

# VI

## FINANCIAL REGULATION AND SUPERVISION

VI.1 The Reserve Bank continued to build a regulatory and supervisory architecture in line with the international best standards, adapted to suit the domestic conditions. The objective has been to make the Indian banking sector more competitive, efficient, sound and dynamic. Foreign banks and domestic banks with overseas presence successfully migrated to Basel II on March 31, 2008. The focus of the Reserve Bank's policy initiatives during the year was on strengthening corporate governance practices in banks and improving customer service. Events unfolding in the global financial markets were carefully monitored with a view to drawing appropriate lessons. The Reserve Bank continued to strengthen the urban co-operative banks treading on the path laid down in the Vision Document. The efforts to strengthen the non-banking financial companies (NBFCs) continued with a focus on systemically important financial institutions within the sector.

VI.2 This Chapter details the various regulatory and supervisory measures initiated by the Reserve Bank relating to banks and other financial institutions during 2007-08. The year witnessed major progress in implementation of the New Capital Adequacy Framework (Basel II). The Pillar II guidelines were issued during the year. Certain amendments were also carried out in the framework issued earlier. Newer avenues of raising capital were provided to banks to accord them with greater flexibility in meeting the Basel II requirement. Special emphasis was laid upon liquidity and asset liability management. Important initiatives in the area of corporate governance included guidelines on corporate social responsibility, sustainable development and non-financial reporting and guidelines on 'fit and proper' criteria for elected directors on the boards of public sector banks. Significant measures were also undertaken in the areas of anti-money laundering (AML) and know your customer (KYC) guidelines. Policy initiatives relating to customer service included guidelines for recovery agents and grievance redressal mechanism.

VI.3 The regulatory measures relating to urban co-operative banks (UCBs) were aimed at

consolidating the gains of the memoranda of understanding (MoUs) and Task Force for Urban Co-operative Banks (TAFUCB) arrangement. UCBs were provided with greater business opportunities and capital raising options. Of the financial institutions supervised by the Reserve Bank, IFCI and TFCL were given the NBFC status during the year. IIBI is in the process of being wound up. Important developments relating to NBFCs included formulation of regulatory framework for mortgage guarantee companies and various measures in the area of prudential guidelines and customer service.

### REGULATORY FRAMEWORK FOR THE INDIAN FINANCIAL SYSTEM

VI.4 The regulatory purview of the Reserve Bank extends to a large segment of financial institutions, including commercial banks, co-operative banks, non-banking financial institutions and various financial markets. At end-March 2008, there were 79 commercial banks [excluding regional rural banks (RRBs)], 91 RRBs, 1,770 urban co-operative banks (UCBs), 4 development finance institutions (DFIs), 12,834 non-banking financial companies (NBFCs) (of which 376 NBFCs are permitted to accept/hold public deposits) and 19 primary dealers (PDs) (of which 10 are banks undertaking PD business as a departmental activity and nine are non-bank entities, also referred to as stand-alone PDs). The Board for Financial Supervision (BFS) continued to exercise its supervisory role over those segments of the financial institutions that are under the purview of the Reserve Bank.

### Board for Financial Supervision

VI.5 The Board for Financial Supervision (BFS), which was constituted on November 16, 1994 by the Central Board of Directors of the Reserve Bank under the Reserve Bank (BFS) Regulations, 1994, continued to exercise its oversight over commercial banks, financial institutions, urban co-operative banks (UCBs), regional rural banks (RRBs), non-banking financial companies (NBFCs) and primary dealers (PDs). The BFS in its 11 meetings held during the period January 2007 to December 2007

and five meetings in 2008 (till June 4, 2008) considered various memoranda on the performance of various segments of the financial sector. The BFS remained the chief guiding force behind the effective handling of supervisory and regulatory issues by the Reserve Bank. The BFS reviewed the inspection findings in respect of commercial banks/urban cooperative banks, periodical reports on critical areas of functioning of banks such as reconciliation of accounts, frauds monitoring, overseas operations, financial position of banks under monthly monitoring and issued a number of directions with a view to strengthening the functioning of banks. Some of the important issues deliberated by the BFS are set out in this section.

VI.6 During 2007-08, 98 annual financial inspection (AFI) reports in respect of 28 public sector banks, 26 private sector banks, 34 foreign banks, four local area banks and six all-India financial institutions (AIFIs) were brought before BFS for review. BFS reviewed the inspection reports of 12 scheduled UCBs classified in Grades III and IV besides reviewing the financial highlights of 41 scheduled UCBs classified in Grades I and II. Considering the common and recurring concerns observed in the functioning of banks, the Board felt that the issues brought out had a bearing on the level of corporate governance in banks. Accordingly, separate formats for public sector and private sector banks have been devised. These formats touch upon all the governance issues (including the 'fit and proper' criteria) as covered under the Banking Regulations Act 1949, Clause 49 of the Listing Agreement of the stock exchanges, guidelines issued from time to time and those raised by the Consultative Group to look into the Role of Bank/FI Boards (Chairman: Dr. A.S. Ganguly). The objective behind the design of these formats is to assess the banks' performance on corporate governance in a systematic and comprehensive manner and to make an attempt to classify the banks into different categories based on their performance. A copy each of the formats was forwarded to the Indian Banks Association (IBA) also for their comments and suggestions.

VI.7 The BFS reviewed the extant regulatory guidelines and supervisory processes and issued

directions with a view to ensuring their robustness and effectiveness in an extremely dynamic and fast evolving banking environment. Some of the measures undertaken during the year under the aegis of the BFS included; (i) guidelines on engagement of recovery agents in view of the rise in the number of litigations against banks in the recent past relating to recovery agents and the serious reputation risk for the bank and the banking sector as a whole; (ii) guidelines on assessment of financial impact of letters of comfort (LOCs) issued by banks by ascertaining the exact liability/obligations embedded in LOCs and adequate disclosure; (iii) norms relating to consolidation that mandated recording of 'intent' by the Board of respective bank at the time of acquisition regarding holding of the investment for a temporary period or otherwise. An approach paper on the regulatory and supervisory process in respect of 'Financial Conglomerates' was also under preparation as per the directions of BFS. Other important issues considered by the BFS included future set up of local area banks, disclosure of supervisory ratings of banks and banks' exposure to the real estate sector.

VI.8 During the year, the BFS reviewed the roles and set up of the financial institutions with a view to providing clarity on their regulatory and supervisory architecture and their emerging role in the financial sector. The role of Small Industries Development Bank of India (SIDBI) *vis-à-vis* its exposure to the State Financial Corporations (SFCs) continued to engage the attention of the BFS and was discussed at length. On the directions of the BFS, SIDBI was advised to increase the risk weights on its exposure to SFCs, make full provisioning in respect of SFCs which had defaulted even after extension of restructuring/one-time settlement (OTS) packages and revise the norms for asset classification to 'borrower wise' instead of 'facility wise' in respect of its exposures to SFCs. With regard to the transfer of the holdings of the erstwhile IDBI in SFCs to SIDBI and valuation thereof, the BFS directed that a view on the valuation of the holdings by IDBI Ltd. at fair value (instead of the face value) needs to be taken before finalisation of the accounts of IDBI Ltd. as on March 31, 2007. The Government issued a notification dated January

17, 2008 notifying January 31, 2008 as the appointed date for the transfer of all the shares of every SFC subscribed to by IDBI and amount outstanding in respect of loans in lieu of capital provided by IDBI as on date immediately preceding the notified date to SIDBI.

VI.9 The Board also initiated several measures relating to the co-operative banking and non-banking sector. Pursuant to the directions of the BFS, an inter-departmental group was constituted in the Reserve Bank to examine the issue of applicability of Basel norms to the Reserve Bank regulated entities other than the commercial banks, *i.e.*, urban co-operative banks, state co-operative banks, district central co-operative banks and Regional Rural Banks. Other measures for UCBs included: (i) policy framework for UCBs defaulting in maintaining prescribed CRR/SLR; (ii) measures for UCBs under directions; (iii) supervisory action framework on the basis of TAFcUB's recommendations; and (iv) laying down principles for considering proposals for restructuring UCBs. Besides undertaking an evaluation of systemic risks arising out of the NBFCs sector, the BFS also deliberated upon the areas of (i) protecting consumers against opportunistic behaviour by suppliers of financial services by putting in place a fair practice code; (ii) re-classification of NBFCs to create a new class of NBFC, *viz.*, asset finance company (AFC); (iii) future set up of SIDBI; and (iv) future framework of NHB.

VI.10 On the directions of the BFS, a number of studies of important areas of functioning of banks having implication for financial soundness were carried out by the Reserve Bank. The studies related to NPA management, vulnerability assessment, exposure to group and large borrowal accounts, interest rate risk, investment portfolio and exposure to the real estate sector.

## REGULATORY INITIATIVES

### Commercial Banks

VI.11 Policy measures initiated by the Reserve Bank during 2007-08 were aimed at enhancing the prudential standards of the banking system in order to make it more resilient and align these with the international best practices while ensuring customer protection.

### Prudential norms

VI.12 In January 2008, on a review of the risk weight for the educational loans, it was decided that the 'educational loans' need not be classified as part of consumer credit for the purpose of capital adequacy. Accordingly, the risk weight applicable to educational loans was stipulated at 100 per cent in respect of banks under Basel I framework; under Basel II framework, such loans are treated as a component of the 'regulatory retail' portfolio and attract a risk weight of 75 per cent.

VI.13 In May 2008, the limit of bank loans for housing was enhanced to Rs.30 lakh from Rs.20 lakh for the purpose of applying concessional risk weights for capital adequacy purposes under both Basel I and Basel II framework. Accordingly, where the loan-to-value (LTV) ratio was equal to or less than 75 per cent, the loans up to Rs.30 lakh would carry a risk weight of 50 per cent, whereas loans of higher amount would attract a risk weight of 75 per cent. The risk weight in the case of other loans, *i.e.*, loans with LTV ratio of above 75 per cent, irrespective of the size, continue to attract 100 per cent risk weight.

VI.14 With a view to encouraging the flow of credit to the infrastructure sector, banks were advised in December 2007 that they may invest in unrated bonds of companies engaged in infrastructure activities within the ceiling of 10 per cent for unlisted non-SLR securities. In May 2008, the Reserve Bank modified the prudential norms on asset classification pertaining to infrastructure projects with regard to delays in completion of infrastructure projects for legal and other extraneous reasons. Accordingly, it was decided that in the case of infrastructure projects financed by the bank after May 28, 2002, the date of completion of the project should be clearly spelt out at the time of financial closure of the project and if the date of commencement of commercial production extends beyond a period of two years after the date of completion of the project, as originally envisaged, the account should be treated as sub-standard.

VI.15 The norms relating to issuance of letter of comforts (LoCs) on behalf of a bank's subsidiary and in favour of overseas regulators were tightened in

March 2008 in view of the possible liabilities/ obligations that may have to be met by the issuing banks in future. In this context, following prudential norms were laid down: (i) the bank should lay down a well-defined policy for issuance of LoCs and every issuance of LoC should be subject to the prior approval by the Board of Directors of the bank; (ii) the bank should make an assessment, at least once a year, of the likely financial impact that might arise from the LoCs issued by it and outstanding, in case it is called upon to support its subsidiary in India or abroad, as per the obligations assumed under the LoCs issued; (iii) any LoC that is assessed to be a contingent liability of the bank by a rating agency/internal or external auditors/internal inspectors or the Reserve Bank inspection team, is treated, for all prudential regulatory purposes, on the same footing as a financial guarantee issued by the bank; and (iv) the banks should disclose full particulars of all the LoCs issued by them during the year, including their assessed financial impact, as also their assessed cumulative financial obligations under the LoCs issued by them in the past and outstanding, in its published financial statements, as part of the 'notes to accounts'.

VI.16 The annual financial inspection (AFI) reports and consolidated prudential return (CPR) revealed that some of the banks had extended large loans to various mutual funds (MFs) and also issued irrevocable payment commitments (IPCs) to stock exchanges (BSE & NSE) on behalf of MFs/foreign institutional investors (FIIs). However, the banks had not included these exposures for computation of their capital market exposure (CME). Accordingly, in December 2007, banks were advised to be judicious in extending finance to mutual funds and grant loans and advances to MFs only to meet their temporary liquidity needs for the purpose of repurchase/ redemption of units within the ceiling of 20 per cent of the net asset of the scheme and for a period not exceeding six months. Such finance, if extended to equity-oriented MFs is to form part of banks' capital market exposure. It was also clarified that since IPCs are in the nature of non-fund based credit facility for purchase of shares, such exposure of banks will form part of their CME. Furthermore, entities such as FIIs

are not permitted to avail of fund or non-fund based facilities like the IPCs from banks. A transition period of nine months upto September 13, 2008 has been allowed to enable banks to comply with the above requirements.

VI.17 In view of instances of some of the banks selling NPAs for much less than the value of available securities without any justification, the Reserve Bank, in October 2007, modified the existing guidelines on purchase/sale of NPAs among banks. Accordingly, while selling NPAs banks are required to work out the net value of the estimated cash flow associated with the realisable value of the available securities, net of the cost of realisation. The sale price should generally not be lower than the net present value arrived at in the manner described above. The same principle should be used in compromise settlements. As the payment of the compromise amount may be in installments, the net present value of the settlement amount should be calculated and this amount should generally not be less than the net present value of securities.

#### *Basel II Implementations*

VI.18 During 2007-08, significant progress was made towards implementation of the 'New Capital Adequacy Framework (Basel II) framework evolved by the Basel Committee on Banking Supervision (BCBS). Foreign banks operating in India and Indian banks having operational presence outside India migrated to the revised framework from March 31, 2008. The major regulatory developments during the year included amendment to NCAF guidelines (Box VI.1), guidelines on supervisory review process (Pillar 2) and issuance of preference shares as part of regulatory capital.

#### *Pillar II Guidelines*

VI.19 The Basel II Framework has three Pillars. The Pillar 1 is the minimum capital requirements while the Pillar 2 and Pillar 3 relate to the supervisory review process (SRP) and market discipline, respectively. The Pillar 2 of the framework makes the Basel II much more comprehensive in its coverage of the universe of various risks to which the banks are exposed *vis-à-vis* the Basel I Framework of 1988, which addressed only the credit

**Box VI.1**

**Amendments to the New Capital Adequacy Framework**

A review of the April 2007 guidelines on 'Implementation of the New Capital Adequacy Framework' was undertaken in March 2008, and certain clarifications/amendments were issued. The amendments, *inter alia*, included the following:

- (i) Investment in State Government securities, other direct loan/credit/overdraft exposures, if any, by banks to the State Governments would attract zero risk weight.
- (ii) The counterparty exposure in respect of the personal loans secured by gold and gold jewellery could be worked out under the comprehensive approach treating the gold as the risk mitigant.
- (iii) In respect of application of haircut on the exposure, it was clarified that since the purpose was to capture market volatility inherent in the value of exposures, and the exposures acquired by way of loan disbursement/ investment would be a 'cash transaction', the haircut need not be applied on the same. The banks were, however, advised that they need to make upward adjustment in respect of exposures arising out of repo-style transactions, as the value of the securities sold/ lent/pledged in the repo transactions would be subject to market volatility and attract the haircut.
- (iv) Banks could recognise the collaterals by way of deposits held with them, even if the tenor of such deposits was less than three months or there was a maturity mismatch of deposits *vis-à-vis* the exposures, provided explicit consent of the depositor was obtained for adjusting the maturity proceeds of such deposits against the outstanding loan or for renewal of such deposits till the full repayment of the underlying loan.
- (v) Banks were advised to calculate the capital charge for equities based on their current market value in bank's trading book.
- (vi) In respect of exposures against non-scheduled banks, risk weights ranging from 100 per cent to 625 per cent, linked to their level of CRAR were prescribed. In case of banks where no capital adequacy norms were prescribed by the Reserve Bank, the banks were advised to calculate the CRAR notionally, by obtaining the necessary information from the investee banks, using the capital adequacy norms as applicable to the commercial banks.
- (vii) In view of the excessive volatility in the stock market across the world, the equities were removed from the list of eligible financial collaterals.
- (viii) Standard supervisory haircut for exposures and collaterals, which are obligations of foreign central sovereigns/corporates were provided.
- (ix) Banks were also advised of the capital adequacy framework applicable for repo/reverse-repo style transaction.
- (x) Detailed guidelines were incorporated for measuring the capital charge for interest rate risk (specific risk) in debt securities and other interest rate related instruments in the available for sale (AFS) and held for trading (HFT) categories.

risk and market risk. While the guidelines on Pillar 1 and Pillar 3 were issued by the Reserve Bank in April 2007, the guidelines regarding the Pillar 2, comprising the SRP and internal capital adequacy assessment process (ICAAP), were issued in March 2008 (Box VI.2).

VI.20 While the basic elements of Basel II framework have been put in place, the banks and the supervisors need to build in capabilities for adoption of advanced approaches under Basel II (Box VI.3).

VI.21 With a view to providing a wider choice of instruments to Indian banks for raising Tier I and Upper Tier II capital, banks were allowed in October 2007 to issue preference shares in Indian Rupees, subject to extant legal provisions through issuance of perpetual non-cumulative preference shares (PNCPS) as Tier I capital. Furthermore, the perpetual

cumulative preference shares (PCPS), redeemable non-cumulative preference shares (RNCPS) and redeemable cumulative preference shares (RCPS) were allowed as Upper Tier II capital. The perpetual non-cumulative preference shares are treated on par with equity, and hence, the coupon payable on these instruments is treated as dividend. The Upper Tier II preference shares are treated as liabilities and the coupon payable thereon is treated as interest. The total amount raised by the bank by issue of PNCPS is not reckoned as liability for calculation of net demand and time liabilities for the purpose of reserve requirements and, as such, does not attract CRR/SLR requirements. The total amount raised by a bank through the issue of Upper Tier II instruments is reckoned as liability for the calculation of net demand and time liabilities for the purpose of reserve requirements and, as such, attracts CRR/SLR requirements.

**Box VI.2****Guidelines on Internal Capital Adequacy Assessment Process (ICAAP) and Supervisory Review Process (SRP)**

The objective of the SRP is to ensure that the banks have adequate capital to support all the risks in their business as also to encourage them to develop and use better risk management techniques for monitoring and managing their risks. This, in turn, requires a well-defined internal assessment process within the banks through which they assure the Reserve Bank that adequate capital is indeed held towards the various risks to which they are exposed. The process of assurance could also involve an active dialogue between the bank and the Reserve Bank so that, when warranted, appropriate intervention could be made to either reduce the risk exposure of the bank or augment/restore its capital.

In terms of the guidelines on Basel II, the banks are required to have a board-approved policy on internal capital adequacy assessment process (ICAAP) and to assess the capital requirement as per ICAAP at the solo as well as consolidated level. The ICAAP is required to form an integral part of the management and decision-making culture of a bank. The implementation of ICAAP is to be guided by *the principle of proportionality* and the degree of

sophistication adopted in the ICAAP with regard to risk measurement and management is to be commensurate with the nature, scope, scale and the degree of complexity in the bank's business operations. The ICAAP is required to be subject to regular and independent review through an internal or external audit process, separately from the review conducted by the Reserve Bank, to ensure that the ICAAP is comprehensive and proportionate. Reckoning that some of the risks are less readily quantifiable, the banks' ICAAP document is required to clearly demarcate the quantifiable and qualitatively assessed risks. The ICAAP is also required to include stress tests and scenario analyses, to be conducted periodically, particularly in respect of the bank's material risk exposures, in order to evaluate the potential vulnerability of the bank to some unlikely but plausible events or movements in the market conditions that could have an adverse impact on the bank's capital. However, there is no mandated requirement by the Reserve Bank for adoption of complex and sophisticated econometric models for internal assessment of their capital requirements.

*Liquidity Management*

VI.22 As per the asset liability management guidelines prescribed in 1999, liquidity is tracked through traditional maturity or cash flow mismatches. It was felt that for better liquidity management, the time interval of the first bucket in the structural liquidity statement, viz., 1-14 days was too broad a time span. In due consideration of the international practices in this regard, the level of sophistication of banks and the need for a sharper assessment and better liquidity management, it was decided that this 1-14 days time bucket be made more granular by splitting into three time bands, viz., *day 1 (i.e., next day)*, 2-7 days and 8-14 days. Further, banks were advised that the net cumulative negative mismatches during the next day, 2-7 days, 8-14 days and 15-28 days should not exceed 5 per cent, 10 per cent, 15 per cent and 20 per cent of the cumulative outflows in order to recognize the cumulative impact on liquidity. Banks were advised that they may undertake dynamic liquidity management and should prepare the structural liquidity statement on a daily basis. Guidelines in this regard were issued in October 2007. In the absence of a fully networked environment, banks were allowed to compile the statement on best available data coverage initially

but were advised to make conscious efforts to attain 100 per cent data coverage in a timely manner. The frequency of supervisory reporting of the structural liquidity position was also increased to fortnightly, with effect from April 1, 2008.

*Anti-Money Laundering*

VI.23 The extant know your customer (KYC) regime was supplemented by putting in place on February 15, 2006 the requirement of reporting of cash transaction report (CTR)/suspicious transaction report (STR) by banks to Financial Intelligence Unit –India (FIU-IND) under the Prevention of Money Laundering Act, 2002. Banks were also advised on April 13, 2007 to incorporate complete originator information (names, address and account number) in wire transfer transactions. Based on the feedback received on the extant KYC/AML/CFT regime, the relevant guidelines were revised on February 18, 2008 (Box VI.4).

*Consolidation and Diversification*

VI.24 The process of consolidation and diversification continued during the year. Under sub-section (4) of Section 44A of the Banking Regulation Act, 1949, the Reserve Bank sanctioned on August 27, 2007 the Scheme of Amalgamation of the Lord

## Box VI.3

## Advanced Approaches under Basel II

The Basel II framework is highly complex on account of the several factors such as: (i) variety of available options; (ii) diversity in exercise of national discretions and their likely impact; (iii) lack of clarity on regulatory approach to various implementation issues, especially in a cross border situation; and (iv) likely unintended scope for regulatory arbitrage. Under the Basel II framework, in addition to maintaining capital for credit and market risks, banks are required to maintain capital for operational risk also.

*Credit Risk*

The two options under credit risk are standardised approach (SA) and internal rating based approach (IRB). Under the SA, the banks use a risk-weighting schedule for measuring the credit risk of banks' assets by suitably classifying assets and assigning risk weights based on the evaluation by the external credit rating agencies taking due cognisance of other factors such as risk mitigants, instrument type and asset quality, among others. The IRB approach, on the other hand, allows banks to use their own internal ratings of counterparties and exposures, which permit a finer differentiation of risk for various exposures and hence delivers capital requirements that are better aligned to the degree of risks. The IRB approach hinges on a formula provided by Basel Committee which has four major variables, viz., probability of default (PD), loss given default (LGD), exposure at default (EAD) and effective maturity (M). While PD of a borrower or group of borrowers is the central measureable concept on which the IRB approach is built, banks need to estimate LGD and EAD to arrive at a combined measure of expected intrinsic or economic loss. The IRB approaches are of two types:

- Foundation IRB (FIRB): the bank estimates the PD associated with each borrower, and the supervisor supplies other inputs such as LGD and EAD.
- Advanced IRB (AIRB): in addition to PD, the bank adds other inputs such as EAD, LGD, and M. The requirements for this approach are more exacting.

The adoption of advanced approaches would require the banks to meet minimum requirements relating to internal ratings at the outset and on an ongoing basis such as those relating to the design of the rating system, operations, controls, corporate governance, and estimation and validation of credit risk components, viz., PD for both FIRB and AIRB and LGD and EAD for AIRB. The banks should have, at the minimum, PD data for five years and LGD and EAD data for seven years. The manpower skills, the IT infrastructure and MIS at the banks would have to be upgraded substantially. The supervisors would need to develop skills in validation and back testing of models.

In India, banks were advised to compute capital requirements for credit risk adopting the SA. As building up of required data, developing credit risk models and their back testing pose considerable challenges to the banks in terms of huge skilled manpower requirements and upgradation of IT infrastructure, as also on the part of the supervisors to validate the models and undertake approval process, the Reserve Bank preferred to implement the simpler approaches by banks in India, to begin with. A

decision to offer choice of adopting advanced approaches will be taken by the Reserve Bank in due course.

*Market risk*

The capital charge for market risk was introduced by the Basel Committee on Banking Supervision through the Market Risk Amendment of January 1996 to the capital accord of 1988 (Basel I Framework). There are two methodologies available to estimate the capital requirement to cover market risks:

- The Standardised Measurement Method: This method, currently implemented by the Reserve Bank, adopts a 'building block' approach for interest-rate related and equity instruments which differentiate capital requirements for 'specific risk' from those of 'general market risk'. The 'specific risk charge' is designed to protect against an adverse movement in the price of an individual security due to factors related to the individual issuer. The 'general market risk charge' is designed to protect the interest rate risk in the portfolio.
- The Internal Models Approach (IMA): This method enables banks to use its proprietary in-house method which must meet the qualitative and quantitative criteria set out by the BCBS and is subject to the explicit approval of a bank's supervisory authority.

Recognising that banks in India are still at nascent stage of developing their internal risk management models, it was decided that, to start with, banks may adopt the Standardised Measurement Method. The internal model framework of the capital regulations offer banks an incentive to improve the accuracy of their internal model estimates of market risk. Based on the progress made by the banks, they could be permitted to adopt advanced approaches.

*Operational Risk*

The revised framework offers the following three approaches for estimating capital charges for operational risk:

- The Basic Indicator Approach (BIA): This approach sets a charge for operational risk as a fixed percentage of 'gross income', which serves as a proxy for the bank's risk exposure.
- The Standardised Approach (SA): This approach requires that the institution separate its operations into eight standard business lines, and the capital charge for each business line is calculated by multiplying gross income for that business line by a factor (denoted beta) assigned to that business line.
- Advanced Measurement Approach (AMA): Under this approach, the regulatory capital requirement will equal the risk measure generated by the banks' internal operational risk measurement system.

In India, the banks have been advised to adopt the BIA to estimate the capital charge for operational risk. They are encouraged to move along the spectrum of available approaches as they develop more sophisticated operational risk measurement systems and practices.

**Box VI.4****The Revised Guidelines on Know Your Customer and Anti-Money Laundering – Salient Features**

- In case of close relatives who find it difficult to furnish documents relating to place of residence while opening accounts, banks can obtain an identity document and a utility bill of the relative with whom the prospective customer is living, along with a declaration from the relative that the said person (prospective customer) wanting to open an account is a relative and is staying with him/her. Banks can also use any other supplementary evidence such as a letter received through post for further verification of the address.
- Banks were advised to keep in mind the spirit of the instructions and avoid undue hardships to individuals who were otherwise classified as low risk customers.
- Banks were required to review the risk categorisation of customers at a periodicity of not less than once in six months.
- Banks were also required to introduce a system of periodic updation of customer identification data (including photograph/s) after the account is opened, which should be not less than once in five years in the case of low risk category customers and not less than two years in the case of high/medium risk customers.
- In cases of variance in home and host country KYC/AML regulation, the overseas branches/subsidiaries were required to adopt the more stringent regulation of the two.
- While opening accounts, banks should ensure that the name/s of the customer does/do not appear in the United Nations' Security Council Resolutions (UNSCRs) list. Furthermore, banks should scan all existing accounts to ensure that no account is held by or linked to any of the entities or individuals included in the list. Full details of accounts bearing resemblance with any of the individuals/entities in the list should immediately be intimated to the Reserve Bank and FIU-IND.
- Banks were required to put in place adequate screening mechanism as an integral part of their recruitment/hiring process of their personnel.

Krishna Bank Ltd. (LKB) with the Centurion Bank of Punjab Ltd. (CBOP). The scheme came into force with effect from the commencement of business on August 29, 2007. Under the same statutory provisions, the Scheme of Amalgamation of Centurion Bank of Punjab Ltd. with HDFC Bank Ltd. was sanctioned by the Reserve Bank on May 20, 2008 and the Scheme came into force with effect from the commencement of business on May 23, 2008.

VI.25 Consequent to the global acquisition of banking business (excluding its credit card and travel related business) of American Express Bank Ltd. (AEBL) by Standard Chartered Bank as a stock sale, the Reserve Bank sanctioned amalgamation of the Indian branches of AEBL with the Indian branches of Standard Chartered Bank on March 5, 2008. Furthermore, American Express Banking Corporation (AEBL), the parent bank of AEBL was issued a limited banking licence on 'stand still basis' under Section 22 of BR Act, 1949 to open its maiden branch in New Delhi for conducting the business relating to credit cards, travel related services and institutional deposits of AEBL which was transferred to it prior to the sale of AEBL's banking business to Standard Chartered Bank. Authorisation for four credit card centres was given to AEBL, in lieu of earlier authorisation issued to erstwhile AEBL.

VI.26 Notifications dated February 7, 2008 and April 9, 2008 were issued relating to change of name of "Sonali Bank" to "Sonali Bank Limited" and Arab Bangladesh Bank Limited" to "AB Bank Limited", respectively, in terms of clause (c) of sub-section (6) of Section 42 of the Reserve Bank of India Act, 1934 (2 of 1934).

VI.27 No fresh opening of off-shore banking units (OBUs) was reported during the year. Seven OBUs of six banks, viz., State Bank of India, Bank of Baroda, Union Bank of India, Punjab National Bank, ICICI Bank Ltd. and Canara Bank continued to operate from three special economic zones (SEZs), viz., SEEPZ (Mumbai), Noida and Kochi.

VI.28 State Bank of India was granted an in-principle approval for setting up a subsidiary to act as pension fund manager, subsequent to issue of guidelines by the Reserve Bank on pension fund management by banks on June 28, 2007.

VI.29 At end-June 2008, 74 banks were under liquidation all over India. The matter regarding early completion of liquidation proceedings is being followed up with official/court liquidators.

VI.30 Indian banks continued to expand their presence overseas. Between July 2007 and June 2008, Indian banks opened 17 branches/

subsidiaries/representative offices overseas (Table 6.1). At end-June 2008, 18 Indian banks (13 public sector banks and five private sector banks had presence abroad with a network of 203 offices (131 branches, 43 representative offices, seven joint ventures and 22 subsidiaries) in 51 countries.

VI.31 During the calendar year 2007, the Reserve Bank issued 19 approvals for opening branches by foreign banks in India. Several foreign banks opened branches and representative offices in India during the year (Table 6.2). Since July 2007, permission has been granted to the three existing banks to open 18 branches and to five new foreign banks, (*viz.*, JSC VTB Bank, UBS AG, Dresdner Bank AG, American Express Banking Corporation and United Overseas Bank Ltd.) to open one branch each in India. At end-June 2008, 30 foreign banks were operating in India with 279 branches. Besides, 41 foreign banks were also operating in India through representative offices.

#### *NPA Management*

VI.32 Banks in India have several mechanisms for resolution of their NPAs. The legal forums available to banks include: the Securitisation and Reconstruction of Financial Assets and Enforcement

**Table 6.1: Offices of Indian Banks Opened Abroad – July 2007 to June 2008**

Name of the Bank	Type of presence	Country	Place
1	2	3	4
Bank of Baroda	Branch	South Africa	Johannesburg
	Branch	United Kingdom	London
	Branch	Bahrain	Manama
	RO	Australia	Sydney
Bank of Baroda (Ghana) Ltd.	Subsidiary	Ghana	Accra
Bank of Baroda (Trinidad and Tobago) Ltd.	Subsidiary	Trinidad & Tobago	Port of Spain
Bank of India	RO	South Africa	Johannesburg
Federal Bank Ltd.	RO	UAE	Abu Dhabi
ICICI Bank Ltd.	Branch	Qatar	Doha (QFC)
	Branch	USA	New York
Indian Overseas Bank	RO	Vietnam	Ho Chi Minh City
Punjab National Bank	Branch	Hong Kong	Hong Kong
Union Bank of India	RO	UAE	Abu Dhabi
Bank of India	Branch	United Kingdom	Glasgow
Union Bank of India	Branch	Hong Kong	Central Hong Kong
Bank of India	Subsidiary	Tanzania	Dar-E-Salaam
Axis Bank Ltd.	RO	UAE	Dubai

RO: Representative Office.

**Table 6.2: Offices of Foreign Banks Opened in India – July 2007 to June 2008**

Name of the Bank	Type of presence	Place
1	2	3
Deutsche Bank AG	Branch	Kolhapur, Aurangabad
Standard Chartered Bank	Branch	Silguri, Jalgaon
Barclays Bank PLC	Branch	Junagarh
HSH Nordbank AG (Germany)	RO	Mumbai
Woori Bank (South Korea)	RO	New Delhi
Westpac Banking Corporation, (Australia)	RO	Mumbai
Royal Bank of Canada (Canada)	RO	Mumbai
FirstRand Bank Ltd. (South Africa)	RO	Mumbai
Skandinaviska Enskilda Banken AB (Sweden)	RO	New Delhi
Bayerische Landesbank (Germany)	RO	Mumbai
Citibank N.A.	Branch	Akola
JSC VTB Bank (Russia)	Maiden Branch	New Delhi

RO: Representative Office.  
Note: Data are provisional.

of Security Interest Act, 2002 (SARFAESI Act, 2002), the Recovery of Debts due to Banks and Financial Institutions Act, 1993 (RDDB Act) and the forum of *Lok Adalats* (People's court). Among the three routes, the mechanism through Debt Recovery Tribunals has been the most successful, closely followed by the SARFAESI Act. The mechanism of Lok Adalats has also been successfully used in resolving a large number cases involving smaller amount (Table 6.3).

#### *Corporate Governance and Corporate Social Responsibility*

VI.33 In order to highlight the developments that are taking place worldwide regarding sustainable development as also to raise the level of awareness, the Reserve Bank issued guidelines introducing the concepts of corporate social responsibility (CSR), sustainable development (SD) and non-financial reporting (NFR). CSR entails the integration of social and environmental concerns by companies in their business operations as also in interactions with their stakeholders. SD essentially refers to the process of maintenance of the quality of environmental and social systems in the pursuit of economic development. NFR is basically a system of reporting by organisations on their activities especially with regard to the triple bottomline, *i.e.*, the environmental, social and economic accounting. Global warming and climate change are particularly important in the context of sustainable development.

**Table 6.3: Resolution of NPAs**  
(Cumulative as at end-March 2008)

(Amount in Rs. crore)

Resolution Mechanism	No.	Amount	No.	Amount	No.	Amount
1	2	3	4	5	6	7
SARFAESI	Notices Issued		Recovery		Compromise Proposals	
	279,996	56,060	172,809	15,415	62,432	9,043
Debt Recovery Tribunals*	Cases Filed		Adjudicated Cases		Recovery	
	79,169	1,26,378	45,088	58,719	N.A.	21,541
Lok Adalats	Cases Filed		Cases Decided		Recovery	
	1,164,650	7,740	404,378	2,009	322,732	885

\* : No. of DRTs/DRATs was at 29 and 5, respectively, at end-September 2007.

N.A. : Not available.

VI.34 The Banking Companies (Acquisition and Transfer of Undertakings) and Financial Institutions Laws (Amendment) Act, 2006 came into force from October 16, 2006 which required the Central Government to nominate, on the recommendation of the Reserve Bank, a person possessing necessary experience and expertise in matters relating to regulation or supervision of commercial banks instead of nominating an officer of the Reserve Bank. Effectively, all the then existing directors on boards of nationalised banks were replaced with retired officials with effect from February 27, 2007. The amendment to the above Act also introduced a new Section 9(A) and empowered the Reserve Bank to appoint one or more additional directors, if found necessary, in the interest of banking policy/public interest/interest of the bank or the depositors. In terms of the above Section, the Reserve Bank appointed an additional director on the Board of Punjab and Sind Bank. Similarly, the State Bank of India (Subsidiary Banks Laws) Amendment Act, 2007, came into force from July 9, 2007, which required the Reserve Bank to nominate a person possessing necessary experience and expertise in matters relating to regulation or supervision of commercial banks instead of nominating an officer of the Reserve Bank. Accordingly, all the then existing directors on boards of subsidiary banks of State Bank of India were replaced with retired officials.

VI.35 The Reserve Bank also laid down the 'fit and proper' criteria for the elected directors on the Boards of nationalised banks and associate banks of State Bank of India (Box VI.5).

VI.36 With a view to reducing the burden on boards of banks on account of the calendar of reviews to be undertaken by them and to ensure that the calendar of reviews reflects the present day concerns, the calendar items were revised in April 2008. The above calendar outlines the critical minimum requirements of review and the bank boards will have the discretion to prescribe additional reviews to suit their requirements. The revised schedule, which is required to be in force with effect from June 2008, would be under the two heads, viz., 'review of operations' and 'review of strategy'. Banks were also advised that in every board meeting a separate time slot should be allocated for taking up strategy review for business plan – targets and achievement, review of non-fund business, human resources management, training and industrial relations, new prospective business/products lines and closure of existing business/products lines.

#### **Supervisory Initiatives**

VI.37 The scope and coverage of off-site returns submitted by banks to the Reserve Bank under off-site monitoring and surveillance (OSMOS) system is periodically revised to incorporate new regulatory

## Box VI.5

**Fit and Proper Criteria for Elected Directors of Nationalised Banks and Associate Banks of State Bank of India**

The Reserve Bank had issued 'fit and proper' criteria for directors on the boards of private sector banks in June 2004 based on the Report of the Consultative Group of Directors of Banks/Financial Institutions (Chairman: Shri A.S. Ganguly). Extending this further, the Reserve Bank notified in November 2007 'fit and proper' criteria for elected directors on the boards of nationalised banks and associate banks of State Bank of India as detailed below:

- a) Nationalised banks and associate banks of SBI are required to constitute a 'nomination committee' consisting of a minimum of three directors (all independent directors/non-executive directors) from amongst the board of directors. The board of directors should also nominate one among them as Chairman of the nomination committee. The quorum required is three, including the chairman. At the time of constituting the nomination committee, the board can decide on its tenure.
- b) The nomination committee is required to undertake a process of due diligence to determine the 'fit and Proper' status of the existing elected directors/person to be elected as a director under Sec.9(3)(i) of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/80 (as amended in 2006) in the case of nationalised banks and under Sec.25 (1)(d) of the State Bank of India (Subsidiary Banks) Act, 1959 (as amended in 2007) in the case of associate banks of SBI. For this purpose, banks have to obtain necessary information and declaration from the existing elected directors/ persons, who file their nominations for election. The nomination committee is required to meet before the last date of acceptance of nominations in case of candidates to be elected and decide whether or not the person's candidature should be accepted based on certain criteria.

The nomination committee is required to determine the 'fit and proper' status of the existing elected directors/ proposed candidates based on the broad criteria such as: educational qualification; experience and field of expertise; and track record and integrity.

The nomination committee should see whether non-adherence to any of the above criteria would hamper the existing elected director/proposed candidate from discharging the duties as a director on the board of the bank. Furthermore, the candidate coming to the adverse notice of any authority/regulatory agency or insolvency or default of any loan from any bank or financial institution would make the candidate unfit and improper to be a director on the board of a bank.

- c) It is desirable that the board ensures, in the public interest, that the elected directors execute the deed of covenants as recommended by the Ganguly Group after the election and also every year as on March 31. The deed of covenants contain, *inter alia*, the responsibilities, ethical values and disclosure standards from the directors and role of expectations of directors and banks.

The nomination committee was also required to complete the process of determining the 'fit and proper' status of the existing elected directors on the board of the bank. Further, it is mandatory for all the elected directors to furnish a simple declaration every year as on March 31 that the information already provided by them has not undergone any change and where there is any change, requisite details are furnished by the directors forthwith. If there are any significant changes, the nomination committee is required to undertake the due diligence exercise afresh and examine the 'fit and proper' status of the director.

changes and other data requirements. The last revision of the off-site returns was done in December 2004. A revision of the off-site returns was necessitated on account of new regulatory prescriptions, changes in supervisory focus, other additional reporting requirements and improvements in existing reporting/data processing. Accordingly, a comprehensive review of the coverage and scope of the off-site returns is currently underway.

VI.38 In view of the implementation of New Capital Adequacy Framework in phases with effect from March 31, 2008, it was felt necessary to devise a new capital adequacy return under the off-site reporting framework. Accordingly, an internal group suggested revision in the reporting format.

VI.39 Banks have so far been submitting off-site returns to the Reserve Bank through e-mail using stand alone software. It was decided that online returns filing system (ORFS) of the Reserve Bank should be the single window data receptacle for receiving all the data from external entities. Consequently, it was decided to migrate all the returns to the ORFS. The system requirement specification (SRS) has been completed for all the 22 existing returns and is in different stages of implementation. The new Basel II return would also be implemented on ORFS. The structural liquidity statement (STL) as per revised asset liability management guidelines, has already been made operational from February 2008. Furthermore, to obviate the problem of

distribution of modified/new reports to the regional offices, it is envisaged that all the reporting tools would also be web-enabled so that regional offices would immediately get the latest modified reports.

#### *Monitoring of frauds*

VI.40 While introduction of new products and innovations in banking has resulted in greater efficiency and quicker delivery of services, it has also exposed banks to greater operational risks. This is observed in the increase in number of frauds reported by banks to the Reserve Bank (Table 6.4).

VI.41 The Reserve Bank as a part of its supervisory process has been sensitising banks from time to time about common fraud prone areas, *modus operandi* of frauds and the measures to be taken by them to prevent/reduce the incidence of frauds. Banks were directed to report fraud cases involving Rs.1 lakh and above to the Reserve Bank. On receipt of fraud report from banks, the Reserve Bank advises the concerned banks (i) to file a complaint with police/CBI; (ii) examine staff accountability and complete proceedings against the erring staff expeditiously; (iii) take steps to recover the amount involved in the fraud; (iv) claim insurance wherever applicable; (v) streamline the system and procedures; and (vi) plug loopholes in the system so that similar frauds do not recur. Public sector banks are required to report frauds involving Rs.1 crore and above to the Economic Offences Wing of Central Bureau of Investigation and those below Rs.1 crore to local police. Private sector banks are required to report fraud cases involving Rs.10,000 and above to local police. Private sector and foreign banks are required

to report frauds involving Rs.1 crore and above to Serious Frauds Investigation Office (SFIO).

VI.42 Caution Advices were issued in confidence to banks by the Reserve Bank containing the details of borrowers involved in frauds of Rs.25 lakh and above so that banks could exercise due care while considering sanction of credit facilities to the concerned entities.

#### *Customer Service*

VI.43 The Banking Codes and Standards Board of India (BCSBI), set up in 2006, continued its efforts to improve customer service in banks by way of active dialogue with member banks to translate the promises made by them in the Code of Bank's Commitment to Customers (Code) into tangible performance. Seventy scheduled commercial banks are members of BCSBI at present. In order to ascertain the actual position of implementation of the Code, the BCSBI commissioned a survey of 700 branches of member banks in five cities, Chennai, Kolkata, Mumbai, New Delhi and Hyderabad to ascertain systems in vogue for distribution of copies of the Code, transparency in various banking services offered, tariff schedule, interest rates, KYC procedures, status of opening of 'no-frills accounts' grievance redressal systems *etc.* The survey findings revealed that banks need to gear up their machinery in disseminating the contents of the Code to all their customers, reaching out to customers with information on terms and conditions of their deposits and their implications, bringing out transparency in their tariff Schedule, educating their customers on the availability of a system for redressal of their grievances and in fulfilling certain basic obligations to borrowers *etc.* The survey findings were discussed with the banks concerned and CEOs of banks agreed to set right the deficiencies.

VI.44 The Working Group on Reasonableness of Bank Charges (Chairman: Shri N. Sadasivan) that submitted its report in September 2006 suggested that BCSBI may track from time to time, the changes in the levels of the service charges and on a comparative basis, to identify any abnormal increases. Accordingly, BCSBI made a preliminary

**Table 6.4: Frauds in the Banking Sector**

(Amount in Rs. crore)

Year	All frauds		Large Value frauds	
	No.	Amount	No.	Amount
1	2	3	4	5
2001-02	2,035	556	76	486
2002-03	4,056	502	82	375
2003-04	6,853	776	76	421
2004-05	10,450	779	96	461
2005-06	13,914	1,381	194	1094
2006-07	23,618	1,194	150	840
2007-08	21,247	1,059	177	659

sample study of a few select member banks' charges on most commonly availed banking services, namely, penalty for non-maintenance of minimum balance, charges for collection of outstation cheques, for issue of demand drafts and cheque books and for closure of savings bank accounts. Prima-facie, the study revealed that over and above the high minimum balance prescription by foreign and new private sector banks, the penalty charged by them for non-maintenance of the minimum balance is also on the higher side as compared with public sector and old private sector banks. The other four charges in the sample study are not totally out of alignment across banks. The status reported in the prescribed format of annual statement of compliance as on December 31, 2007 was discussed with the chief executive officers/executive directors of each bank, against the backdrop of the sample survey findings and mutually agreed time frames were fixed for implementation of the various Code provisions. Barring a few, member banks have adopted model policies brought out by IBA on cheque collection, grievance redressal, security repossession and compensation after incorporating certain suggestions made by BCBSI. The review also showed that banks are taking active steps to improve dissemination of information and to enhance transparency in their day to day dealings with customers. While 15 member banks have completed the task of distribution of copies of the Code to all their existing customers, remaining banks are expected to complete the task shortly. The recent spate of cases by customers alleging selling of products by banks without giving full details of the products highlights the importance of implementing the Code provisions not only in letter but also in spirit.

VI.45 In terms of the fair practices code for lenders guidelines issued in May 2003, the banks/FIs were required to furnish a copy of the loan agreement along with a copy each of all enclosures quoted in the loan agreement to all the borrowers at the time of sanction/disbursement of loans. The instructions were reiterated in August 2007, as it was observed that some banks were furnishing a copy of the loan agreement only on request made by the borrowers. Similar guidelines were also issued for NBFCs.

VI.46 Banks were advised from time to time to constitute the branch level customer service committees. It was, however, understood that such Committees were either non-existent or in a dormant state. In order to encourage a formal channel of communication between the customers and the bank at the branch level, banks were advised in September 2007 to take necessary steps to strengthen the branch level committees with greater involvement of customers. Banks were advised that it was desirable that branch level committees included their customers too, including senior citizens. The guidelines also specified reporting requirements for the branch level committees to the Standing Committee on Customer Service and conduct of regular meeting.

VI.47 Some banks were offering special term deposit products to customers, in addition to regular term deposits, ranging from 300 days to five years, with lock-in periods ranging from 6 to 12 months and prohibiting premature withdrawal during the lock-in period. In case of premature withdrawal during the lock-in period, no interest was paid. Furthermore, rates of interest offered on these deposits were not in tune with the rates of interest on normal deposits. However, part pre-payment was allowed by some banks, subject to certain conditions. In this connection, the Reserve Bank advised the banks that they should not discriminate in the matter of interest paid on deposits, between one deposit and another, accepted on the same date and for the same maturity, whether such deposits are accepted at the same office or at different offices of the bank. The only exceptions were allowed in respect of fixed deposit schemes specifically for resident Indian senior citizens under which banks could offer higher and fixed rates of interest as compared to normal deposits of any size and single term deposits of Rs.15 lakh and above on which banks could offer varying rates of interest on the basis of size of the deposits. Banks were advised in October 2007 that the special schemes, with lock-in periods and other features referred to above, were not in conformity with the instructions contained in the Master Circular on

'Interest Rates on Rupee Deposits held in Domestic Deposits, etc.' and that it should be discontinued and compliance reported.

VI.48 It was felt that adverse publicity in view of the rise in the number of disputes and litigations against banks for engaging recovery agents in the recent past would result in serious reputational risk for the banking sector as a whole. The Reserve Bank, in April 2008 therefore, issued detailed guidelines on the policy, practice and procedure involved in the engagement of recovery agents by banks in India (Box VI.6).

VI.49 In May 2008, banks were directed to ensure that a suitable mechanism exists for receiving and addressing complaints from customers/constituents with specific emphasis on resolving them fairly and expeditiously regardless of the source of the complaints. In this regard, banks were also advised to: (i) ensure that the complaint registers are kept at prominent place in their branches which would make it possible for the customers to enter their complaints; (ii) have a system of acknowledging the complaints, where the complaints are received through letters/forms; (iii) fix a time frame for resolving the complaints received at different levels; (iv) ensure that redressal of complaints emanating from rural areas and those relating to financial assistance to priority sector and Government's poverty alleviation programmes also forms part of the above process; (v) prominently display at the branches, the names of the officials who can be contacted for redressal of complaints, together with their direct telephone number, fax number, complete address (not Post Box No.) and e-mail address.

VI.50 Banks were also advised that where the complaints are resolved within the next working day, they need not include the same in the statement of complaints required to be disclosed along with financial results. This is expected to serve as an incentive to the banks and their branches to resolve the complaints within the next working day. Furthermore, banks were also advised that where the complaints were not redressed within one month, the concerned branch/controlling office should

forward a copy of the same to the concerned nodal officer under the banking ombudsman scheme and keep him updated regarding the status of the complaint. Furthermore, to ensure that the customer is made aware of his rights to approach the concerned banking ombudsman in case he is not satisfied with the bank's response, banks were advised to indicate in the final letter sent to the customer regarding redressal of the complaint that the complainant can also approach the concerned Banking Ombudsman. Banks were also advised to give wide publicity to the grievance redressal machinery through advertisements and also by placing them on their websites.

VI.51 Banks were advised that all telemarketers, viz., direct selling agents/direct marketing agents (DSAs/DMAs) engaged by them register themselves with Department of Telecommunications (DoT) as telemarketers. Further, they were also advised to instruct DSAs/DMAs/telemarketers to scrub the calling list and not to make any telemarketing calls without scrubbing their calling lists with national do not call registry (NDNC) as envisaged in the provisions of the Unsolicited Commercial Communications Regulations, 2007 (Box VI.7).

VI.52 In the area of customer service, the cherished principles in treating customers fairly are transparency, reasonableness, truth in selling, confidentiality and assistance when needed, apart from effective grievance redressal mechanism. The Reserve Bank is continuously taking steps to ensure that customers are treated fairly. Banking Ombudsman offices continue to receive the complaints relating to grievances against commercial banks, regional rural banks and scheduled primary co-operative banks. Complainants have the facility to send the complaints by email, online or by post. The complaints are tracked by Banking Ombudsman offices by means of a complaint tracking software. During 2007-08, 47,887 complaints were received by 15 Banking Ombudsman offices as against 38,638 complaints received during 2006-07. In terms of the Banking Ombudsman Scheme 2006 (as amended

**Box VI.6  
Guidelines on Recovery Agents**

The guidelines on recovery agents, *inter alia*, covered various aspects of engagement, incentives, methods, training, complaints redressal and penalty.

*Engagement of Recovery Agents*

- Recovery agent was defined to cover agencies engaged by the bank and the agents/employees of the concerned agencies.
- Banks are required to follow a due diligence process for engagement of recovery agents. Furthermore, banks need to ensure that the agents engaged by them in the recovery process carry out verification of the antecedents of their employees, which may include pre-employment police verification, as a matter of abundant caution.
- To ensure due notice and appropriate authorisation, banks should inform the borrower the details of recovery agency firms/companies while forwarding default cases to the recovery agency. Furthermore, the agent should also carry a copy of the notice and the authorisation letter from the bank along with the identity card issued to him by the bank or the agency firm/company.
- The notice and the authorisation letter should, among other details, also include the telephone numbers of the relevant recovery agency. Banks were advised to ensure that there was a tape recording of the content/text of the calls made by recovery agents to the customers, and *vice-versa*. Banks need to take reasonable precaution such as intimating the customer that the conversation is being recorded.
- The up-to-date details of the recovery agency firms/companies engaged by banks may also be posted on the bank's website.
- Where a grievance/complaint has been lodged, banks should not forward cases to recovery agencies till it has been finally disposed of. However, where the borrower is continuously making frivolous/vexatious complaints, it may continue with the recovery proceedings even if a grievance/complaint is pending with them.
- Each bank should have a mechanism whereby the borrowers' grievances with regard to the recovery process can be addressed.

*Incentives to Recovery Agents*

- It was understood that some banks set very stiff recovery targets or offer high incentives to recovery agents. Banks were, therefore, advised to ensure that the contracts with the recovery agents did not induce adoption of uncivilised, unlawful and questionable behaviour or recovery process.

*Methods followed by Recovery Agents*

- Banks were advised to strictly adhere to the various guidelines issued by the Reserve Bank such as fair practices code for lenders, guidelines on credit card operations and also the code of banks' commitment to customers formulated by BCSBI during the loan recovery process.

*Training for Recovery Agents*

- Banks should ensure that the recovery agents are properly trained to handle with care and sensitivity, their responsibilities, in particular aspects such as hours of calling, privacy of customer information, etc.

- The Reserve Bank requested the Indian Banks' Association to formulate, in consultation with Indian Institute of Banking and Finance (IIBF), a certificate course for direct recovery agents with minimum 100 hours of training. Once the above course is introduced by IIBF, banks should ensure that over a period of one year, all their recovery agents undergo the above training and obtain the certificate from the above institute.

*Taking possession of property mortgaged/hypothecated to banks*

- Banks were advised that it was desirable that they rely only on legal remedies available under the relevant statutes such as the SARFAESI Act while enforcing security interest without intervention of the courts.
- Where banks have incorporated a re-possession clause in the contract with the borrower and rely on such re-possession clause for enforcing their rights, they were advised to ensure that the re-possession clause was legally valid, complies with the provisions of the Indian Contract Act in letter and spirit, and that such repossession clause was clearly brought to the notice of the borrower at the time of execution of the contract. The terms and conditions of the contract should be strictly in terms of the recovery policy.

*Use of forum of Lok Adalats*

- Banks were encouraged to use the forum of Lok Adalats for recovery of personal loans, credit card loans or housing loans with less than Rs.10 lakh as suggested by the Supreme Court.

*Utilisation of credit counsellors*

- Banks were encouraged to have in place an appropriate mechanism to utilise the services of the credit counsellors for providing suitable counselling to the borrowers where it became aware that the case of a particular borrower deserved sympathetic consideration.

*Complaints against the bank/its recovery agents*

- Banks were advised that complaints received by the Reserve Bank regarding violation of the above guidelines and adoption of abusive practices followed by banks' recovery agents would be viewed seriously.
- The Reserve Bank may consider imposing a ban on a bank from engaging recovery agents in a particular area, either jurisdictional or functional, for a limited period. Similar supervisory action could be attracted when the High Courts or the Supreme Court pass strictures or impose penalties against any bank or its directors/officers/agents with regard to policy, practice and procedure related to the recovery process.
- It is expected that banks would, in the normal course ensure that their employees also adhere to the above guidelines during the loan recovery process.

*Periodical Review*

- Banks engaging recovery agents were advised to undertake a periodical review of the mechanism to learn from experience, to effect improvements, and to bring to the notice of the Reserve Bank suggestions for improvement in the guidelines.

**Box VI.7****Unsolicited Commercial Communications – National Do Not Call Registry**

In view of the continuous complaints from credit card subscribers and the observations of the High Court of Delhi in the context of public interest litigation in this regard, the Telecom Regulatory Authority of India (TRAI) framed the Telecom Unsolicited Commercial Communications Regulations 2007 for curbing unsolicited commercial communications (UCC). Furthermore, the Department of Telecommunications (DoT) issued relevant guidelines for telemarketers along with the registration procedure on June 6, 2007. These regulations envisaged that all the telecom service providers would set up a mechanism to receive requests from subscribers who do not want to receive UCC and for this purpose they will maintain and operate a 'private do not call' list. The list will include telephone numbers and other details of all such subscribers who do not wish to be called. The telephone numbers and area code from this list will be updated online by the operators to a national do not call registry (NDNC) which will be maintained by National Informatics Centre (NIC). Telemarketers will have to register in the NDNC Registry. They would submit online the calling list to the NDNC Registry where the list will be modified/scrubbed by excluding the numbers listed in the registry and the modified/scrubbed list will be online transferred back to the telemarketers for making calls. For the effective implementation of the UCC Regulations, TRAI has mandated that the telemarketers have to register themselves with the Department of Telecommunications (DoT) Ministry of Communication and Information Technology, Government of India within three months of the issue of the guidelines for telemarketers by DoT, failing which their telecom services may face disconnection.

The telecom service providers were directed to disconnect the telephone connections provided to the telemarketers in case of violation of the UCC Regulations by them.

In alignment with the above policy, banks were advised to implement the following instructions:

- Banks should not engage telemarketers (DSAs/DMAs) who do not have a valid registration certificate from DoT, Government of India, as telemarketers.
- Banks should furnish the list of telemarketers (DSAs/DMAs) engaged by them along with the registered telephone numbers being used by them for making telemarketing calls to IBA to enable IBA to forward the same to TRAI.
- Banks should ensure that all telemarketers (DSAs/DMAs) presently engaged by them register themselves with DoT as telemarketers.
- In addition to DSAs/DMAs, banks/their call centres, who make solicitation calls, are also required to be registered as telemarketers with DoT and banks/their call centres, while registering themselves as telemarketers, are required to give the details of the telephone numbers used for telemarketing.
- Banks were also advised to instruct DMAs/DSAs/telemarketers to scrub the calling list and not to make any telemarketing calls without scrubbing their calling lists with NDNC as envisaged in the provisions of the Unsolicited Commercial Communications Regulations, 2007.

up to May 2007), bank customers and banks can appeal to the Appellate Authority against the decisions given by Banking Ombudsman. During 2007-08, 186 such appeals were received.

VI.53 The Reserve Bank institutionalised the process of examining the important feedback emanating out of the complaints received at the Banking Ombudsman Offices. Meetings, designated as 'Customer Service Meeting', are held on a quarterly basis to examine systemic issues reported by the Banking Ombudsmen. The meeting also focuses on other customer service issues, including the Code and the Banking Ombudsman (BO) Scheme. The meetings are attended by members at the senior level representing regulatory and supervisory departments of the Reserve Bank, Banking Ombudsmen, Indian Banks' Association and Banking Codes and Standards Board of India (BCSBI). It adopts an integrated approach to ensure that appropriate corrective action is taken through

self-regulation or the Reserve Bank regulation in a time bound manner. The meeting also ensures that a common approach, in the interest of the customer, is adopted. The consensus/decisions/recommendations evolved during the meeting are only advisory in nature and need to be examined by the concerned regulatory departments.

**Regional Rural Banks**

VI.54 Consequent upon the initiation of the process of amalgamation of Regional Rural Banks (RRBs) by the Government of India with effect from September 2005 in terms of Section 23A of the Regional Rural Banks Act, 1976, the number of RRBs declined to 91 operating in 26 States across 585 districts with a network of 14,788 branches as on March 31, 2008. With further amalgamation, and formation of a new RRB in Union Territory of Puducherry, the total number of RRBs declined to 88 as on May 30, 2008.

VI.55 The Government of India issued a notification dated May 17, 2007 specifying 'Regional Rural Bank' as 'bank' for the purpose of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002. In May 2007, RRBs were allowed to take up corporate insurance agency business without risk participation for distribution of all insurance products without prior permission from the Reserve Bank. RRBs were also permitted to take up consortium lending within the permissible exposure limits. In order to strengthen the capital structure of RRBs as also in the context of financial stability of the whole system, it was announced in the Mid-Term Review of the Annual Policy Statement for the year 2007-08 that RRBs should disclose the level of CRAR as on March 31, 2008 in their balance sheets and a road-map be evolved for achieving the desired level of CRAR by these banks.

VI.56 With a view to improving the performance of RRBs and giving more powers and flexibility to the Boards in decision making, the Reserve Bank had constituted a Task Force (Chairman: Dr. K. G. Karmakar) in September 2006 to deliberate and suggest areas where more autonomy could be given to the Boards, particularly in matters of investments, business development and staffing, *viz.*, determination of staff strength, fresh recruitment and promotions, among others. Majority of recommendations made by the Task Force have been accepted/implemented.

VI.57 Consequent upon the announcement made in the Mid-Term Review of the Annual Policy Statement for the year 2007-08, and in order to prepare RRBs to adopt appropriate technology and migrate to core banking solutions for better customer services, a Working Group (Chairman: Shri G. Srinivasan) was constituted with representatives from NABARD, sponsor banks and RRBs to prepare a roadmap. The Group has since submitted its report in August 2008. The Committee (Chairman: Dr. Y.S.P. Thorat) constituted to formulate a comprehensive HR policy for RRBs submitted its report to the Government of India in October 2007 which is under examination of the Government of India.

VI.58 In order to work out the modalities of assistance to be provided to RRBs, a Working Group (Chairman: Shri G. Padmanabhan) was constituted to explore various affordable information and communication technology (ICT) based solutions suitable for RRBs and to identify the cost elements and recommend the manner and criteria for funding such ICT solutions, including installation of solar power generating devices in remote areas. The Group's report has been placed in the web-site for public comments.

VI.59 The Deposit Insurance and Credit Guarantee Corporation (DICGC) has been extending insurance cover to small depositors with the objective of maintaining the confidence of small investors in the banking system of the country and promoting financial stability. As part of public awareness program, the DICGC disseminates information about deposit insurance scheme to the public through insured banks, its website and booklet on guidelines on deposit insurance. The DICGC's website, *inter alia*, furnishes detailed information on deposit insurance system in India, answers to 'frequently asked questions' (FAQs), manner of settlement of claims, list of insured banks, details of claims settled and circulars issued to insured banks. For the convenience of the depositors, the DICGC releases information/data on claims settled with the name of the bank along with the amount on its web-site. During 2007-08, the DICGC settled aggregate claims for Rs.161 crore (22 original claims and 18 additional claims) of co-operative banks.

VI.60 The DICGC aims at ensuring prompt reimbursement to the depositors, particularly small depositors (Box VI.8).

### **Co-operative Banks**

VI.61 The UCB sector has witnessed significant improvement in recent years. The significant growth in the number of UCBs in late 1990s and in the beginning of the current decade led to certain weaknesses in the sector that adversely affected public perception. In response to the above situation, the Reserve Bank as a first step announced in May 2004 that licenses would not be issued for setting

### Box VI.8 Expeditious Settlement of Claims of Depositors of Insured Banks

The Deposit Insurance and Credit Guarantee Corporation (DICGC) has taken several initiatives to eliminate delay in settlement of claims of the depositors. The Corporation has formulated policy guidelines to mitigate hardship to the depositors of insured banks due to delay on account of liquidation order having been challenged in court of law. Further, in extraordinary situations where the DICGC does not receive the claim list from liquidators even after considerable delay and prolonged correspondence, it issues an advertisement in local newspapers informing the depositors about the non-receipt of claims at its end and requesting them to make a claim with the liquidators under intimation to DICGC. However, it has been observed that though this has yielded the desired results in some cases, in many other cases the response has been poor. The Corporation has studied the reasons for delay in settlement of claims and taken further steps to remove the impediments in the process. In a special situation where claim list has not been submitted by the liquidator even after a long period because of delay in audit of accounts, the DICGC has suggested for appointment of Chartered Accountant (CA) firm by the Registrar of Co-operative Societies (RCS) to assist the liquidator of co-operative banks in completing the audit and/or preparation of the claim list. On being satisfied about the authenticity of claims, the DICGC may waive, as a special case, the submission

of audited balance sheet as on the cut-off date. It has been suggested by the Corporation that CA for the above purpose may be appointed by the RCS on the recommendation of the sub-committee of the Task Force on Urban Co-operative Bank (TAFUCB) and they should carry out audit as per the terms approved by the sub-committee. The Corporation will also consider requests in other genuine circumstances on a case-to-case basis.

The cumulative impact of the above policies relating to settlement of claims during the pendency of court cases, issue of advertisement by the Corporation regarding non receipt of claim list, among others has been encouraging and the DICGC has settled such claims in respect of 14 banks for total amount of Rs.132 crore in respect of 193,873 depositors. Further, the DICGC had revised the policy on joint deposit accounts such that joint deposits held in the names of A & B and B & A have been treated as two separate accounts, eligible for maximum claim of Rs.1 lakh each. In response to this policy change additional claims in respect of nine banks amounting to Rs.216 lakh were settled.

Though the above steps have brought about some relief to the depositors of failed banks, the corporation is concerned about the delay in receipt of claim list from liquidators of co-operative banks, which requires to be curtailed further.

up new UCBs pending a review of the legislative, regulatory and supervisory framework for UCBs. In March 2005, a draft 'Vision Document for UCBs' was prepared and placed in public domain. The Vision Document discussed the characteristics of the sector, analysed the problems afflicting these banks and proposed strategies for dealing with their problems. A significant proposal of the Vision Document related to addressing the problem of dual control of UCBs by signing of Memoranda of Understanding (MOUs) between the Reserve Bank and the respective State governments, and establishing a consultative platform for supervision of the banks. Accordingly, the Reserve Bank approached the States having large network of UCBs for signing MOUs. Since June 2005, MOUs have been signed with 19 State Governments and with the Central Government in respect of multi-State UCBs and Task Force on Urban Co-operative Banks (TAFUCB) have been formed with them. In all 1,597 UCBs (90.0 per cent) have been covered under the MoUs representing 95 per cent of deposits of the sector. The mechanism of TAFUCBs has been able to restore the confidence

in the UCB sector and there has been significant improvement (Box VI.9).

VI.62 Based on the representations received from the UCB sector, the definition of Tier I UCBs was amended in March 2008. According to the revised definition tier I UCBs were defined as: (i) unit banks, *i.e.*, banks having a single branch/head office and those with deposits below Rs.100 crore, whose branches are located in a single district; (ii) banks with deposits below Rs.100 crore having branches in more than one district, provided the branches are in contiguous districts, and deposits and advances of branches in one district separately constitute at least 95 per cent of the total deposits and advances, respectively, of the bank; (iii) banks with deposits below Rs.100 crore, whose branches were originally in a single district but subsequently, became multi-district due to reorganisation of the district. The remaining UCBs are treated as Tier II UCBs. The deposit base of Rs.100 crore is determined on the basis of average of fortnightly net demand and time liabilities (NDTL) in the financial year concerned, and

**Box VI.9**

**Impact of Vision Document on Urban Co-operative Banks**

The impact of the various measures can be assessed through the changing profile of the sector. The number of Grade III and Grade IV UCBs taken together, implying weakness/sickness in UCBs, declined between March 2005 and March 2007. The number of UCBs in Grade III declined continuously after 2004. Although the UCBs in Grade IV increased at end-March 2005 and 2006, the number declined in end-March 2007 (Table A).

The overall asset quality of UCBs also improved with the gross NPAs of the UCBs declining from 23.2 per cent of total advances in 2005 to 17.0 per cent in 2007. The quality of assets and grade-wise distribution of UCBs over the last four years was also reflected in the improvement in the overall health of UCB sector.

The increased public confidence in the UCB sector is reflected in the growth in the deposits by 6.1 per cent during 2006-07 over and above the increase of 8.6 per cent during

2005-06, thereby reversing the declining trend of 2004-05. Similarly, advances increased by 9.8 per cent during 2006-07 on top of an increase of 7.1 per cent during 2005-06. The increased comfort of coordinated supervision/regulation in States that have signed MOUs enabled the Reserve Bank to expand additional business opportunities to the eligible UCBs in such States and to the multi-State UCBs. These facilities included permission to set up currency chests, sell mutual fund products, conduct insurance business on non-risk participation basis, open new ATMs, convert extension counters into branches and deal in foreign exchange as authorised dealer in category I and II. Further, as announced in the Annual Policy Statement for 2007-08, financially sound UCBs in such states were also permitted to open new branches, a facility which was discontinued in 2004.

**Table A: Improvement in Financial Position of UCBs- 2004-2007**

Year	No of UCBs	Gross NPAs (Rs. crore)	Gross NPA as a percentage of total advances	Migration of UCBs in different Grades				Percentage of UCBs in Grade III and IV
				I	II	III	IV	
1	2	3	4	5	6	7	8	9
2004	1,919	15,406	22.7	880	307	529	203	38.1
2005	1,872	15,486	23.2	807	340	497	228	38.7
2006	1,853	13,506	18.9	716	460	407	270	36.5
2007	1,813	13,363	17.0	652	598	295	268	31.1

that of advances on the basis of fortnightly average in the financial year concerned.

*Prudential guidelines*

VI.63 It was clarified in July 2007 that UCBs would be prohibited from extending any fund based or non-fund based credit facilities whether secured or unsecured to stockbrokers (against shares and debentures and against other securities such as fixed deposits, and LIC policies, among others) and extending any facility to commodity brokers (including issue of guarantees on their behalf). However, they were permitted to extend advances against units of mutual funds only to individuals as in the case of advances against the security of shares, debentures and bonds. Any credit facility in force, but not in consonance with the above instructions was required to be withdrawn/closed without any delay.

VI.64 The norms relating to amortisation of goodwill on merger in case of mergers of UCBs were modified in July 2007 taking into consideration the underlying provisions of AS-14 of Accounting Standards issued

by the Institute of Chartered Accountants of India. Reviewing instructions on non-SLR investments, UCBs were allowed greater flexibility to invest in 'A' or equivalent rated CPs, debentures and bonds that are redeemable in nature, units of debt mutual funds and money market mutual funds, among others. Aligning with the directions issued to scheduled commercial banks, UCBs were advised in September 2007 to ensure that loan facilities were utilised by borrowers for the purpose sanctioned and action be taken against borrowers in case there was any diversion.

VI.65 In January 2008, UCBs also were advised not to classify education loans as consumer credit for the purpose of capital adequacy norms and apply risk weight of 100 per cent as against 125 per cent earlier.

VI.66 In September 2007, the existing instructions with regard to maintenance of statutory reserves and provisioning requirements on exposure of UCBs to district central co-operative banks (DCCBs), which had financial problems were modified with differing

treatment accorded to i) DCCBs which have defaulted in payment/placed under directions; and ii) deposits with DCCBs under liquidation.

#### *Customer Service*

VI.67 UCBs were advised to ensure that cheques/drafts issued by clients containing fraction of a rupee were not rejected or dishonoured by them and that the concerned staff was well versed with the instructions, so that general public did not suffer. UCBs were required to ensure that appropriate action was taken against members of their staff who were found to have refused to accept cheques/drafts containing fraction of a rupee.

VI.68 In keeping with a recent Allahabad High Court judgment, UCBs were advised to generally insist that a person opening a deposit account makes a nomination. The bank should explain the advantages of a nomination facility to the depositor and, if the person still does not want to nominate, the bank should ask him to give a specific letter to the effect that he does not want to make nomination.

VI.69 UCBs were advised to lay down appropriate internal principles and procedures, so that usurious interest, including processing and other charges, were not levied by them on loans and advances. In laying down such principles and procedures in respect of small value loans, particularly, personal loans and such other loans of similar nature, banks were advised to take into account certain broad guidelines.

VI.70 In order to facilitate raising of capital funds (Tier I and Tier II), UCBs have been permitted to issue preference shares, viz., (i) perpetual non-cumulative preference shares (PNPCS), (ii) perpetual cumulative preference shares (PCPS), (iii) redeemable non-cumulative preference shares (RNCPS), and (iv) redeemable cumulative preference shares (RCPS). Further, UCBs have also been permitted to raise term deposits for a minimum period of not less than five years, which will be eligible to be treated as Tier II capital.

VI.71 Extensive guidelines were issued on extension of safe deposit locker/safe custody article facility and access to safe deposit lockers/return of safe deposit articles by UCBs.

VI.72 Similar to the guidelines issued to the scheduled commercial banks, UCBs were advised to ensure before launching new domestic deposit mobilisation schemes, that the provisions of the Reserve Bank's directives on interest rates on deposits, premature withdrawal of term deposits, sanction of loans and advances against term deposits, among others, issued from time to time, were strictly adhered to.

VI.73 On the lines of instructions issued to commercial banks, UCBs were advised to rely upon the Guardianship Certificate issued either by the District Court under Mental Health Act or by the Local Level Committees under the said Act for the purpose of opening/operating bank accounts for persons with autism, cerebral palsy, mental retardation and multiple disabilities. UCBs were also advised to ensure that their branches give proper guidance so that the parents/relatives of the disabled persons do not face any difficulty in this regard.

#### *Business facilitation*

VI.74 UCBs registered in those States that entered into memoranda of understanding (MoUs) with the Reserve Bank or those registered under Multi-State Co-operative Societies Act, 2002, were allowed to undertake insurance agency business as corporate agents without risk participation, subject to compliance with certain eligibility norms. UCBs were permitted to lay down policies with the approval of their boards for sanction of gold loans with bullet repayment option, subject to certain guidelines. UCBs, which are authorised to install on-site/off-site ATMs, as per the policy in force, were permitted to introduce ATM-cum-debit cards with the approval of their boards keeping in view the prescribed guidelines. UCBs were advised not to issue such cards in tie up with non-bank entities. Issuance of offline debit card was, however, not permitted. Also similar to the guidelines issued to commercial banks, a framework of service charges for implementation by all UCBs was prescribed by the Reserve Bank.

VI.75 The earlier guidelines prohibiting UCBs from acting as agents/sub-agents under money transfer service schemes (MTSS) were reviewed and it was decided that UCBs holding authorised dealer

category I and II licence could act as agents/sub-agents under MTSS in conformity with the guidelines issued by the Reserve Bank, subject to the certain conditions. Also, UCBs were permitted to shift their branches from one city to another in their area of operation within the same State subject to the following conditions: (i) the new centre should be of the same or lower population group as the existing centre; (ii) a branch located in under-banked district can be shifted to another centre in under-banked district only; and (iii) the shifting should be beneficial to the bank in terms of cost and business.

VI.76 In terms of the earlier guidelines, UCBs were normally required to refrain from sanctioning loans to builders/contractors. However, where contractors undertake comparatively small construction work on their own, UCBs were permitted to consider extending financial assistance to them against hypothecation of construction material, provided such loans and advances were in accordance with the bye-laws of the UCBs and instructions/directives issued by the Reserve Bank from time to time. It was clarified to UCBs in February 2008 that they should not extend fund based/non-fund based facilities to builders/contractors for acquisition of land even as a part of a housing project. Furthermore, where land was accepted as collateral, valuation of such land should be at current market price only.

VI.77 The consolidation of the UCB sector through the process of merger of weak entities with stronger ones was set in motion by providing transparent and objective guidelines for granting no-objection to merger proposals. Pursuant to the issue of guidelines on merger of UCBs in February 2005, the Reserve Bank received 104 proposals for merger in respect of 91 banks. The Reserve Bank issued no objection certificate (NOC) in 67 cases. Of these, 53 mergers became effective upon the issue of statutory orders by the Central Registrar of Co-operative Societies (CRCS)/Registrar of Co-operative Societies (RCS) concerned. Twenty proposals for merger were rejected by the Reserve Bank, while four proposals were withdrawn by the banks. The remaining 13 were under consideration. Most of the target banks were loss-making UCBs. In a few cases, mergers were permitted even of profit making banks with the aim

of consolidation and in some cases mergers were permitted in respect of such banks, as they were not considered viable on a stand-alone basis in the long run.

### **Rural Co-operatives**

VI.78 Based on the recommendations of the Task Force on Revival of Rural Co-operative Credit Institutions (Chairman: Prof. A. Vaidyanathan) and in consultation with the State Governments, the Government of India approved a package for revival of the short-term rural co-operative credit structure. So far, twenty five States (Andhra Pradesh, Arunachal Pradesh, Assam, Bihar, Chhattisgarh, Gujarat, Haryana, Jammu & Kashmir, Jharkhand, Karnataka, Madhya Pradesh, Maharashtra, Manipur, Meghalaya, Mizoram, Nagaland, Orissa, Punjab, Rajasthan, Sikkim, Tamil Nadu, Tripura, Uttarakhand, Uttar Pradesh and West Bengal) have executed Memoranda of Understanding (MoUs) with the Government of India and the NABARD, as envisaged under the package. Eight States carried out necessary amendments to their Co-operative Societies Acts. An aggregate amount of Rs.3,348 crore were released by the NABARD as the Government of India's share. Seven State Governments released their share to the tune of Rs.338 crore for recapitalisation assistance of Primary Agricultural Credit Societies (PACS). Implementation and monitoring of the revival package are being overseen by the National Implementing and Monitoring Committee (NIMC) set up by the Government of India. Further, a study of the long-term co-operative credit structure was also entrusted to the same Task Force by the Government of India which submitted its report in August 2006. It was announced in the Union Budget 2008-09 that the Central Government and the State Governments have reached an agreement on the content of the package for revival of the long-term co-operative credit structure. The cost of the package was estimated at Rs.3,074 crore, of which the Central Government's share was at Rs.2,642 crore.

VI.79 In order to strengthen the capital structure as also in the context of financial stability of the entire financial system, State co-operative banks (StCBs)

and district central co-operative banks (DCCBs) were required to disclose the level of CRAR as on March 31, 2008 in their balance sheets and thereafter every year as 'Notes on Accounts' to their balance sheets. StCBs/DCCBs were also issued guidelines on acceptance of special deposits with restrictive provisions and excessive interest rates charged on the lines issued to scheduled commercial banks.

VI.80 As on March 31, 2008, 121 out of 371 DCCBs and six out of 31 StCBs did not comply with the provisions of Section 11 (1) of the Banking Regulation Act, 1949 (AACS). Similarly, six StCBs and 121 DCCBs did not comply with the provisions of Sections 22(3) (a) (*i.e.*, being in a position to pay its present and future depositors in full as their claims accrue) and 28 StCBs and 342 DCCBs did not comply with Section 22 (3) (b) (*i.e.*, as the affairs of these banks were not being conducted in a manner not detrimental to the interests of their depositors) of the Act *ibid*. As on March 31, 2008, two StCBs and nine DCCBs were placed under the Reserve Bank's directions prohibiting them from granting loans and advances to certain areas and/or accepting fresh deposits, among others.

### Financial Institutions

VI.81 The all-India financial institutions (AIFIs) have been facing difficulties since the onset of financial reforms as their business model of cheaper and assured liabilities and assets came under stress. Two of the financial institutions have converted themselves into banks and a few others have been repositioned as NBFCs. As on March 31, 2008, there were four institutions, *viz.*, Exim Bank, NABARD, NHB and SIDBI regulated by the Reserve Bank as AIFIs.

VI.82 SIDBI has a significant exposure to SFCs by way of refinancing. In view of the poor financial health of SFCs, and its likely spill-over effect on financial health of SIDBI, measures were taken to sharpen the regulatory focus of SIDBI. The risk weight to SIDBI's exposure to SFCs was raised from 100 per cent to 125 per cent. SIDBI was instructed to make full provisions in respect of those SFCs that had defaulted even after restructuring/one-time settlement (OTS) package was extended to them, and not to sanction refinance to those SFCs that

continued to show negative net worth. Furthermore, SIDBI was advised to follow the norms applicable to banks in asset classification and provisioning in respect of its exposure to SFCs (it involved a change to "borrower-wise" classification from that of "facility-wise" classification applicable to FIs). SIDBI was also advised to ensure that all SFCs follow uniform accounting standards similar to those followed by banks. However, on reconsideration, based on requests from the Central Government to review the decision regarding extension of refinance by SIDBI to SFCs with negative net worth, and on the intimation from Central Government that four State Governments had committed to provide funds to their respective SFCs in a time bound manner to bring the net worth of the concerned SFCs into positive, it was decided that SIDBI could provide refinance to the four SFCs as long as the concerned State Governments kept their commitments.

VI.83 During 2007-08, two all-India financial institutions (AIFIs), *viz.*, IFCI and TFCL, which are registered as NBFCs with the Reserve Bank and were earlier exempted from NBFC regulations and as such were being regulated as AIFIs, were subjected to NBFC regulations. Among others, IIBI is in the process of being voluntarily wound up in view of weak financial position.

### Non-Banking Financial Companies

VI.84 NBFCs provide depth and resilience to the financial system, besides complementing banks in financial intermediation. In accordance with their significance in the financial sector, the Reserve Bank continued its efforts to strengthen the sector and make it vibrant and healthy. Apart from deposit taking NBFCs, the regulation of large non-deposit taking NBFCs has also assumed significance because of their systemic importance. Reflecting the new and emerging supervisory concerns, the Reserve Bank took several measures during 2007-08.

VI.85 In view of several complaints regarding levying of excessive interest and other charges on certain loans and advances by NBFCs, they were advised to lay down appropriate internal principles and procedures for determining interest rates and processing and other charges, even though interest

rates are not regulated by the Reserve Bank. NBFCs were advised to keep in view the guidelines on 'fair practices code' to ensure transparency.

VI.86 SEBI permitted FIMMDA to set up its reporting platform for corporate bonds and it went live from September 1, 2007. All NBFCs were required to report their secondary market transactions in corporate bonds in the OTC market, on FIMMDA's reporting platform with effect from September 01, 2007.

VI.87 All deposit-taking NBFCs (including RNBCs) were advised on March 5, 2008 that the cases of 'negligence and cash shortages' and 'irregularities in foreign exchange transactions' were to be reported as fraud if the intention to cheat/defraud was suspected/proved. However, the following cases where fraudulent intention was not suspected/proved at the time of detection, were required to be treated as fraud and reported accordingly: (i) cases of cash shortages of more than Rs.10,000; and (ii) cases of cash shortages of more than Rs.5,000, if detected, by management/auditor/inspecting officer and not reported on the occurrence by the persons handling cash.

VI.88 The regulations of Mutual Benefit Financial Companies (Notified Nidhis) and Mutual Benefit Companies (Potential Nidhis) have been with the Ministry of Corporate Affairs from 2001. Accordingly, reflecting this status, the provisions of the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998 as applicable to Mutual Benefit Financial Companies and Mutual Benefit Companies were updated and such companies were exempted from the provisions of the said directions. However, it was clarified in October 2007 that if the application of any MBC (Potential Nidhi) for grant of Nidhi status was rejected by the Central Government under the provisions of the Companies Act, 1956, the provisions of the aforementioned Directions as applicable to NBFCs will apply to such companies.

VI.89 On the lines of the guidelines issued to banks on unsolicited commercial communications, NBFCs were advised in November 2007: (i) not to engage telemarketers (DSAs/DMA) who did not have any valid registration certificate from

Department of Telecommunications (DoT), Government of India, as telemarketers; (ii) to furnish the list of telemarketers (DSAs/DMA) engaged by them along with the registered telephone numbers being used by them for making telemarketing calls to TRAI; and (iii) to ensure that all agents presently engaged by them register themselves with DoT as telemarketers.

VI.90 In terms of paragraph 5A of the Residuary Non-Banking Companies (Reserve Bank) Directions, 1987, it is obligatory on the part of the residuary non-banking companies (RNBCs) to inform depositors about the maturity of the deposit at least two months before the date of maturity of the deposit. RNBCs were advised on December 14, 2007 that in the interest of the depositors, where an RNBC fails to repay the deposit along with interest on maturity on the claim made by the depositor, it shall be liable to pay interest in the following manner: (i) if the company has intimated about the maturity to the depositor at least two months before the date of maturity and has sufficient evidence for the same, viz., acknowledgement from the depositor, but the depositor fails to submit his claim on maturity, then the company will be required to pay interest at the rate as applicable to the deposit from the date of claim till the date of repayment along with the amount due on maturity; (ii) if the company has not intimated about the maturity to the depositor two months before the date of maturity, then, as and when the depositor makes a claim, the company will be required to pay interest at the rate as applicable to the deposit from the date of maturity till the date of repayment along with the amount due on maturity.

VI.91 Securitisation Companies/Reconstruction Companies (SCs/RCS) were advised in March 2008 to furnish a copy of audited balance sheet along with the Directors' Report/Auditors' Report every year within one month from the date of annual general body meeting, in which the audited results were adopted, starting with the balance sheet as on March 31, 2008. Furthermore, in order to enable the investors to make informed decision on investment in security receipts (SRs), additional disclosures were prescribed, including date of acquisition of the assets, valuation of the assets and the interest of SCs/RCS in such assets at the time of issue of SRs.

VI.92 An important development during 2007-08 related to the inclusion of mortgage guarantee company (MGC) as a category of NBFC (Box VI.10). A company, which primarily transacts the business of providing mortgage guarantee with

at least 90 per cent of the business turnover from mortgage guarantee business or at least 90 per cent of the gross income is from mortgage guarantee business, would qualify as a MGC.

#### Box VI.10

##### Mortgage Guarantee Company

Mortgage guarantee company (MGC) is defined as a company which primarily transacts the business of providing mortgage guarantee. Such companies issue guarantees for the repayment of the amount of housing loan and interest accrued thereon to a credit institution on the occurrence of a pre-determined trigger event. These guarantees help the primary lenders of the housing loan sector to transfer their credit risk to the MGC. Thus, MGCs are envisaged as providing a credit risk mitigation product. Globally, MGCs have played a crucial role in credit risk mitigation. MGCs were notified as NBFC by the Reserve Bank with the prior approval of the Central Government on January 15, 2008 in exercise of the powers conferred under Section 45 I (f)(iii) of the Reserve Bank of India Act, 1934. The mortgage guarantee product is a tri-partite contract between the borrower, the mortgage guarantee company and the creditor institution (banks/HFCs) in accordance with the proposals made in Union Budget 2007-08. The guidelines on registration and operations of MGCs and prudential norms and investment directions applicable to such companies were placed on the Reserve Bank's website on February 15, 2008.

##### *The features of a mortgage guarantee contract*

The essential features of a mortgage guarantee contract are:

- It shall be a contract of guarantee under Section 126 of the Indian Contract Act, 1872.
- The mortgage guarantee contract shall be unconditional and irrevocable and the guarantee obtained shall be free from coercion, undue influence, fraud, misrepresentation, and/or mistake under Indian Contract Act, 1872.
- The MGC shall guarantee the repayment of the principal and interest outstanding in the housing loan account of the borrower, up to the amount of guarantee.
- The guarantor shall pay the guaranteed amount on invocation without any adjustment against the realisable value of the mortgage property.
- It shall be a tri-partite contract among the borrower, the creditor institution and the mortgage guarantee company, which provides the mortgage guarantee.

##### *Features of Mortgage Guarantee Company*

The essential features of MGCs, in brief, are as under:

- It shall obtain a certificate of registration from the Reserve Bank before commencing business of mortgage guarantee.
- It shall have a minimum net owned fund of Rs.100 crore at the time of commencement of business, which shall be reviewed for enhancement after 3 years.
- It shall have a diversified share holding.

- It shall not accept public deposits. It shall not avail external commercial borrowings and shall adhere to prescribed prudential norms.
- It is required to create and maintain a contingency reserve by transfer of 40 per cent of the premium or fee earned or 25 per cent of the profit after provision or tax whichever is higher.
- A MGC is required to make good the guarantee liability without demur on the happening of trigger event.
- A MGC can not provide mortgage guarantee for a housing loan with 90 per cent and above loan to value ratio.

##### *Investment Directions*

*Some features of the investment directions for MGCs include the following:*

- The MGC shall frame its investment policy in line with the investment directions issued by the Reserve Bank.
- It shall invest only in the following instruments: (i) Government securities; (ii) securities of corporate bodies/public sector undertakings guaranteed by Government; (iii) fixed deposits/certificate of deposits/bonds of scheduled commercial banks/PFIs; (iv) listed and rated debentures/bonds of corporate; (v) fully debt oriented mutual fund units; (vi) unquoted Government securities and Government guaranteed bonds.
- A mortgage guarantee company shall hold not less than 25 per cent of the total investment portfolio in Central/ State Government securities and the remaining investments with a ceiling of 25 per cent in any one category.
- All investment shall be marked to market.

##### *Prudential Norms Directions*

The MGCs are subject to the following prudential norms:

- An asset acquired from creditor institution on the happening of the trigger event is straightway required to be classified as non-performing asset.
- Income on an asset taken over from creditor shall be recognised only on cash basis. Other income will be recognised in accordance with directions applicable to non-deposit taking NBFCs.
- The premium or fee on the mortgage guarantee contracts shall be treated as income in the profit and loss account in accordance with the accounting standards issued by the Institute of Chartered Accountants of India.
- A MGC is required to maintain minimum capital adequacy ratio of 10 per cent, of which at least 6 per cent will be Tier I capital.

VI.93 To ensure a measured movement towards strengthening the financials of all deposit taking NBFCs by increasing their NOF to a minimum of Rs.200 lakh in a gradual, non-disruptive and non-discriminatory manner it was advised that NBFCs having a minimum NOF of less than Rs.200 lakh and eligible to accept public deposits may freeze their deposits at the level currently held by them. Further, such NBFCs were required to bring down public deposits to the revised ceiling of deposits as prescribed.

VI.94 Important changes in the existing guidelines on frauds strengthening the existing reporting mechanism and anti money laundering guidelines in the lines of other segments of the financial sector were also issued during the year.

#### *Recent Developments in International Financial Markets and Lessons for Supervisors*

VI.95 The credit markets in the developed economies especially in the US have witnessed turbulent conditions and significant loss of market liquidity, leading to financial distress in a few institutions prompting some of the major central banks to inject liquidity in the markets. While India has been relatively insulated from the impact of the credit market squeeze, the sub-prime episode, in retrospect, provides several useful lessons for the banks as also for the banking supervisors all over the world. The credit market developments were triggered by a combination of circumstances arising, *inter alia*, from (i) change in the macroeconomic environment not factored in by the credit intermediaries in their credit assessments; (ii) the adoption of 'originate-to-distribute' models by the credit/banking institutions, which tended to weaken their incentives for ensuring rigorous due diligence; (iii) large-scale reliance by the credit intermediaries on credit-risk transfer (CRT) instruments, including securitisation structures, which enabled the hiving off of such exposures to a variety of special purpose vehicles (SPVs) through issuance of securitised paper/mortgage backed securities (MBS)/structured finance products; and (iv) ready acceptance of the securitised products by the investors such as hedge funds, asset managers, structured investment

vehicles (SIVs) and other specially designed conduits in various segments of the market, which led to a wide dispersal of the underlying credit risk to a larger number of investors who were not necessarily better equipped than the originating banks to assess the underlying credit risks. The turmoil holds many lessons for supervisors, particularly in the developing countries (Box VI.11).

VI.96 The crisis led to a co-ordinated attempt by financial supervisors for an evaluation of the country practices with regard to the existing regulatory and supervisory arrangements to deal with the stability concerns that arose from the turmoil (Box VI.12).

VI.97 In the backdrop of global financial developments the effectiveness of rules *versus* principle based regulations has been highlighted (Box VI.13).

#### **MACRO-PRUDENTIAL INDICATORS REVIEW**

VI.98 Monitoring of macro-prudential indicators (MPIs) since March 2000 has been an important element of supervision of the Reserve Bank. It supplements the on-site and off-site supervisory endeavour of the Reserve Bank. The MPIs comprise both aggregated micro-prudential indicators (AMPs) of the health of individual financial institutions and macroeconomic indicators (MEIs) associated with the financial system soundness.

VI.99 An overview of MPIs for 2007-08 indicates a further improvement in various indicators of the major constituents of the financial sector (Table 6.5). Capital adequacy ratios continued to remain significantly above the minimum requirements for scheduled commercial banks. Asset quality, in general, improved. Return on assets of scheduled commercial banks during 2007-08 improved slightly from the previous year's level, while that of primary dealers (PDs) witnessed a moderate decline.

#### **Capital Adequacy**

VI.100 The capital to risk-weighted asset ratio (CRAR) of scheduled commercial banks improved further at end-March 2008 in comparison with the position at end-March 2007, suggesting that the expansion of capital outpaced the increase in total

### Box VI.11 Lessons from Sub-Prime Crisis

The major lessons emanating from the recent financial market turmoil are briefly enumerated below:

#### *Underwriting Standards*

The episode has once again brought to the fore the imperative of observing prudent underwriting standards by the credit intermediaries. The traditional banking tools such as the loan-to-value ratio, debt service ratio (particularly, after the initial “teaser rates” came to an end), purpose of the loan, verification of documentary evidence of income and assets of the borrowers and ongoing monitoring of the borrowers’ affairs have demonstrated their continued relevance, despite rapid advancements in the financial technology and products. The products created through sophisticated financial engineering may not be sustainable over the long term if their building blocks are not underpinned by rigorous underwriting standards.

#### *Risk Transfer*

The risk transfer by adoption of “originate-to-distribute” models by the credit intermediaries tended to weaken their incentives for ensuring rigorous due diligence at the credit appraisal stage, leading to assumption of significant amount of credit risks on low-quality/sub-prime counterparties. The insufficient understanding as to how complex structured products work, the nature of the risks to which the investors were actually exposed, and, in the case of risk transfer, where the risk ultimately resided (indeed, whether any risk has really been transferred) further added to the problem. Also, many investors had difficulties in interpreting the external ratings of complex structured products and often thought that market and liquidity risks were covered by the external ratings when, in fact, they were not.

#### *Liquidity Risk*

There had been an insufficient recognition on the part of supervisors and banks of the close link between market liquidity (ability to rapidly execute large volume transactions without impacting prices) and an individual bank’s funding liquidity (ability to fund increase in assets and meet obligations as they come due). The recent credit turmoil has underscored the importance, for both banks and supervisors, of considering market disruption scenarios as well as institution-specific scenarios in liquidity planning – which should also encompass the liquidity demands arising from off-balance sheet commitments, implicit or explicit, of the credit intermediaries. The assumptions underlying the liquidity contingency plans such as assuming assets’ inherent liquidity through asset marketability due to loan sales and securitisation, as well as ability to drawdown contingent facilities, need to be realistic, and not overly optimistic, with greater emphasis on cash-flows and stress-testing.

#### *Valuation*

The recent market turmoil and resulting illiquidity has highlighted the importance of reliable valuations and transparency of risk exposures. Some banks seem to have used inappropriately optimistic valuation and modelling methodologies to determine the initial and ongoing value

of certain securitisation exposures such as collateralised debt obligations (CDOs) and residual interests. The feasibility of mark-to-market model valuations and valuations inferred from the market value of underlying assets for CDOs and other structured products has been called into question.

#### *Residual risks in structured products*

There was insufficient recognition of residual risks in the structured products on the part of investing banks, as well as those banks acting as issuers and sponsors of asset-backed commercial paper (ABCP) programmes. For instance, banks that extended liquidity facilities to ABCP programmes were exposed to high degrees of credit risk, which may be subtly embedded within the facilities’ provisions. While all commitments embody some degree of credit risk, certain commitments extended to ABCP programmes for providing liquidity could subject the extending institution to the credit risk of the underlying asset pool, often trade receivables or other structured products, or of a specific company using the ABCP program for funding. Securitisation exposures may also expose banks to significant reputational risks. Often, banks sponsoring the issuance of asset-backed securities act as servicer, administrator, or liquidity provider in the securitisation transaction. In order to avoid a possible increase in their funding costs, banks may support their securitisation transactions beyond their contractual obligations by improving the performance of the securitised asset pool, for instance, by adding higher quality assets to the securitised asset pool. Similarly, owing to the liquidity problems faced by the bank-sponsored structured investment vehicles (SIVs), the sponsor banks brought their SIVs on to their balance sheets, for reputational reasons, even though there was no contractual obligation to do so.

#### *Transparency and Disclosure*

The recent difficulties experienced by banks and investors alike with respect to complex structured products highlighted the lack of transparency due to insufficient disclosure. But the turmoil also made clear that investors did not make full use of information even in those instances where it was available. These problems might perhaps have been avoided or at least mitigated through greater transparency, particularly with respect to the exposures of some large international institutions to CDOs of securities backed by subprime mortgages originated in the United States.

#### *Regulatory Scope*

In view of ever-increasing integration of different segments of the financial market, the potential of the unregulated market participants for infecting the regulated parts of the system, no matter how well supervised, needs better recognition by the financial supervisors. The regulatory gaps in which the unregulated entities operate need to be identified and effectively addressed so that the systemically-important regulated entities are not put to undue risk by the activities of the unregulated entities, entailing significant public cost.

### Box VI.12 Financial Stability Forum (FSF) Report - Status

In the wake of the global financial market turmoil, the FSF's Report (April 2008) identified the underlying causes and weaknesses in the international financial markets. The Report contains, *inter alia*, proposals of the FSF for implementation by end-2008 for strengthening prudential oversight of capital, liquidity and risk management, enhancing transparency and valuation, changing the role and uses of credit ratings, strengthening the authorities' responsiveness to risk and implementing robust arrangements for dealing with stress in the financial system. The Reserve Bank had put in place regulatory guidelines covering many of these aspects, while in regard to others, actions are being initiated. In many cases, actions have to be considered as work in progress. In any case, the guidelines are aligned with the global best practices while tailoring them to meet country-specific requirements at the current stage of institutional developments. Several proposals made by the FSF have already been implemented in India as detailed below:

#### *Strengthened Prudential Oversight of Capital, Liquidity Risk Management*

- The phased implementation process of Basel II is underway and the process of implementation is being monitored on an ongoing basis for calibration and fine-tuning.
- The minimum capital requirement has been prescribed at higher levels of nine per cent, under Basel Framework. Banks' exposure to sensitive sectors and their liquidity position are monitored on a regular basis. Extensive guidelines have been issued for off-balance sheet vehicles in the form of SPVs for the purpose of securitisation with prescription of capital charge for liquidity facilities to such SPVs. There is a requirement to put in place policies and framework for stress test for various risk factors.
- The credit conversion factors, risk weights and provisioning requirements for specific off-balance sheet items including derivatives are at an enhanced level while complex structures like synthetic securitisation are not permitted.
- Broad guidelines for asset-liability management have been put in place. Banks have been provided flexibility in devising their own risk management strategies as per board-approved policies. Greater granularity to measurement of liquidity risk was introduced by splitting the first time bucket and placing caps on net cumulative negative mismatches in them.
- The overnight unsecured market for funds has been restricted only to banks and primary dealers (PDs) resulting in shift of trading volumes to the collateralised market from the overnight unsecured market. Limits have been placed on (i) borrowing and lending in the call money market to 100 per cent of capital funds (*i.e.*, sum of Tier I and Tier II capital) on a fortnightly average basis; and (ii) 'purchased inter-bank liabilities' (IBL) to 200 per cent of its net worth (300 per cent for banks with a CRAR above 11.25 per cent).

#### *Enhancing Transparency and Valuation*

- The valuation norms and market discipline in respect of complex financial products including issuance of guidelines on valuation of various instruments/assets have been strengthened. Comprehensive guidelines have been put in place on derivatives

incorporating risk management and corporate governance aspects, suitability and appropriateness policy, prudential norms relating to derivatives, specific transparency and valuation standards, such as prescription of making available a calculator or at least access to a calculator for selling structured products by banks which will enable the users to mark-to-market these products on an ongoing basis. All permitted derivative transactions can be calculated only at prevailing market rates.

- A set of disclosure requirements has been developed which allow the market participants to assess key pieces of information on capital adequacy, risk exposure, risk assessment processes and key business parameters. This in turn, will provide a consistent and understandable disclosure framework that enhances comparability; compliance requirement with the Accounting Standard on disclosure of accounting policies issued by the Institute of Chartered Accountants of India (ICAI).
- Detailed formats for disclosures under the Pillar 3 of Basel II framework have been prescribed with clause for imposition of penalty including financial penalty for non compliance.

#### *Changes in the Role and Uses of Credit Ratings*

- A detailed process of identifying the eligible credit rating agencies has been undertaken. Norms have been prescribed to ensure consistency in selection of credit rating agencies by banks and application of their rating while disallowing banks to 'cherry pick' the assessments provided by different credit rating agencies. The names of the credit rating agencies, the risk weights associated with the particular rating grades and aggregated risk weighted assets, are required to be disclosed.

#### *Strengthening the Authorities' Responsiveness to Risks*

- A system has been put in place for exchanging supervisory information on specific issues with a few other overseas banking supervisors/regulators. A working group has been constituted to lay down a roadmap for adoption of a suitable framework for cross-border supervision and supervisory cooperation with overseas regulators and examine the arrangement of supervisory college arrangement.

#### *Robust Arrangements for Dealing with Stress in the Financial System*

- Institutional arrangement has been put in place to oversee the functioning of the financial markets on a daily basis.
- Institutional arrangements have been put in place for liquidity management facilities, including the liquidity adjustment facility (LAF), open market operations (OMOs) and market stabilisation scheme (MSS) besides standing facilities such as export credit refinance (ECR) and the liquidity facility for standalone PDs.
- The Reserve Bank has been empowered under the existing legal framework to deal with the resolution of weak and failing banks. Enabling provisions exist in the Banking Regulation Act for voluntary amalgamation and compulsory merger of banks under Sections 44A and 45, respectively;
- The deposit insurance cover is offered by the Deposit Insurance and Credit Guarantee Corporation of India (DICGC).

## Box VI.13

## Principle-based Regulation

Principle-based or 'light-touch' regulation was originally conceived at the Bank of England prior to the 1997 reforms. It refers to moving away where possible, from dictating through detailed prescriptive rules and supervisory actions on how firms should operate their business. It accords regulated firms the responsibility to decide how best to align their business objectives and processes with the outcomes as specified by the regulators. This entails laying down desirable regulatory outcomes in principles and outcome-focused rules, enabling the regulators to engage with the firms' senior management in pursuit of these outcomes.

The shift to a more principle-based approach to regulation complements the risk and evidence-based models. In evidence based-approach it is considered first and foremost whether there is a market failure that needs to be addressed and, if so, whether regulation is the best way to deal with it. Principle-based regulation steers the expectations of firms and the way to deal with them. Principle-based regulation is considered by many as the natural next step in the process of regulatory evolution, allowing continuance of improvement in the regulatory regime for the financial services industry and consumers.

According to the proponents of principle-based regulation, past experience suggests that prescriptive standards have been unable to prevent misconduct. The ever-expanding rule books, designed to prevent misdemeanour, have not stopped mis-selling, market misconduct or other undesirable practices. Instead, it is believed that detailed rules have become an increasing burden on the regulator and the industry's resources. Financial markets are constantly changing. Continuous innovation and new product development are important ways in which the financial services industry generates benefits for consumers and markets. It is important that regulation can respond rapidly to the pace of change in markets and allows them to continue to develop for the benefit of its users. Regulation that focuses on outcomes rather than prescription is more likely to support this development and innovation. In a quickly changing market place, principles are far more durable. The merits of principle-based approach to financial regulation are as follows:

- It is easier to generate a set of principles rather than a set of detailed rules.
- Understanding a set of principles is easier for all stakeholders.

risk-weighted assets (Table 6.5). The growth in risk-weighted assets during 2007-08 was lower than the previous year, reflecting lower growth in the advances portfolio of banks. The increase in regulatory capital was mainly on account of core capital (*i.e.*, Tier I). The core capital ratio increased from 8.3 per cent at end-March 2007 to 9.1 per cent at end-March 2008.

- Owing to its greater flexibility, it is particularly suitable for a heterogeneous banking sector.
- The financial services industry has more flexibility to develop its own compliance ethos within the context of its own markets, legislative backgrounds and cultures.
- It encourages a co-operative and outcome-oriented relationship between a firm and its regulator and facilitates mutual understanding among regulators.
- It provides a basis for open dialogue between the regulator and the regulated, promotes a co-operative and educative approach to supervision, *etc.*

On the other hand a principle-based regulation is considered to have several problems and downsides such as:

- Principle-based regimes do not give the industry the comfort of knowing where it stands because the meaning of the principles is not sufficiently certain.
- The move to more principle-based regulation could result in concerns over accountability in a number of ways.
- There is a risk that principle-based regulation can give rise to charges of "regulatory creep".
- The overall effectiveness of principle-based regulation is critically dependent on the ethical and governance standards that prevail in the financial and corporate worlds in any country.
- Regulators see principle-based regulation as posing high regulatory risks and they fear that the operating flexibility that principle-based regulation permits could be misused in environments with insufficiently high standards of internal corporate ethics, compliance and governance.
- Violation of rigid but specific rules is much easier to establish than broader principles that are more open to subjective interpretation.

Rule-based and principle-based supervisory approaches are not mutually exclusive. The Financial Services Authority (FSA) of the UK has a rule book of over 6,000 pages. Principles could help in framing the rules and discipline rule making. The regulators, therefore, need to identify the areas in which these supervisory approaches are effective and boost the effectiveness of the regulations in their entirety, based on the optimal combination of these two approaches.

All the banks complied with the prescribed minimum CRAR at end-March 2008 (Table 6.6).

VI.101 The CRAR of the scheduled UCBs at end-March 2008, was higher than that at end-March 2007 (Table 6.5). Out of 53 scheduled UCBs, the CRARs of 41 UCBs were 9 per cent and above, while that of 10 UCBs were less than 3 per cent.

**Table 6.5: Select Financial Indicators**

(Per cent)

Item	Year ended March	Scheduled Commercial Banks	Scheduled Urban Cooperative Banks	Development Finance Institutions	Primary Dealers	Non-Banking Financial Companies
1	2	3	4	5	6	7
CRAR	2007	12.3	11.4	25.3	33.4	21.1
	2008	13.1	11.9	26.3	37.5	22.4
Gross NPAs to Gross Advances	2007	2.7	17.7	5.6	n.a.	1.6
	2008	2.4	14.2	0.6	n.a.	2.6
Net NPAs to Net Advances	2007	1.1	3.3	0.1	n.a.	0.0
	2008	1.1	2.3	0.1	n.a.	0.3
Return on Total Assets	2007	0.9	0.7	1.5	2.9	1.0
	2008	1.0	0.7	1.3	2.5	n.a.
Return on Equity	2007	13.2	n.a.	6.7	9.0	8.6
	2008	12.5	n.a.	6.1	10.7	n.a.
Cost/Income Ratio	2007	51.2	58.9	20.5	49.9	17.3
	2008	49.2	56.2	21.2	25.4	n.a.

n.a.: Not available.

**Note :** 1. Data are provisional.

2. Data for 2008 in respect of Non-Banking Financial Companies (NBFCs) pertain to the period ended September 2007.

3. Data for scheduled commercial banks pertain to the domestic operations only and may not tally with the balance sheet data.

4. The above figures pertain to stand-alone Primary Dealers (PDs) which increased to nine as at end-March 2008 from eight as at end-March, 2007 with the authorisation of a new stand-alone PD on November 01, 2007.

**Source :** Off-site returns for scheduled commercial banks, scheduled urban co-operative banks, NBFCs and PDs and FIs.

VI.102 The CRAR of FIs as a group increased from 25.3 per cent at end-March 2007 to 26.3 per cent at end-March 2008 (Tables 6.5 and 6.7). This was mainly on account of an increase in the CRAR of refinancing institutions.

VI.103 The CRAR of the NBFCs as a group increased from 21.1 per cent at end-March 2007 to 22.4 per cent at end-September 2007, well above the regulatory minimum (12 per cent). Companies having CRAR less than 12 per cent declined both

**Table 6.6 : Scheduled Commercial Banks – Frequency Distribution of CRAR  
(End-March)**

(Per cent)

Bank Group	End-March	Negative	Between 0 and 9 per cent	Between 9 and 10 per cent	Between 10 and 15 per cent	15 per cent and above	Total
1	2	3	4	5	6	7	8
Public Sector Banks	2007	0	0	0	28	0	28
	2008	0	0	0	28	0	28
Nationalised Banks	2007	0	0	0	20	0	20
	2008	0	0	0	20	0	20
SBI Group	2007	0	0	0	8	0	8
	2008	0	0	0	8	0	8
Private Sector Banks	2007	1*	0	2	19	3	25
	2008	0	0	1	17	5	23
Old Private Sector Banks	2007	1*	0	2	11	3	17
	2008	0	0	1	10	4	15
New Private Sector Banks	2007	0	0	0	8	0	8
	2008	0	0	0	7	1	8
Foreign Banks	2007	0	0	0	10	19	29
	2008	0	0	1	7	20	28
All Banks	2007	1	0	2	57	22	82
	2008	0	0	2	53	24	79

\* : Pertains to Sangli Bank, subsequently merged with ICICI Bank.

**Note :** Data are provisional and unaudited.

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

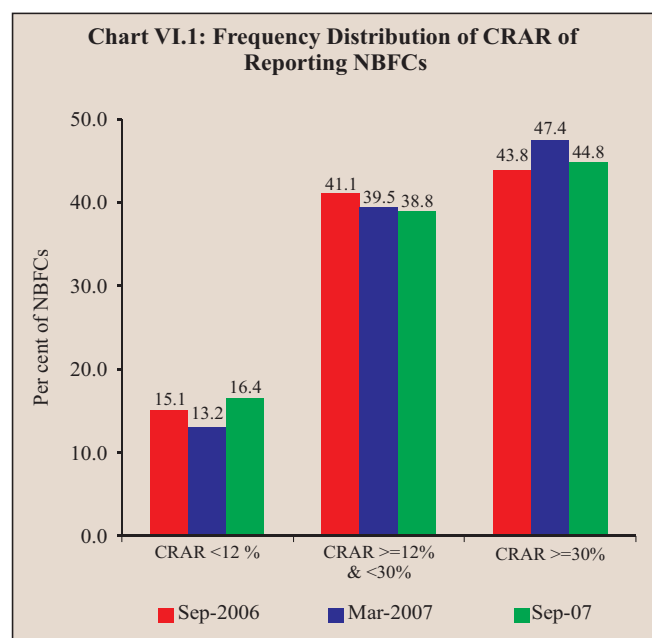
**Table 6.7: CRAR and Net NPAs of Select Financial Institutions**

(End-March 2008)

Financial Institution	(Per cent)		
	CRAR (Per cent)	Net NPAs (Rupees crore)	Net NPAs to Net loans
1	2	3	4
<b>Term-Lending Institutions (TLIs)</b>			
EXIM Bank	15.13	113.06	0.39
<b>All TLIs</b>	<b>15.13</b>	<b>113.06</b>	<b>0.39</b>
<b>Refinancing Institutions (RFIs)</b>			
NABARD	26.61	19.28	0.02
NHB	22.56	0.00	0.00
SIDBI	46.55	49.06	0.25
<b>All RFIs</b>	<b>30.84</b>	<b>68.34</b>	<b>0.06</b>
<b>All FIs</b>	<b>26.28</b>	<b>181.40</b>	<b>0.12</b>

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

in absolute and percentage terms, while companies having CRAR in excess of 30 per cent declined in absolute terms, but increased in percentage terms, implying that the sector has been consolidating. The number of companies having CRAR above 30 per cent constituted almost 50 per cent of the total number of companies. Companies with CRAR of less than 12 per cent were largely problem/weak companies (Chart VI.1). The CRAR of PDs increased to 37.5 per cent at end-March 2008 from 33.4 per cent at end-March 2007. The CRAR of PDs remained much higher than their regulatory minimum.

**Asset Quality**

VI.104 Asset quality of scheduled commercial banks improved further during the year. The gross NPA ratio declined to 2.4 per cent while the net NPA ratio remained at 1.1 per cent at end-March 2008 (Table 6.8). Robust economic activity and better recovery climate have facilitated the reduction in non-performing assets in recent years. Net NPAs of only six banks were in excess of 2 per cent of net advances (Table 6.9). Asset quality of financial institutions and scheduled UCBs also improved

**Table 6.8: Scheduled Commercial Banks – Performance Indicators**

(Per cent)

Item/Bank Group	2007-08				2007 -08	2008- 09 Q1
	Q1	Q2	Q3	Q4		
1	2	3	4	5	6	7
<b>Operating Expenses/Total Assets*</b>						
Scheduled Commercial Banks	2.1	1.9	2.0	1.4	1.8	1.9
Public Sector Banks	1.8	1.7	1.6	1.1	1.6	1.6
Old Private Sector Banks	1.9	1.7	1.7	1.3	1.7	1.7
New Private Sector Banks	2.5	2.5	2.6	2.3	2.5	2.6
Foreign Banks	2.9	2.5	3.3	2.7	2.8	2.7
<b>Net Interest Income/Total Assets*</b>						
Scheduled Commercial Banks	2.8	2.3	2.4	2.0	2.4	2.5
Public Sector Banks	2.7	2.1	2.1	1.7	2.2	2.3
Old Private Sector Banks	2.9	2.5	2.4	1.8	2.4	2.7
New Private Sector Banks	2.3	2.2	2.6	2.4	2.4	2.7
Foreign Banks	4.2	3.4	3.7	3.9	3.8	3.8
<b>Net Profit/Total Assets*</b>						
Scheduled Commercial Banks	1.0	1.0	1.0	0.9	1.0	0.9
Public Sector Banks	0.9	0.9	1.0	0.7	0.9	0.6
Old Private Sector Banks	1.1	1.0	1.2	0.7	1.0	0.8
New Private Sector Banks	0.8	1.0	1.1	1.1	1.0	0.6
Foreign Banks	2.2	1.8	0.9	2.4	1.8	2.7
<b>Gross NPAs to Gross Advances**</b>						
Scheduled Commercial Banks	2.8	2.7	2.6	2.4	2.4	2.4
Public Sector Banks	2.9	2.8	2.6	2.4	2.4	2.2
Old Private Sector Banks	3.1	2.8	2.7	2.3	2.3	2.4
New Private Sector Banks	2.5	2.6	2.7	2.9	2.9	3.2
Foreign Banks	2.0	1.9	1.9	1.8	1.8	1.9
<b>Net NPAs to Net Advances**</b>						
Scheduled Commercial Banks	1.2	1.2	1.1	1.1	1.1	1.1
Public Sector Banks	1.2	1.2	1.1	1.1	1.1	1.0
Old Private Sector Banks	0.9	0.8	0.7	0.7	0.7	0.8
New Private Sector Banks	1.3	1.3	1.4	1.4	1.4	1.5
Foreign Banks	0.8	0.8	0.8	0.8	0.8	0.7
<b>CRAR**</b>						
Scheduled Commercial Banks	12.6	13.3	13.1	13.1	13.1	12.7
Public Sector Banks	12.9	12.8	12.7	12.6	12.6	12.3
Old Private Sector Banks	13.0	13.1	13.7	14.1	14.1	13.9
New Private Sector Banks	11.5	15.9	15.4	14.4	14.4	14.1
Foreign Banks	12.3	11.4	11.8	13.4	13.4	12.2

\* : Annualised to ensure comparability between quarters.

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

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

significantly during 2007-08, with net NPA ratios at 0.1 per cent and 2.3 per cent, respectively (see Table 6.5). Out of 53 scheduled UCBs, net NPA ratios of 37 UCBs were 5 per cent or less (Table 6.10).

### Earnings and Profitability Indicators

VI.105 Total income of SCBs increased from 8.04 per cent of their assets in 2006-07 to 8.59 per cent in 2007-08 due to an increase in both non-interest income and interest income (Table 6.11). Non-interest income of the SCBs increased by more than 50 per cent during the year.

**Table 6.9: Net NPAs to Net Advances of Scheduled Commercial Banks**

1	Public Sector Banks		Private Sector Banks		Foreign Banks
	SBI Group	Nationalised Banks	Old	New	
2	3	4	5	6	
<b>2003-04</b>					
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
<b>2004-05</b>					
Up to 2 per cent	7	10	4	6	22
Above 2 per cent and up to 5 per cent	1	8	12	3	2
Above 5 per cent and up to 10 per cent	0	2	4	1	2
Above 10 per cent	0	0	0	0	4
<b>2005-06</b>					
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
<b>2006-07</b>					
Up to 2 per cent	8	18	14	7	27
Above 2 per cent and up to 5 per cent	0	2	2	1	1
Above 5 per cent and up to 10 per cent	0	0	1	0	0
Above 10 per cent	0	0	0	0	1
<b>2007-08*</b>					
Up to 2 per cent	7	19	15	7	25
Above 2 per cent and up to 5 per cent	1	1	0	1	2
Above 5 per cent and up to 10 per cent	0	0	0	0	0
Above 10 per cent	0	0	0	0	1

\* : Data as on March 31, 2008 are unaudited and provisional.

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

**Table 6.10: Net NPAs to Net Advances of Scheduled Urban Co-operative Banks\***

(Frequency Distribution)

Net NPAs to Net Advances	2005-06	2006-07	2007-08
1	2	3	4
Up to 2 per cent	25	23	24
Above 2 and up to 5 per cent	8	14	13
Above 5 and up to 10 per cent	10	9	6
Above 10 per cent	11	7	10
<b>Total</b>	<b>54</b>	<b>53</b>	<b>53</b>

\* Data are provisional.

Source : Off-site supervisory returns.

VI.106 Higher interest expenses, however, led to an increase in total expenditure (as per cent to total assets), despite the fall in operating expenses. As a result, during 2007-08, profits before provisions and taxes (as per cent to total assets) remained at the same level as that of the previous year. However, returns on assets (profit as per cent to total assets) at 0.99 per cent during 2007-08 were slightly higher than those during 2006-07 (0.89 per cent) due to lower provisions. As many as 51 banks (out of 79

**Table 6.11: Operational Results of Scheduled Commercial Banks – Key Ratios**

(Per cent to total assets)

Indicator	2005-06	2006-07	2007-08
1	2	3	4
1. Total Income (i+ii)	8.03	8.04	8.59
i) Interest Income			
(net of interest tax)	6.65	6.88	7.17
ii) Non-Interest Income	1.38	1.16	1.42
2. Total Expenditure (i+ii)	5.98	6.11	6.66
i) Interest Expenses	3.82	4.13	4.81
ii) Operating Expenses	2.16	1.97	1.85
3. Earnings Before Provisions and Taxes (EBPT)	2.05	1.92	1.92
4. Provisions and Contingencies	1.17	1.03	0.93
5. Profit after Tax	0.88	0.89	0.99

(Amount in Rupees crore)

Indicator	2005-06	2006-07	2007-08
1	2	3	4
1. Total Income (i+ii)	2,16,286	2,66,266	3,54,093
i) Interest Income			
(net of interest tax)	1,79,087	2,27,731	2,95,688
ii) Non-Interest Income	37,199	38,535	58,405
2. Total Expenditure (i+ii)	1,61,048	2,02,167	2,74,452
i) Interest Expenses	1,02,866	1,36,899	1,98,236
ii) Operating Expenses	58,182	65,267	76,216
3. Earnings Before Provisions and Taxes (EBPT)	55,212	63,429	79,254
4. Provisions and Contingencies	31,549	33,991	38,283
5. Profit after Tax	23,663	29,438	40,971

**Note :** 1. Off-site supervisory returns submitted by the banks pertaining to their domestic operations only.

2. Data for March 2008 are provisional and unaudited.

banks) recorded an increase in return on assets during the year (Table 6.12).

VI.107 The return on total assets of scheduled UCBs was maintained at 0.67 per cent in 2007-08 as compared with 0.69 per cent in 2006-07 (Table 6.13). The return on assets of PDs declined marginally to 2.48 per cent during 2007-08 from 2.92 per cent during 2006-07 (refer Table 6.5).

### Sensitivity to Market Risk

#### Interest Rate Risk

VI.108 The major portion of investment portfolio of the banking system at end-March 2008 comprised securities in the 'held to maturity' (HTM) category (about 60 per cent). As investments under the HTM category are not required to be marked to market (MTM), unlike those in the trading book, viz., (i) 'available for sale' (AFS) and (ii) 'held for trading' (HFT), the investment portfolio of the scheduled commercial banks is relatively less sensitive to interest rate risk. However, banks reported high MTM losses during March 2008 on account of upward movement in sovereign yields. As a result, the cushion available, in the form of outstanding balance in provisions for depreciation in respect of investments held in trading book, declined to a negligible amount after taking into account the MTM losses. Although banks have adopted various

**Table 6.13 Operational Results of Scheduled Urban Co-operative Banks - Key Ratios**

(as per cent to total assets)

No.	Item	2006-07	2007-08
1	2		3
1.	Total Income (i+ii)	6.63	6.59
	i) Interest Income	5.82	6.11
	ii) Non-Interest Income	0.81	0.48
2.	Total Expenses (i+ii)	5.43	5.45
	i) Interest Expenditure	3.53	3.94
	ii) Non-interest Expenses	1.90	1.51
3.	Earnings Before Provisions and Taxes	1.20	1.14
4.	Provisions and Contingencies	0.51	0.47
5.	Profit after Tax	0.69	0.67

**Note** : All data are provisional.

portfolio management techniques such as reduction of duration, particularly in the case of the trading book in conjunction with reduction in the size of the trading book itself, to mitigate the interest rate risk, the system would be under pressure if the yield increase continues unabated.

#### Currency Risk

VI.109 In the foreign exchange market, the Indian rupee exhibited generally two-way movement vis-à-vis the US dollar during 2007-08. This reinforces the need for all agents with foreign currency exposure to use appropriate hedging instruments and strategies to cushion against possible adverse exchange rate movements.

**Table 6.12: Operational Results of Scheduled Commercial Banks – 2007-08**

(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	New Private Sector		
1	2	3		4	5	6	7
1.	Total Income	8	16	12	8	17	61
	i) Interest Income	7	15	12	8	17	59
	ii) Non-Interest Income	7	15	12	7	17	58
2.	Total Expenditure	8	19	13	8	16	64
	i) Interest Expenses	8	20	14	7	16	65
	ii) Operating Expenses	1	0	2	6	14	23
3.	Earnings before Provisions and Taxes (EBPT)	1	6	8	6	19	40
4.	Provisions and contingencies	0	4	4	7	14	29
5.	Profit after Tax	4	11	11	5	20	51

**Note** : 1. Off-site supervisory returns submitted by the banks pertaining to their domestic operations only.  
2. Data are provisional and unaudited.

### *Commodity Risk*

VI.110 Global commodity prices increased sharply in recent months, driven by strong growth worldwide, especially in emerging market economies and speculative price pressures in financial markets. The Commodity Research Bureau (CRB) Index for the commodities increased from 316.7 as on July 2, 2007 to 462.7 as on June 30, 2008. During this period, the price of spot gold increased from US\$ 654.75 to US\$ 930.25 and that of crude (Brent) increased from USD 73.81 to USD 139.30. Apart from fuelling inflation, this also led to significant portfolio rebalancing for global financial institutions. In India, the volatility of the commodity prices impact the banks either through investment or through the credit channel. The principal channel of risk transmission is through their credit exposure to commodity traders and industries, whose profitability is contingent upon stable commodity prices, unless hedged by them. It would, therefore, be necessary for the banks to be alive to this risk and take appropriate risk containment measures.

### *Equity risk*

VI.111 With the rationalised norms on capital market exposure being applicable from April 2007, the regulatory limit on individual banks' exposure to capital market is now capped at 40 per cent of banks' net worth as at end-March of the previous year. The overall exposure of the banking system to capital market at end-March 2008 was 28 per cent of net worth. Several regulatory requirements prescribed by the Reserve Bank ensure that the banks' participation in the capital market is within limits and also that the banks' advances are well collateralised, so that they are able to protect their advances for investments in the capital market.

### **Liquidity**

VI.112 Capital flows and swings in cash balances of the Governments were the main drivers of liquidity conditions in the financial markets, imparting some volatility to overnight interest rates. The Reserve Bank continued with its policy of active management of liquidity through the appropriate use of all policy instruments at its disposal flexibly. The ratio of liquid assets to total assets in respect of scheduled commercial banks were at 32.3 per cent at end-March 2008, the same level as at end of the previous year.

### **Outlook**

VI.113 Various initiatives undertaken by the Reserve Bank were aimed at aligning its regulatory environment with international best practice. Foreign banks and banks with international presence successfully migrated to Basel II on March 31, 2008. The remaining commercial banks would migrate to Basel II on March 31, 2009. The recent global financial market developments provide some useful lessons for the regulators and supervisors. The Financial Stability Forum has made several proposals for implementation by end-2008. While India has already implemented some of these proposals, other proposals would be carefully examined and appropriate action would be taken, wherever necessary. In the coming years, banks need to strengthen their risk management framework in view of the domestic and international developments, particularly in the emerging areas of risk, viz., liquidity risk and risks arising out of off-balance sheet and derivatives markets transactions. Improvement in customer service, including rationalisation of service charges and speedy grievance redressal would be the focus areas.