI.57 All financially sound and well managed UCBs having required headroom capital in terms of assessed net worth per branch including existing branches and satisfying other criteria were allowed to open branches/extension counters beyond the annual ceiling of 10 per cent of existing branch network.

*Use of business correspondents/ business facilitators by UCBs*

VI.58 With the objective of ensuring greater financial inclusion and increasing the outreach of the UCBs in providing basic and affordable banking services in their area of operation, it was decided to consider requests from well managed and financially sound UCBs to engage business facilitator/business correspondent using ICT solutions.

*Collection of account payee cheques*

VI.59 With a view to mitigating the difficulties faced by the members of co-operative credit societies in collection of account payee cheques, UCBs were permitted to collect account payee cheques drawn for an amount not exceeding ₹50,000 to the account of their customers who are co-operative credit societies, if the payees of such cheques are the constituents of such co-operative credit societies.

### RURAL CO-OPERATIVES

*Package for revival of Rural Co-operatives*

VI.60 Based on the recommendations of the Task Force on Revival of Rural Co-operative Credit Institutions (Chairman: Prof. A. Vaidyanathan) and in consultation with state governments, the central government had approved a package for revival of rural co-operatives at the apex level. An aggregate amount of ₹8,993 crore has been released by NABARD up to June 30, 2011 towards Government of India's share for recapitalisation of PACS in sixteen States while the State Governments have also released ₹854 crore as their share.

*Licensing of Rural Co-operative Banks*

VI.61 The Annual Policy Statement of April 2009 had announced a roadmap for licensing of unlicensed state and central co-operative banks in a non-disruptive manner and revised guidelines were issued for the same in October 2009. Subsequent to the issuance of revised guidelines, 10 StCBs and 160 DCCBs have been licensed taking the total number of licensed StCBs and DCCBs to 24 and 235 respectively as at end-June, 2011. Efforts are being made to ensure that the remaining unlicensed banks meet the criteria for licensing by the stipulated date.

*Raising RRB branches to CBS platform*

VI.62 The Working Group of Technology Upgradation in Regional Rural Banks (RRBs) (Chairman: Shri G. Srinivasan) had recommended that CBS should be fully implemented in all RRBs by September 2011. As on date, out of total 82 RRBs, CBS has been fully implemented in 45 RRBs while in remaining 37 it is in progress.

### DEPOSIT INSURANCE AND CREDIT GUARANTEE CORPORATION

VI.63 Deposit insurance constitutes an important element in preventing any runs on the banks due to unforeseen events. Deposit Insurance and Credit Guarantee Corporation (DICGC) is a wholly owned subsidiary of Reserve Bank of India. Deposit insurance extended by DICGC covers all commercial banks, including Local Area Banks (LABs) and Regional Rural Banks (RRBs) in all the States and Union Territories (UTs). All Co-operative Banks across the country except three UTs of Lakshadweep, Chandigarh, and Dadra and Nagar Haveli are also covered by deposit insurance. The number of registered insured banks as on March 31, 2011 stood at 2,217 comprising 82 Commercial Banks, 82 RRBs, 4 LABs and 2,049 Co-operative Banks. With the present limit of deposit insurance in India at ₹1 lakh, the number of fully protected accounts (977 million) as on March 31, 2011 constituted 93 per cent of the total number of accounts (1,052 million) as against the international benchmark[1] of 80 per cent. Amount-wise, insured deposits at ₹17,35,800 crore constituted 35 per cent of assessable deposits at ₹49,52,427 crore against the international benchmark[1] of 20 to 40 per cent. At the current level, the insurance cover works out to 1.63 times per capita GDP as on March 31, 2011 as against the international benchmark of around 1 to 2 times per capita GDP prior to the financial crisis.

VI.64 The Corporation builds up its Deposit Insurance Fund (DIF) through transfer of its surplus, *i.e.*, excess of income (mainly comprising premia received from insured banks, interest income from investments and cash recovery out of assets of failed banks) over expenditure each year, net of taxes. This

[1] : Accepted as a Rule of Thumb at the First Annual Conference of the International Association of Deposit Insurers (IADI) in Basel, Switzerland in May 2002

fund is used for settlement of claims of depositors of banks taken into liquidation/reconstruction/ amalgamation, *etc*. During the year 2010-11, the Corporation settled aggregate claims for ₹379 crore in respect of a commercial bank (supplementary claim) and 73 Co-operative Banks (28 original claims and 45 supplementary claims) as compared with claims for around ₹655 crore during the previous year. The size of the DIF stood at ₹24,704 crore as on March 31, 2011, yielding a Reserve Ratio (DIF/insured deposits) of 1.4 per cent.

VI.65 An assessment team comprising representatives of IADI and IMF visited DICGC in end-September 2010 to undertake a field test of the Draft Assessment Methodology for Core Principles for Effective Deposit Insurance Systems. According to the assessment of the team, DICGC is compliant or largely compliant with about half of the 18 core principles for 'effective deposit insurance systems'. In its "paybox" function, the DICGC is fully or largely compliant on all core principles. However, weaknesses in the overall insolvency framework which are outside the control of the DICGC makes overall compliance with many core principles limited. The report made several recommendations such as removing insolvent co-operative banks from the system, obtaining deposit-specific information from banks in a standard format, executing MoUs by DICGC with other deposit insurers whose banks have a presence in India, granting DICGC an access to a "fast-track" source of funding from either RBI or Ministry of Finance (MoF) to provide funds needed for prompt depositor reimbursement, developing a formal public awareness programme and establishing a reasonable target reserve fund by DICGC. The Working Group on Reforms in Deposit Insurance, including Amendments to DICGC Act, would be looking into the recommendations of the field test team.

## BANKING CODES AND STANDARDS BOARD OF INDIA

VI.66 The membership of BCSBI has grown from 67 banks in 2006 to 112 banks in 2011 and the membership of 14 more banks is under process. During the year, BCSBI undertook a Survey of 1,000 branches and 135 hubs of 49 member banks (excluding RRBs and Urban Co-operative Banks), spread over 22 cities in India, to independently verify compliance with the provisions of the Code of Bank's Commitment to Customers and Code of Bank's Commitment to Micro and Small Enterprises. More than 2,000 customers were also interviewed at the branches to obtain their responses. In general, the Survey findings reveal perceptible improvement in customer service.

## NON-BANKING FINANCIAL COMPANIES

VI.67 As announced in the Annual Policy 2010-11, the regulatory framework for Core Investment Companies (CICs) was announced (Box VI.6).

*Provision of 0.25 per cent for standard assets of NBFCs*

VI.68 In the interest of counter cyclicality and also to ensure that NBFCs create a financial buffer as a protection from the effect of economic downturns, provisioning for standard assets was introduced to NBFCs at 0.25 per cent of the outstanding standard assets.

*Participation in currency futures*

VI.69 NBFCs (excluding residuary non-banking companies (RNBCs)) were allowed to participate in the designated currency futures exchanges recognised by SEBI as clients only for the purpose of hedging their underlying forex exposures. NBFCs were advised to make appropriate disclosures regarding transactions undertaken in the balance sheet.

*Exemption for Long Term Infrastructure Finance Bonds*

VI.70 Amount raised by issue of infrastructure bonds by Infrastructure Finance Companies, shall not be treated as 'public deposit' under the 'Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998.

## Box VI.6
## Regulatory Framework for Core Investment Companies (CICs)

Core Investment Company (CIC) is a non-banking financial company carrying on the business of acquisition of shares and securities and which (a) holds not less than 90 per cent of its net assets in the form of investment in equity shares, preference shares, bonds, debentures, debt or loans in group companies and (b) its investments in the equity shares in group companies constitutes not less than 60 per cent of its net assets as on the date of the last audited balance sheet.

CICs were not required to obtain Certificate of Registration (CoR) from Reserve Bank under Section 45 IA of the RBI Act 1934. In practice however, it proved very difficult to determine whether a company has invested in the shares of another company for the purpose of holding stake or for the purpose of trade. It was therefore decided that investing in shares of other companies, even for the purpose of holding stake should also be regarded as carrying on the business of acquisition of shares. Furthermore, in view of the peculiar business model of CICs, *viz.*, holding stake in group companies and funding group concerns, CICs find it difficult to comply with the extant net owned fund (NOF) requirements and exposure norms for NBFCs prescribed by the Reserve Bank. Considering these issues, a revised regulatory framework for CICs was announced in August 2010. The salient features of the framework are as follows:

i) Core Investment Companies (CIC) with an asset size of less than ₹100 crore will be exempted from the requirements of registration with RBI. For this purpose all CICs belonging to a Group will be aggregated.

ii) CICs with asset size above Rs. 100 crore but not accessing public funds are also exempted from the requirement of registration with RBI.

iii) Due to systemic implications on account of access to public funds (such as funds raised through Commercial Paper, debentures, inter-corporate deposits and borrowings from banks/FIs), CICs having asset size of 100 crore or above are categorised as Systemically Important Core Investment Companies (CICs-ND-SI) and are required to obtain CoR from the Reserve Bank.

iv) Every CIC-ND-SI shall ensure that at all times it maintains a ‘minimum capital ratio’ whereby its adjusted net worth shall not be less than 30 per cent of its aggregate risk weighted assets and risk adjusted value of off-balance sheet items.

v) Every CIC-ND-SI shall ensure that its outside liabilities at all times shall not exceed 2.5 times its adjusted net worth.

vi) A CIC-ND-SI which adheres to the requirements regarding capital and leverage ratio as specified at (iii) and (iv) above, may to the extent necessary, be exempted from compliance with maintenance of statutory minimum NOF and requirements of “Non-Banking Financial (Non-Deposit accepting or holding) Companies Prudential Norms (Reserve Bank) Directions, 2007” including requirements of capital adequacy and exposure norms.

In view of the changed regulatory framework, all CICs-ND-SI, irrespective of whether they were specifically exempted in the past from registration with the Reserve Bank or not, were directed to apply for obtaining the CoR. In order to operationalise the changed policy environment in a non-disruptive manner, companies which apply for CoR within the stipulated time were directed to carry on the existing business till the disposal of their application by the Reserve Bank. However, companies which fail to apply for the CoR within the stipulated period will be regarded as contravening the provisions of Section 45IA of the Reserve Bank of India Act, 1934. Companies which presently have an asset size of less than ₹100 crore would be required to apply to RBI for CoR within three months of the date of achieving a balance sheet size of ₹100 crore.

### *Amendment to Definition of Infrastructure Loan*

VI.71 NBFCs were advised to include telecom towers also as an infrastructure facility for availing credit facility. Further NBFCs were advised that only Credit Rating Agencies (CRAs) approved by the Reserve Bank can give the rating to Infrastructure Finance Companies (IFCs).

### *NBFCs not to be Partners in Partnership firms*

VI.72 In view of the risks involved in NBFCs associating themselves with partnership firms, it was decided to prohibit NBFCs from contributing capital to any partnership firm or to be partners in partnership firms. In cases of existing partnerships, NBFCs were advised that they may seek early retirement from the partnership firms.

### *Loan facilities to the physically / visually challenged*

VI.73 NBFCs were advised that there should be no discrimination in extending financial products and facilities including loan facilities to the physically/ visually challenged applicants on grounds of disability and all possible assistance may be provided to such customers.

*Applicability of exemption from concentration norms*

VI.74 Under the extant instructions, any NBFC-ND-SI not accessing public funds, either directly or indirectly, may make an application to the Reserve Bank for modifications in the prescribed ceilings with regard to concentration of credit/investment norms. NBFCs-ND-SI may also be issuing guarantees and devolvement of these guarantees might require access to public funds. Accordingly, any NBFC-ND-SI not accessing public funds, either directly or indirectly, or not issuing guarantees may approach Reserve Bank of India for appropriate dispensation.

*Enhancing CRAR to fifteen per cent*

VI.75 It was decided to align the minimum capital ratio of all deposit taking NBFCs as well as NBFCs-ND-SI to 15 per cent. Accordingly, all deposit taking NBFCs were advised to raise the minimum capital ratio consisting of Tier I and Tier II capital, which shall not be less than 15 per cent of its aggregate risk weighted assets on balance sheet and risk adjusted value of off-balance sheet item with effect from March 31, 2012.

*Review of guidelines on entry of NBFCs into insurance business*

VI.76 As per extant instructions, NBFCs registered with the Reserve Bank and satisfying the eligibility criteria will be permitted to set up a joint venture (JV) company for undertaking insurance business with risk participation. The maximum equity contribution an NBFC can hold in a JV company is 50 per cent of its paid-up capital. In case more than one company (irrespective of doing financial activity or not) in the same group of NBFC wishes to take a stake in the insurance company, the contribution by all companies in the same group shall be counted for the limit of 50 per cent prescribed for the NBFCs in an insurance JV.

*Opening of branch/subsidiary/ joint venture/ representative office or undertaking investment abroad by NBFCs.*

VI.77 Presently, an Indian party requires prior approval of the concerned regulatory authorities both in India and abroad, to make an investment in an entity outside India engaged in financial services activities. No-objection certificate will be issued by Reserve Bank to the NBFC before opening of subsidiary/joint venture/representative office or undertaking investment abroad subject to the NBFC fulfilling the conditions specified by Reserve Bank on June 14, 2011.